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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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PUB00489	Question we've been asked	How do the bright-line rollover relief provisions apply to transfers of residential land between associated persons?	8 November 2024
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PUB00458	Interpretation statement	Income tax – Using the cost method to determine foreign investment fund (FIF) income	29 November 2024

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IN SUMMARY

New legislation

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This Order in Council signed on 26 August 2024 allows Inland Revenue to make FamilyBoost payments into the bank accounts of applicants from 1 October 2024.

Interpretation statement

IS 24/08: Charities – Business income exemption 3

This interpretation statement considers what income is from a business and the extent to which business income a charitable entity derives is exempt from tax under s CW 42.

Technical decision summary

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The establishment of a limited partnership to hold the shares in a holding company. The long form amalgamation of the holding company and one of its subsidiaries under Part 13 of the Companies Act 1993, with the subsidiary remaining as the amalgamated company. The distribution by the holding company of cash and shares in subsidiary companies on amalgamation as consideration for the cancellation of its shares.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Tax Administration (Direct Credit of FamilyBoost Tax Credit) Order 2024

Section184B of the Tax Administration Act 1994

Order (SL 2024/172)

The Tax Administration (Direct Credit of FamilyBoost Tax Credit) Order 2024 authorises the Inland Revenue to make payments of the FamilyBoost tax credit direct to bank accounts on and from 1 October 2024.

Background

For Inland Revenue to make a payment to a taxpayer's nominated bank account, an Order in Council was required that specified the date refunds can be made from. This requirement has existed since 1999 under sections 184A and 184B of the Tax Administration Act 1994.

The first FamilyBoost tax credit payment can be claimed by parents and caregivers from 1 October 2024, for the period 1 July – 30 September 2024.

Effective date

The Order in Council was signed on 26 August 2024 and takes effect from 1 October 2024.

Further information

The Order in Council can be found at:

https://www.legislation.govt.nz/regulation/public/2024/0172/latest/whole.html

INTERPRETATION STATEMENT

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

Some interpretation statements may be accompanied by a fact sheet summarising and explaining the main points. Any fact sheet should be read alongside its corresponding interpretation statement to completely understand the guidance. Fact sheets are not binding on the Commissioner. Check **taxtechnical.ird.govt.nz/publications** for any fact sheets accompanying an interpretation statement.

IS 24/08: Charities – Business income exemption

Issued | Tukuna: 16 September 2024

This interpretation statement considers what income is from a business and the extent to which business income a charitable entity derives is exempt from tax under s CW 42.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Summary | Whakarāpopoto

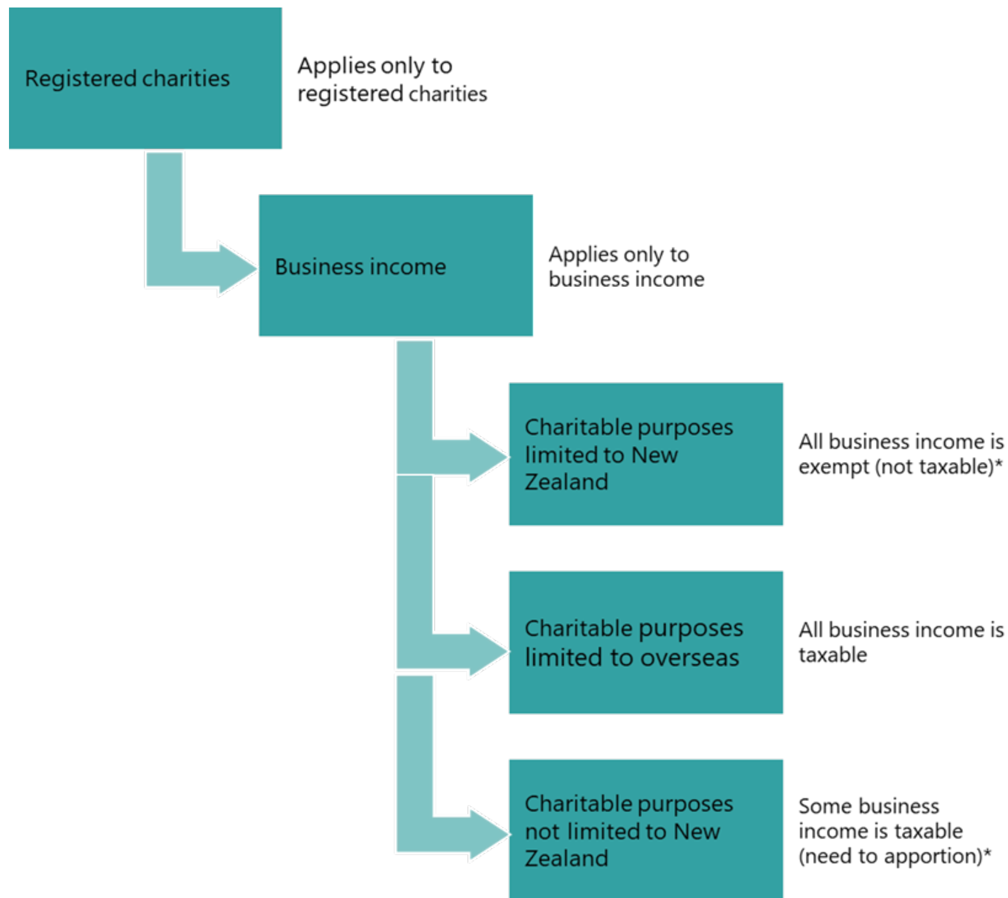
1. Income a tax charity derives can broadly be classified as either "business income" or "non-business income". Both types of income can be exempt (non-taxable) if a tax charity meets the requirements of ss CW 41 and CW 42.
2. A tax charity that derives business income must apply s CW 42 to work out the extent to which that income is exempt. For all other income a tax charity applies s CW 41. The main difference between the two sections is that business income is subject to additional restrictions compared with non-business income. These restrictions could result in some, or all, of a tax charity's business income not being exempt, whereas generally all of a tax charity's non-business income is exempt.
3. Those additional restrictions in s CW 42 are as follows:
   - If a tax charity's charitable purposes are not limited to New Zealand, income derived from the business in the relevant annual period must be split on a reasonable basis between its charitable purposes in New Zealand and those outside New Zealand. Only the part that a tax charity apportions for tax purposes to its charitable purposes in New Zealand is exempt income (which this statement refers to as the "territorial restriction").
   - The business income is not exempt if a person with some control over the business is able to direct or divert an amount derived from the business to the benefit or advantage of a person other than the charity (or charities) for whose benefit the business is carried on, except for a purpose of the charity (or charities) (which this statement refers to as the "control restriction"). If a tax charity breaches the control restriction, all of the business income it derives is taxable.
4. Many tax charities do not derive income from a business. Other tax charities derive income from a business but have no overseas charitable purposes. This statement provides guidance on how s CW 42 applies to tax charities that derive income from a business and have charitable purposes in and outside New Zealand. For example, a tax charity that:
   - carries out its charitable purposes in New Zealand and elsewhere, or
   - carries out its charitable purposes in New Zealand but also donates funds overseas from time to time or occasionally, in response to an unexpected event such as, for example, a natural disaster that occurs outside New Zealand.
5. In summary, the statement draws the following conclusions:
   - Charities that engage in activities on a continuous and ongoing basis, commit time, money and effort to those activities, and conduct a large volume of transactions with the intention of making a surplus are carrying on a business.

- "Surplus" refers to a surplus of income (money or money's worth) over cost and is determined in accordance with ordinary commercial principles.
- A charity might not be carrying on a business because the nature of its activities is not sufficient to result in those activities being a business and/or the activities are not carried on with a profit-making intention. For example, activities carried out on a deliberately loss-making or breakeven basis.
- A charity can be in business even though the object of the business is directed to charitable ends, not private pecuniary gain.
- Section CW 42 applies to income derived from a business carried on exclusively for one or more charities. The business may be carried on by:
  - a charity ("directly"); or
  - another entity for or for the benefit of a charity ("indirectly").
- Many distributions a charity derives from another entity carrying on a business will be exempt non-business income (and not subject to s CW 42) on the basis that:
  - the business is not carried on by the other entity exclusively for one or more charities; and/or
  - in the charity's hands the distribution amount is not itself business income.
- For business income a charity derives to be exempt under s CW 42 both the entity whose income derivation is being considered and, if it is a different entity, the entity carrying on the business must be charitable. The entity deriving the business income must be a tax charity and the entity carrying on the business must be a registered charity.
- Income from a business includes income from a charity's trade or business activities (including income derived from a business of investment) and other income sufficiently connected to a charity's business operations.
- A charity carrying on a business might receive a payment described as a "gift", "donation" or "koha". Whether such a payment is income from a charity's business is a question of fact. However, in many cases, gifts a charity receives will not be business income either because the payment is unrelated to the charity's business activity and prompted by the payer's intention to progress the charity's charitable purpose or the payment received is capital in nature, or both.
- In some cases, a tax charity deriving business income subject to s CW 42 will also derive other amounts not subject to s CW 42 (eg non-business income and capital amounts).
- For the exemption in s CW 42 to apply to a charity's business income, **all** of the following requirements must be satisfied:
  - The entity actually conducting the business must be a registered charity. If the entity conducting the business is not a registered charity, all the income from the business is taxable. This outcome extends to the situation where a trading trust with only a charitable beneficiary (or beneficiaries) distributes business income to a charitable beneficiary. If the trading trust is not a registered charity the business income a charitable beneficiary derives as beneficiary income from the trading trust is not exempt under s CW 42.
  - The charity deriving the income must carry out charitable purposes in New Zealand. It is a question of fact as to where a charity carries out its charitable purposes.
  - The charity deriving the income must be a "tax charity". The definition of "tax charity" includes a registered charity. This statement focuses on tax charities that are registered charities.
  - The tax charity must not breach the control restriction.
- This statement does not consider the control restriction in any detail. If a tax charity breaches the control restriction, all the business income that it derives will be taxable.
- If a tax charity's rules restrict its charitable purposes to New Zealand and its charitable purposes are in fact limited to New Zealand, all of the business income it derives is exempt from tax (subject to the tax charity satisfying the control restriction).
- Where a tax charity's rules do not restrict its charitable purposes to New Zealand but 100% of its charitable purposes are directed to New Zealand, the tax charity can, in certain situations, treat all of its business income as exempt (subject to the tax charity satisfying the control restriction).
- Where a tax charity has only overseas charitable purposes, its business income is fully taxable.

- A tax charity that donates to charitable purposes outside New Zealand is carrying out charitable purposes outside New Zealand. This includes where a tax charity donates to the overseas charitable purposes of a charity listed in sch 32. A tax charity that donates to charitable purposes outside New Zealand is itself carrying out charitable purposes outside New Zealand and will need to reasonably split its business income between its charitable purposes in New Zealand and those outside New Zealand.
- Not all donations a tax charity makes to a charity with some overseas purposes will be for those overseas purposes. For example, where the tax charity and recipient of the donation expressly agree that the donation can only be used for the recipient's New Zealand charitable purposes.
- The purpose of s CW 42 is to exempt business income a tax charity derives to the extent that the income can be apportioned, on a reasonable basis, to the tax charity's charitable purposes carried out in New Zealand.
- A tax charity has the burden of proving that any split of its business income is reasonable. A tax charity's split of business income between charitable purposes in New Zealand and outside New Zealand does not need to be exact to the last dollar but must reflect what an objective person would consider is reasonable in the circumstances.
- This statement describes a number of possible approaches to splitting business income. A tax charity can take a different approach provided it results in a reasonable split of business income between its charitable purposes in New Zealand and outside New Zealand.
- There may be situations where it is reasonable to allocate all of a tax charity's business income to charitable purposes in New Zealand despite the tax charity carrying out charitable purposes in and outside New Zealand. This statement describes two such situations as follows:
  - A tax charity's trust deed or other rules restrict (ring fence) its business income for its charitable purposes in New Zealand and there is appropriate tracking of its business income to demonstrate that it is restricted to carrying out charitable purposes in New Zealand.
  - A tax charity carries out its charitable purposes in New Zealand but also donates funds overseas from time to time or occasionally and it can identify that the donations were sourced from amounts other than business income.
- In the absence of a material change in a tax charity's operations once it determines an approach to splitting its business income that is reasonable, that same approach can be used each year. Where a tax charity changes its approach, the new approach must also be one that results in business income being apportioned, on a reasonable basis, between its charitable purposes in and outside New Zealand.
- Where a tax charity treats some or all of its business income as exempt based on its intention to carry out charitable purposes in New Zealand and this intention then changes, the outcome is that the tax charity is carrying out charitable purposes outside of New Zealand. In this situation:
  - A tax charity has the burden of proving that its split of business income in the relevant annual period is reasonable. A change of intention does not necessarily mean a tax charity's split of business income in a prior period was unreasonable.
  - If the original split of business income was reasonable the Commissioner expects that following the change of intention the amount of business income not exempted under s CW 42 will increase.
- The outcome of applying the territorial restriction is that a proportion of a tax charity's business income (but not particular income amounts) is assessable income and a proportion is exempt income. Depending on the level of a tax charity's deductible business expenditure in the relevant annual period, a tax charity might have net income or a net loss from its business activity.
- A tax charity can split its deductible business expenses on the same basis that it splits its business income between its charitable purposes in and outside New Zealand.

6. How s CW 42 applies to a registered charity is illustrated in Figure | Hoahoa 1.

Figure | Hoahoa 1 – How s CW 42 applies



* All business income is taxable if a person with some control over the business is able to direct or divert business income away from charity.

7. There is also a fact sheet, IS 24/08 FS 1, that summarises the income to which s CW 42 applies and how a registered charity determines the extent to which its business income is exempt under s CW 42 without the detailed explanation and analysis in this statement.

Introduction | Whakataki

8. Section CW 42 contains the business income exemption for tax charities. This exemption has been in place for a long time. However, the wording of the section has changed over time.
9. This statement seeks to clarify:
   - aspects of the interpretation of s CW 42 the Commissioner is aware have caused uncertainty; and
   - how the territorial restriction in s CW 42 applies (for a summary of the territorial restriction see [3]).
10. This statement will interest a tax charity that:
    - derives income from a business carried on exclusively for a charity or charities; and
    - has charitable purposes that are not limited to New Zealand.
11. For example, this statement will be of interest to a tax charity that:
    - carries out its charitable purposes in New Zealand and elsewhere; or
    - carries out its charitable purposes in New Zealand but also donates funds overseas from time to time or occasionally, for example in response to an unexpected event such as a natural disaster that occurs outside New Zealand.

About this statement

12. This statement consists of three parts. Part One considers what income is subject to s CW 42. In particular, it considers:
    - what carrying on a "business" requires ([24] to [35]);
    - what income is "from a business", including how to interpret the words "directly or indirectly" in s CW 42(1) ([36] to [74]); and
    - how to determine when a business is carried on "by, or for, or for the benefit of" a charity ([75] to [84]).
13. Part Two considers the requirements that a charity must satisfy for the income it derives under Part One to be exempt from tax. These requirements are:
    - the entity carrying on the business must be a registered charity ([86] to [87]);
    - the charity must carry out its charitable purposes in New Zealand ([88] to [102]);
    - the charity must be a "tax charity" ([103] to [104]); and
    - the tax charity must not breach the control restriction ([105] to [107]).
14. Part Three considers how the territorial restriction applies to a charity that derives income under Part One and meets the requirements in Part Two. To do so, it considers:
    - when a tax charity's charitable purposes are limited to New Zealand ([110] to [120]);
    - general principles that apply when splitting business income ([121] to [124]);
    - approaches to splitting business income ([125] to [137]);
    - funding overseas purposes with amounts that are not business income ([138] to [147]);
    - changes in charitable purpose ([148] to [154]);
    - approaches to splitting deductible business expenses between taxable and exempt income ([155] to [163]).
15. Section CW 42 does not apply to income derived by a:
    - council-controlled organisation, other than a council-controlled organisation operating a hospital as a charitable activity; or
    - local authority from a council-controlled organisation, other than from a council-controlled organisation operating a hospital as a charitable activity on behalf of the local authority.
16. This statement does not consider the exclusions from the business income exemption described above.
17. This statement also does not consider the control restriction in any detail. If a tax charity breaches the control restriction, all the business income that it derives will be taxable. As the control restriction always applies, it is important that a tax charity that derives business income monitors its compliance with the control restriction on an ongoing basis. For a summary of the control restriction, see from [105].
18. Inland Revenue has discussed the control restriction in other publications. For example, see **OS 22/04:** Charities and donee organisations – Part 1: Charities, *Tax Information Bulletin* Vol 34, No 10 (November 2022).

Terms and examples in this statement

19. This statement refers variously to a "charity", a "registered charity" and a "tax charity".

20. The particular term this statement uses in any given context depends on which part of s CW 42 it is considering. Broadly, income is subject to the test in s CW 42 if it is derived from a business carried on by, or for, or for the benefit of a "charity". Section CW 42 exempts that income only if a "registered charity" carries on the business and a "tax charity" derives the income. This statement offers the following glossary to help readers to understand these terms before discussing them in more detail later:

Charity	A trust for charitable purposes or a society or institution (which includes a company) established and maintained exclusively for charitable purposes and not carried on for the private pecuniary profit of any individual.
Registered charity	Is an entity registered as a charitable entity under the Charities Act 2005.
Tax charity	Is a charity that is a registered charity or a non-resident entity the Commissioner approves as a tax charity.
Trust, society or institution of a kind referred to in s CW 41(1)	Is a charity (see above definition of "charity").

21. This statement provides examples to illustrate how s CW 42 applies. The examples do not reflect existing or past charitable entities; they are illustrative only.

Part One: Determining what income is subject to s CW 42

22. Section CW 42 applies to income an entity derives directly or indirectly from a business carried on by, or for, or for the benefit of a charity. Before s CW 42 applies, there must first be a person who is carrying on a "business". This statement does not consider when a person is in business in any detail. Whether a person is carrying on a business is a factual question that needs to be considered in each case.

23. While not covering when a person is in business in any detail, this statement briefly discusses this question below for completeness.

Carrying on a business

24. Section YA 1 defines "business" as including "any profession, trade, or undertaking carried on for profit". The leading case on what constitutes a business is *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). In *Grieve*, the Court of Appeal held that whether a taxpayer is in business involves a two-fold inquiry as to the:
    - nature of the activities carried on; and
    - intention of the taxpayer in engaging in those activities.

25. In *Grieve*, Richardson J identified six factors relevant to determining whether a taxpayer is carrying on a business. These factors are the:
    - nature of the activity;
    - period over which they engage in the activity;
    - scale of operations and volume of transactions;
    - commitment of time, money and effort;
    - pattern of activity; and
    - financial results.

26. Richardson J went on to say that it may also be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those that are characteristic of ordinary trade in the line of business in which the venture is conducted. However, in the end, the crucial factors are the character and circumstances of the particular venture.

27. Sometimes the nature of the activities a person carries on are not sufficient to result in those activities being a business. For example, a charity owns premises (such as a church hall) that it uses to deliver religious/pastoral instruction or care and occasionally rents the church hall to community groups. This activity is very unlikely to be a business.
28. The words "for profit" in the context of the definition of "business" refer to a surplus of income (money or money's worth) over cost, determined in accordance with ordinary commercial principles (see *Grieve*).
29. How a charity reports revenue from its trading activities for accounting purposes does not determine whether it is carrying on a business for tax purposes.
30. Charities that engage in activities on a continuous and ongoing basis, commit time, money and effort to those activities, and conduct a large volume of transactions, with the intention of making a surplus are carrying on a "business", as s YA 1 defines that term. This is the conclusion even though the object of the business is directed to charitable ends, not private pecuniary gain.
31. Sometimes a charity engages in activities on a continuous and ongoing basis, commits time, money and effort to those activities, and conducts a large volume of transactions without a profit-making intention. For example, a charity that deliberately undertakes an activity on a loss-making or breakeven basis. Such activities will not be a business, as s YA 1 defines that term. Example | Tauira 2 illustrates a situation where a charity deliberately carries on activities to breakeven.
32. Some charities carrying on trading activities related to their charitable purpose with the intention of making a surplus might think they are not in business because their intention in carrying on those activities is to achieve their charitable purpose (not to make a profit). However, that position is not correct. Case law shows that it is possible to be in business even though the trading activity is related to the charity's charitable purpose (see *Brighton College v Marriott* [1925] All ER 600). A charity will be carrying on a business if the nature of its activities is sufficient to support the concept of business and it seeks a surplus.

Extended definition of business for trusts

33. A registered charity may not satisfy the business test in s YA 1 but will in certain cases be treated as carrying on a business for the purposes of s CW 42.
34. Under s CW 42(3), a trustee is treated as carrying on a business for the purposes of s CW 42 where **all** of the following apply:
    - The trustee derives rents, fines, premiums or other revenues from an asset of the trust.
    - The asset was disposed of to the trust by:
        - a settlor or trustee of the trust; or
        - if the trust is a shareholder in the company carrying on the business, a shareholder or director of the company carrying on the business; or
        - a person associated with a settlor, trustee, shareholder or director.
    - The person who disposed of the asset to the trust retains or reserves an interest in the asset, or the asset will revert to them.
35. The extended definition of "business" means the tax treatment of rental income derived from an asset disposed of to a trust in the circumstances described above is determined under s CW 42, not s CW 41.

Amounts that are income "from a business"

36. Where a person is carrying on a business, a question arises as to what income is from the business. The answer is important because income from a business is subject to s CW 42 (whereas other income is subject to s CW 41). As discussed at [3], s CW 42 has additional restrictions compared to s CW 41.
37. The opening words of s CW 42(1) state:

> *Exempt income*
>
> (1) Income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society, or institution of a kind referred to in section CW 41(1) is exempt income if—
>
> …

38. To answer the question at [36], it is necessary to consider the meaning of "directly or indirectly" in the context of s CW 42 and whether these words extend the application of the section to income not usually considered to be income from a business.

INTERPRETATION STATEMENT

Meaning of "directly or indirectly"

39. The Act does not define the individual words "directly" or "indirectly" or the phrase "directly or indirectly". The *Oxford English Dictionary* defines "directly" as "without the intervention of a medium or agent; immediately; by a direct process or mode". It defines "indirectly" as "by indirect action, means, … agency or instrumentality; through some intervening person or thing, in an indirect way or manner".[1]
40. The ordinary meaning of "directly or indirectly" contrasts something that arises in a direct way or manner with something arising in an indirect way or manner.
41. Although the words "directly or indirectly" are placed between the words "income derived" and "from a business" in s CW 42(1), the Commissioner's view is that the words "directly or indirectly" relate to the phrase "by, or for, or for the benefit of" and reflect that a business may be carried on by:[2]
    - a charity ("directly"); or
    - another entity ("indirectly").
42. The reasons for this view are as follows:
    - The words "directly and indirectly" were introduced into a predecessor of s CW 42 in 1940 at the same time as the exemption was extended to apply to income from a business carried on for charity. Prior to this time, the exemption applied to income derived by a charity only.[3]
    - There is nothing to indicate the words "directly or indirectly" were introduced for the purpose of capturing income not usually considered to be income from a business.
43. The outcome of this view is that a more direct relationship is required between an amount of income and a business carried on for charity in order for that income to be subject to s CW 42.
44. The significance of the words "directly or indirectly" has changed because of the enactment of s CW 42(1)(aa). The effect of s CW 42(1)(aa) (discussed at [86]) is that business income subject to s CW 42 is exempt from tax only if the entity carrying on the business is a registered charity. We anticipate that in most cases where income is subject to s CW 42, the income will be derived from a business a registered charity is carrying on (ie directly).

Income from trade or business activities

45. Section CW 42 applies to income a charity derives from its trade or business activities.[4] Example | Tauira 1 illustrates this situation.

Example | Tauira 1 - Income from a charity's business activity

Pet Welfare Centre Ltd is a registered charity. Its charitable purpose is to provide shelter to lost and abandoned animals in New Zealand and Australia. To raise funds for its charitable purpose, Pet Welfare Centre Ltd runs an opportunity shop that sells used furniture and clothing.

Pet Welfare Centre Ltd should apply s CW 42 to determine the extent to which the income it derives from selling used furniture and clothing is exempt from tax.

1 *Oxford English Dictionary* (online version, Oxford University Press, March 2022, accessed 29 August 2022).

2 For a discussion of the meaning of "for" and "for the benefit of" a charity, see from [74].

3 Following the amendment in 1940, s 78k of the Land and Income Tax Act 1923 exempted income derived "directly or indirectly from any business carried on by or on behalf of or for the benefit of" a charity. Section CW 42(1) refers to a business carried on "by, or for, or for the benefit of" a charity. The word "for" replaced "on behalf of" when the Income Tax Act 2004 was enacted. Among other changes, the 2004 Act rewrote Part C of the Income Tax Act 1994. The changes to ss CW 34 and CW 35 of the 2004 Act (now ss CW 41 and CW 42) were intended to clarify the law and did not reflect a change in policy. For this reason, we consider that in the context of s CW 42 "for" means the same as "on behalf of".

4 See **QB 21/03**: **Charities business exemption – business carried on in partnership** for a discussion on businesses carried on by charitable entities in partnership with non-charitable entities.

46. A charity can derive business income and other income that is not itself from a business. Example | Tauira 2 illustrates this situation.

Example | Tauira 2 – Charity carrying on a business and activities that are not a business

The charitable purposes of Pet Welfare Centre Ltd from **Example | Tauira 1** are wider and include promoting animal welfare through a healthy diet.

In addition to running the opportunity shop it manufactures and sells dog treats. It prices the dog treats at an amount sufficient to cover the manufacture and sale costs only, rather than to make a surplus.

Pet Welfare Centre Ltd's activity of manufacturing and selling dog treats (which is separate from its running of the opportunity shop) is not a business. It follows that the income it derives from the manufacture and sale of the dog treats is non-business income and exempt under s CW 41.

47. Some charities carry on more than one business. Income of a charity not derived from the trade or business activities of one business may be derived from a separate business. Example | Tauira 3 illustrates this situation.

Example | Tauira 3 - Charity carrying on two businesses

Pet Welfare Centre Ltd from **Example | Tauira 1** and **Example | Tauira 2** seeks a surplus from the manufacture and sale of the dog treats and runs the activity in a business-like manner.

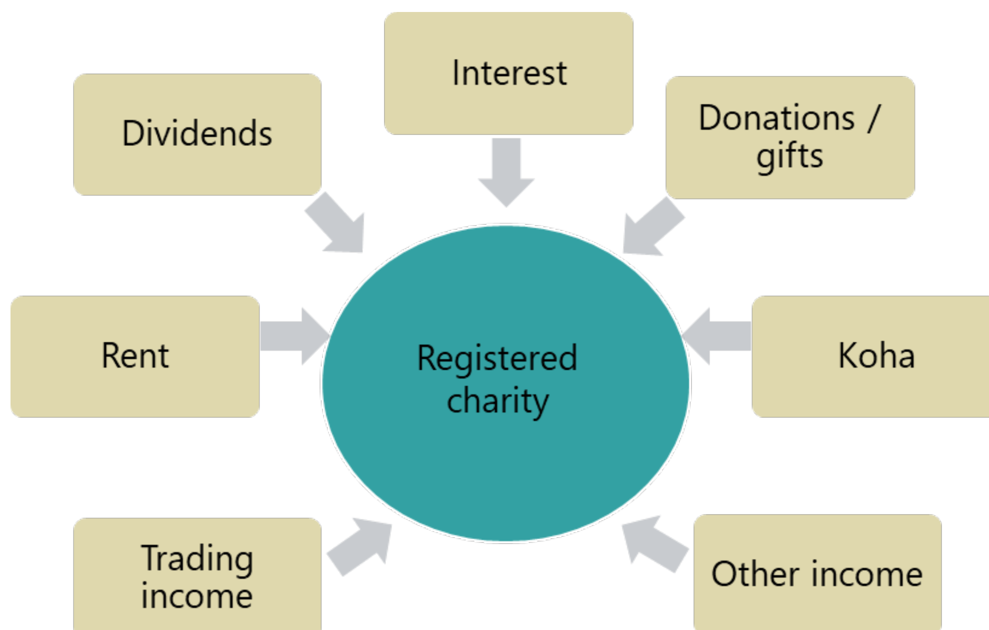
The activity of manufacturing and selling pet treats (which is separate from its running of the opportunity shop) itself constitutes a business. It follows that Pet Welfare Centre Ltd is carrying on two businesses – the opportunity shop and the manufacture and sale of dog treats.

Pet Welfare Centre Ltd should also apply s CW 42 to determine the extent to which the income from the manufacture and sale of dog treats is exempt from tax.

Other amounts a charity may receive

48. In some cases, a charity carrying on a business receives amounts other than from its trade or business activities – for example, interest, dividends, rent and/or donations, as illustrated in Figure | Hoahoa 2.[5] A question arises as to which section (s CW 41 or s CW 42) applies to these amounts.

Figure | Hoahoa 2 – Types of income



5 Rent refers to rental income that is not income a trust derives from a business under the extended business definition in s CW 42(3). See the discussion from [33].

49. The *Oxford English Dictionary* defines "from" as "denoting derivation, source, descent, or the like".[6] Case law has considered what the words "from the business" mean in the context of a predecessor provision of s CB 1(1). Under s CB 1(1), an amount a person derives from a business is income of the person. As s CW 42 applies to income derived from a business, we consider the case law is relevant here.
50. In *CIR v City Motor Service Ltd; CIR v Napier Motors Ltd* [1969] NZLR 1,010, the Court of Appeal concluded that "from the business" must mean from the current operations of the business. An amount is not income "from a business" just because it is related in some way to the business. The question is whether, having regard to the nature of the business and its relationship with the particular amount, it can be said that some part of the business activity gives rise to or produces that income.
51. The requirement that some part of the business activity give rise to or produce the income generally means that other amounts commonly derived by charities, such as dividends and rent, will be non-business income (provided those amounts do not arise from an investment business).
52. Example | Tauira 5, Example | Tauira 6 and Example | Tauira 7 illustrate situations where a charity derives business income and other income that is not itself from a business.

Investment income

53. Income derived from a business of investment will be income from a business and subject to the test in s CW 42. Whether investment income constitutes income from a business depends on the particular circumstances and nature of the business.
54. An investment activity does not need to be a charity's sole or even its principal activity to constitute a business (see *CIR v Stockwell* (1992) 14 NZTC 9,190 (CA)). Case law does not support a presumption against finding that a charity (being a non-individual) is carrying on a business of investment.
55. Case law offers some guidance on factors that are relevant to determining whether investment activities constitute a business. Relevant cases include *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)* 5 TC 159, *National Distributors Ltd v CIR* (1987) 9 NZTC 6,135 (HC) and *Rangatira Limited v CIR* [1997] 1 NZLR 129 (PC).
56. There is a difference between carrying on a business and simply realising an investment (*Californian Copper Syndicate)*.
57. When considering whether a business of investment existed the court in *National Distributors* stated that the continuity and extent of the activity are important, if not dominant, considerations in determining whether a taxpayer is in business. In arriving at a decision as to whether the activities (in that case, the buying and selling of shares) constituted a business, the court said that matters likely to assist were whether:
    - the switching of shares has taken place as an integral part of the taxpayer's investment business so that it amounts to a dealing in shares;
    - the taxpayer has regularly or continuously monitored the share portfolio;
    - there was any system according to which shares were sold;
    - the sales were frequent and part of the taxpayer's normal operations in the course of making profits; and
    - the sales and purchases were on a large scale.
58. The court concluded the taxpayer's share transactions were not the carrying on of a business. This was because the share sales were intermittent and unsystematic and were made in relation to inflationary trends (rather than for profit).
59. In *Rangatira* a company invested on a long-term basis in shares in established, well-performing companies. Over time, it sold these shares and often made profits on the sales. The Privy Council decided the taxpayer's activities had not changed from an investment holding company to a business of dealing in shares. The number and frequency of the transactions (41 sales during a 7-year period) would not, by themselves, have been sufficient to conclude the company was in the business of dealing in shares.
60. For many charities the volume, frequency of transactions, commitment of time, money and effort on investment activities means that those activities are not an investment business.
61. Where a charity is a trust, the trustees may have a duty to invest trust property prudently. It might be thought that, as a result of a trustee's duty to invest prudently under s 30 of the Trusts Act 2019, the trust's investment activities constitute a business for tax purposes.

6 *Oxford English Dictionary* (online version, Oxford University Press, March 2022, accessed 29 August 2022).

62. Section 30 of the Trusts Act 2019 states:

> *30 Duty to invest prudently*
>
> When exercising any power to invest trust property, a trustee must exercise the care and skill that a prudent person of business would exercise in managing the affairs of others, having regard, in particular,—
>
> (a) to any special knowledge or experience that the trustee has or that the trustee holds out as having; and
>
> (b) if the person acts as a trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

63. The duty in s 30 of the Trusts Act 2019 is a default duty that can be modified or excluded by express or implied terms of the trust.

64. Section 30 provides that a trustee should exercise the care and skill that a prudent person of business would exercise in managing the affairs of others.[7] This duty is unrelated to the nature of the trust's investments or investment activities and does not result in a charitable trust's investment activities being a "business" as that term is defined in s YA 1. As discussed from [24], whether a particular activity amounts to a business is a matter of fact and degree.

65. In some cases, investment income a charity derives will still be business income even though the charity is not carrying on a business of investment. Investment income that is so closely connected to a charity's business will constitute income from that business (and therefore be subject to s CW 42). Example | Tauira 4 illustrates this situation.

Example | Tauira 4 – Interest income that is business income

Cooks for Good Ltd is a registered charity. Its charitable purpose is to advance religious education. To raise funds for its charitable purpose, it runs a café that sells food and drink. Cooks for Good Ltd has an interest-bearing business on-call account that it uses to deposit the takings from the café and pay for the café's expenses.

The interest and the income from selling food and drink are income from the business. This outcome arises because the interest income is closely connected to Cooks for Good Ltd's business (and not as a result of the name or nature of the bank account, ie, a "business on-call account"). The ordinary day-to-day transactions of the business give rise to or produce the interest income. The interest income is effectively paid on the takings from the café when they exceed the café's expenses.

66. A charity can derive business income and investment income that is not itself from a business. Example | Tauira 5, Example | Tauira 6 and Example | Tauira 7 illustrate when a charity's investment income is not derived from a business.

Example | Tauira 5 - Interest income that is not business income

Cooks for Good Ltd from **Example | Tauira 4** receives a donation from a member of the public who has heard about and wants to support its work in advancing religious education. Cooks for Good Ltd deposits the donation into its interest-bearing on-call account.

The donation is not Cooks for Good Ltd's business income because it is unrelated to its business (the treatment of gifts, donations or koha is discussed further at [67]).

Any interest income earned on the donation is not income from the business. No part of the business activity gives rise to or produces the interest income.

Cooks for Good Ltd is responsible for demonstrating what interest income is derived from a business.

Cooks for Good Ltd could deposit donations into a bank account separate from its business on-call account. Alternatively, the Commissioner will accept an apportionment of the interest income on any reasonable basis.

7 *Nevills' Law of Trusts, Wills and Administration* (14ed, LexisNexis NZ Ltd, 2023) at [9.3.2]

Example | Tauira 6 – Interest and rental income that is not business income

Cooks for Good Ltd from **Example | Tauira 4** has a large credit balance in its business on-call account. To earn a higher interest rate, it decides to put an amount on term deposit.

In this situation, the interest income earned on the term deposit is not income from a business.

Although the interest income on the term deposit relates to the business (in the sense that the funds put on term deposit came from the café), no part of the business activity (the running of the café) gives rise to or produces the interest income.

The interest will be non-business income and exempt under s CW 41.

The same outcome would arise if, for example, Cooks for Good Ltd invested its business surplus in a rental property. The activity of managing a single rental property is not sufficient to constitute a business. It follows that the rent would also be non-business income and exempt under s CW 41.

Example | Tauira 7 – Dividend income that is not business income

Pet Welfare Centre Ltd from **Example | Tauira 3** is a registered charity carrying on two businesses - the opportunity shop and the manufacture and sale of dog treats.

In addition to carrying on these businesses, it decides to buy shares in two companies that sell flea treatments.

Pet Welfare Centre Ltd's investments in these companies would not constitute a business. The extent of the activity is not sufficient for the investment activities to be a business.

Gifts, donations or koha

67. A charity carrying on a business might receive payments described as "gifts", "donations" or "koha". The label given to such payments does not determine their character or whether they are income derived from a charity's business.

68. In many cases, gifts a charity receives will not be business income either because the payment is unrelated to the charity's business activity and prompted by the payer's intention to progress the charity's charitable purpose or is capital in nature (eg, a gift to a charity running a private hospital to build a new hospital wing), or both.

69. However, case law shows that voluntary payments of money may be business income if they are received in relation to, or as a product of, the business activity.

70. In *Hayes v FCT* (1956) 96 CLR 47, the High Court of Australia considered when a "gift" would be income in contrast to a "mere gift". Fullagar J stated (at 54):

> A voluntary payment of money or transfer of property by A to B is prima facie not income in B's hands. If nothing more appears than that A gave to B some money or a motor car or some shares, what B receives is capital and not income. But further facts may appear which show that, although the payment or transfer was a "gift" in the sense that it was made without legal obligation, it was nevertheless so related to the employment of B by A, or to services rendered by B to A, or to a business carried on by B, that it is, in substance and in reality, not a mere gift but the product of an income-earning activity on the part of B, and therefore to be regarded as income from B's personal exertion.

71. 'Mere gifts' do not relate to any activity or occupation of the donee of an income-producing character and have no significant character except as expressions of a desire to benefit the donee (*Hayes*).

72. Whether or not a particular payment received is business income depends on its quality in the hands of the recipient. All the relevant circumstances of the payment must be taken into account. These circumstances may include the purpose for which the payment was made, the terms on which it was made and whether the charity provides any consideration in return for the gift.[8]

73. Simply because a gift could be described as supplementing a charity's trading receipts or assisting it to carry out its trade does not determine whether it is business income (*Inland Revenue Commissioners. v. City of London Corporation (as the Conservators of Epping Forest)* 1953 1 All ER 1075 (HL)).

74. For further information on the factors that support a conclusion that a gift is or is not business income, see **IS 23/11**: Income tax: Income – when gifts are assessable income *Tax Information Bulletin* Vol 36, No 1 (February 2024): 34 from 47.

8 *Murray v Goodhews* [1978] 2 All ER 40.

Determining when a business is carried on by, or for, or for the benefit of a charity

75. Section CW 42(1) applies to income derived "directly or indirectly" from a business carried on "by, or for, or for the benefit of" a trust, society, or institution of a kind referred to in s CW 41(1) (referred to in this statement as a "charity"). Section CW 41(1) refers to:
    - a trust for charitable purposes; and
    - a society or institution established and maintained exclusively for charitable purposes and not carried on for the private pecuniary profit of any individual.
76. This statement discussed the meaning of the words "directly or indirectly" from [39]. The words "directly or indirectly" relate to the words "by, or for, or for the benefit of" and reflect that a business may be carried on by:
    - a charity ("directly"); or
    - another entity for or for the benefit of a charity ('indirectly").
77. As with the words "directly or indirectly", the significance of the words "or for, or for the benefit of" has changed because of the enactment of s CW 42(1)(aa). The effect of s CW 42(1)(aa) (discussed at [86]) is that for business income to be exempt under s CW 42 both the entity whose income derivation is being considered and, if it is a different entity, the entity carrying on the business must be charitable. The entity deriving the business income must be a tax charity and the entity carrying on the business must be a registered charity.
78. Where a charity is carrying on a business, the income it derives from the business will be subject to s CW 42. The business will be carried on "by" a charity that is either a trust for charitable purposes or a society or institution established and maintained exclusively for charitable purposes and not carried on for the private pecuniary profit of any individual.
79. Where the entity carrying on the business is not a charity, a question arises as to whether that business is carried on "for, or for the benefit of" a charity. Only income derived from a business carried on "for, or for the benefit of" a charity is subject to s CW 42.

Meaning of "for" and "for the benefit of" a charity

80. The Act does not define the terms "for" or "benefit". The *Oxford English Dictionary* defines these terms as follows:[9]

    > **for** 1 in favour of. 2 affecting or with regard to. 3 on behalf of or to the benefit of. 4 having as a purpose or function. 5 having as a reason or cause … 7 representing
    >
    > **benefit** an advantage or profit gained from something … receive an advantage; profit

81. The words "for" and "for the benefit of" do not have strict legal meanings but are used as part of a description of a wide variety of relationships where one person acts as auxiliary to or a representative of another person.[10] The particular meaning intended depends on the context in which the words are used and how they are used in that context.[11] The courts have considered the application of s CW 42. The cases indicate that a business will be carried on "for, or for the benefit of" a charity if the business is carried on for the benefit of trustees for charitable purposes or any society or institution exclusively for such purposes and not for private pecuniary purposes (see *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC) and *Latimer v CIR* (2002) 20 NZTC 17,737 (CA)). In *Latimer*, the court stated that s CW 42 deals with the income from a business, the business must be wholly devoted to making money for charitable purposes.
82. Example | Tauira 8 and Example | Tauira 9 illustrate this requirement that s CW 42 applies to income derived from a business carried on exclusively for the benefit of a charity.

Business carried on for one or multiple charities

83. Section CW 42(1) refers to income derived from a business carried on by, or for, or for the benefit of **a** trust, society or institution (singular). A question arises as to whether the section is limited to income from a business carried on by, or for, or for the benefit of a single charity.

9 *Concise Oxford English Dictionary* (12th ed, Oxford University Press, 2011).

10 *Case X26* 90 ATC 256.

11 *Dale v Mitcalfe* (1928) 13 TC 41 and *Case X26*.

84. Unless the context requires a different interpretation, words in the Act in the singular include the plural and words in the plural include the singular.[12] The Commissioner considers nothing in the context of s CW 42 requires the section to be restricted to situations where a business is carried on by, or for, or for the benefit of a single charity.

Example | Tauira 8 - Business not carried on exclusively for a charity or charities

The Right on Trust is a trading trust. The beneficiaries of the Right on Trust include family members of the settlor and a registered charity, New Way Forward Ltd.

The trustees of the Right on Trust determine to distribute some of the income from the business as beneficiary income to New Way Forward Ltd.

The beneficiary income derived by New Way Forward Ltd is subject to the test in s CW 41 (and not s CW 42). This outcome arises because the beneficiary income is not income derived from a business carried on exclusively for one or more charities.

Any distributions received by New Way Forward Ltd from the Right on Trust will be non-business income and exempt under s CW 41.

Example | Tauira 9 - Business not carried on exclusively for a charity or charities

Sue and Son Computing Ltd carries on business in New Zealand. Sue and Son Computing Ltd has multiple shareholders, including Sue, her son and Fighting Poverty Ltd. Fighting Poverty Ltd is a registered charity.

Sue and Son Computing Ltd pays a dividend to its shareholders, including Fighting Poverty Ltd.

Sue and Son Computing Ltd's business income is not subject to s CW 42. This outcome arises because Sue and Son Computing Ltd is not a charity and its business is not carried on exclusively for the benefit of one or more charities.

Sue and Son Computing Ltd's business income will be taxable.

12 Section 19 of the Legislation Act 2019.

Part Two: Requirements for business income to be exempt

85. This part discusses the requirements a charity must satisfy for business income it derives as described under Part One to be exempt from tax. The requirements (set out in s CW 42(1)(aa) to (c)) must all be satisfied for business income to be exempt. Section CW 42(1) states:

> *Exempt income*
>
> (1) Income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society, or institution of a kind referred to in section CW 41(1) is exempt income if—
>
> (aa) the entity carrying on the business is, at the time that the income is derived, registered as a charitable entity under the Charities Act 2005; and
>
> (a) the trust, society, or institution carries out its charitable purposes in New Zealand; and
>
> (b) the trustee or trustees of the trust, the society, or the institution is or are, at the time that the income is derived, a tax charity; and
>
> (c) no person with some control over the business is able to direct or divert an amount derived from the business to the benefit or advantage of,—
>
> (i) if subparagraph (ii) does not apply, a person other than the trust, society, or institution except for a purpose of the trust, society, or institution:
>
> (ii) if a trust, society, or institution (the **operating entity**) is carrying on the business for or for the benefit of another trust, society, or institution (the **controlling entity**), a person other than the operating entity or the controlling entity except for a purpose of the operating entity or the controlling entity.
>
> Subsections (3) to (8) expand on this subsection.

The entity carrying on the business must be a registered charity

86. Business income to which s CW 42 applies is exempt from tax only if the entity actually conducting the business is a registered charity (s CW 42(1)(aa)). Registration under the Charities Act 2005 carries with it a number of reporting obligations that improve transparency and promote public trust and confidence in the charities sector. The requirement that the entity carrying on the business is a registered charity was introduced so every entity claiming the business income exemption is subject to the public reporting requirements that arise when a charitable entity registers as a charity.[13]

87. Example | Tauira 10, Example | Tauira 11 and Example | Tauira 12 illustrate the effect of this requirement on the business income exemption.

Example | Tauira 10 - Entity carrying on the business at the time the income is derived is not a registered charity

The D&P Cat Rescue Trust, a registered charity, incorporated DEB Cat Rescue Ltd to carry on business exclusively for its benefit.

The D&P Cat Rescue Trust's charitable purposes are limited to New Zealand. DEB Cat Rescue Ltd is not itself a registered charity.

DEB Cat Rescue Ltd derives business income of $15,000 in the 2023/24 income year from a business of selling animal beds and pet accessories.

DEB Cat Rescue Ltd is taxable on the business income of $15,000. This outcome arises because DEB Cat Rescue Ltd (the entity carrying on the business) is not a registered charity at the time the income is derived. Even though the income DEB Cat Rescue Ltd derives is from a business carried on exclusively for the benefit of a charity (D&P Cat Rescue Trust), to be exempt s CW 42 requires that the entity carrying on the business is a registered charity.

Any dividend income the D&P Cat Rescue Trust receives from DEB Cat Rescue Ltd is subject to s CW 41, not s CW 42. This outcome arises because the dividend income derived by the D&P Cat Rescue Trust is not income "from a business". In particular:

- D&P Cat Rescue Trust did not derive income from the business of selling animal beds and pet accessories. This income was derived by DEB Cat Rescue Ltd.
- The dividends are not income from a business of investing in shares.

13 Minister of Revenue, *Commentary on the Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill* (Inland Revenue, June 2018).

Example | Tauira 11 - Business income distributed to a registered charity by an entity that is not a registered charity

Help Our Community Ltd is a registered charity. Its charitable purpose is providing palliative care for people in the greater Christchurch area.

The trust deed of the JR Ranch Trust provides that it carries on its business for the exclusive benefit of the charitable purposes of Help Our Community Ltd. The JR Ranch Trust is not a registered charity.

The JR Ranch Trust derives business income of $85,000 in the 2023/24 year from its commercial rental business. The JR Ranch Trust distributes all the income from the business as beneficiary income to Help Our Community Ltd and as a result Help Our Community Ltd, not the JR Ranch Trust, derives the business income.

The beneficiary income derived by Help Our Community Ltd is subject to the test in s CW 42 (and not s CW 41). This outcome arises because the beneficiary income is income derived from a business carried on exclusively for the benefit of a charity (Help Our Community Ltd). This outcome arises even though the business income is derived by an entity (Help Our Community Ltd) different to the entity conducting the business (JR Ranch Trust).

Help Our Community Ltd is taxable on the business income of $85,000. As in **Example | Tauira 10**, this outcome arises because the JR Ranch Trust (the entity carrying on the business) is not a registered charity at the time the income is derived. This outcome arises even though the income is derived by a registered charity (Help Our Community Ltd) from a business carried on exclusively for a charity (Help Our Community Ltd).

Example | Tauira- 12 - Business income distributed to a registered charity by an entity that is a registered entity

The facts in this example are the same as in **Example | Tauira 11** except that the JR Ranch Trust is also a registered charity.

The $85,000 will be exempt income of Help Our Community Ltd (subject to it satisfying the control restriction). This outcome arises because:

- Its charitable purposes are limited to New Zealand.
- The income is derived by a registered charity (Help Our Community Ltd) from a business carried on by a registered charity (the JR Ranch Trust).

The charity carries out charitable purposes in New Zealand

88. Business income to which s CW 42 applies is exempt from tax only if the charity deriving the income carries out its charitable purposes in New Zealand (s CW 42(1)(a)). Before considering what is required for a charity to satisfy this requirement, it is necessary to consider the meaning of "charitable purpose" and "in New Zealand".

Meaning of "charitable purpose"

89. "Charitable purpose" is defined in s YA 1:

> **charitable purpose** includes every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community, and—
>
> (a) the purpose of a trust, society, or institution is charitable under this Act if the purpose would meet the public benefit requirement apart from the fact that the beneficiaries of the trust, or the members of the society or institution, are related by blood:
>
> (b) a marae has a charitable purpose if—
>
> (i) the physical structure of the marae is situated on land that is a Māori reservation referred to in Te Ture Whenua Māori Act 1993 (the Māori Land Act 1993); and
>
> (ii) the funds of the marae are not used for a purpose other than the administration and maintenance of the land and of the physical structure of the marae, or are used for a purpose that is a charitable purpose

90. The charitable purpose test is the same as the test in the Charities Act 2005.

Meaning of "in New Zealand"

91. In most cases it will be clear from the rules of a charity whether it has charitable purposes "in New Zealand". However, there can be situations where what makes up the boundaries of the country are in issue.
92. The Act defines "New Zealand" inclusively (but not exhaustively) in s YA 1 as including the continental shelf and the water and air space above the continental shelf that is beyond New Zealand's territorial sea (subject to some limitations).
93. To find a definition of "New Zealand" in terms of what it would commonly be thought of as including, it is necessary to refer to s 13 of the Legislation Act 2019, which provides:

> **New Zealand** or similar words referring to New Zealand, when used as a territorial description,—
> (a) means the islands and territories within the Realm of New Zealand; but
> (b) does not include the self-governing State of the Cook Islands, the self-governing State of Niue, Tokelau, or the Ross Dependency

94. The Legislation Act 2019 applies to the Income Tax Act 2007 unless the latter provides otherwise or the context of the legislation requires a different interpretation (s 9 of the Legislation Act 2019). In the Commissioner's view, the Income Tax Act 2007 does not provide otherwise and, for the purposes of s CW 42, does not indicate a different context in terms of overriding the effect of s 9 of the Legislation Act 2019.
95. In the Commissioner's view, the Legislation Act 2019 definition of "New Zealand" applies to s CW 42. Importantly, the definition in s 13 of the Legislation Act 2019 does not include the Cook Islands, Niue, Tokelau or the Ross Dependency in the meaning of "New Zealand".
96. This means "New Zealand" in s CW 42 includes what is commonly understood to be included in this geographical term. That is, it includes the North, South, Stewart, Chatham and Kermadec Islands and all other territories, islands and islets in the geographical areas set out in the New Zealand Boundaries Act 1863 (UK) and the preamble of the Kermadec Islands Act 1887.

Carrying out charitable purposes in New Zealand

97. A charity's rules and where its purposes are actually carried out are relevant in determining whether a charity has a charitable purpose in New Zealand. The Commissioner's view is that a charity carries out its charitable purposes in New Zealand if:
    - any of its purposes are required to be carried out in New Zealand; or
    - any of its purposes are not required to be carried out exclusively outside New Zealand; **and**
    - the charity, at least in part, actually carries out its purposes in New Zealand.
98. Whether a charity has a charitable purpose in New Zealand is a question of fact.
99. The New Zealand courts considered whether a charitable entity's charitable purposes were in or outside New Zealand in *Case T50* (1998) 18 NZTC 8,346 (TRA). This case considered provisions in earlier income tax legislation corresponding to what is now s CW 42. The case law indicates the following principles are relevant to the question of where a charity's charitable purposes are carried out:
    - The geographical location of where a charity's funds are spent or paid does not determine whether its charitable purposes are for purposes in or outside New Zealand.
    - Spending money outside New Zealand for charitable purposes in New Zealand is not sufficient to consider a charity to be carrying out charitable purposes outside New Zealand. Conversely, spending money in New Zealand for charitable purposes overseas is not sufficient to consider a charity to be carrying out charitable purposes in New Zealand.
    - A charity can carry out its charitable purposes by making a donation to a charitable object. In determining whether a donation is for purposes in or outside New Zealand, a New Zealand court might look at:
        - the charitable purposes of the recipient of the donation;
        - any agreement or understanding between the parties as to the use of the donated funds; and/or
        - how the recipient of the donation actually uses the donated funds.

100. The Commissioner's view is that the phrase "in New Zealand" relates to where the purposes are carried out or achieved, rather than to where the funds are applied or spent. This means the geographic location of where funds are spent is not relevant. This view is consistent with the Commissioner's interpretation of the phrase "within Zealand" in s LD 3(2)(a) set out in **IS 18/05:** Income tax – donee organisations – meaning of wholly or mainly applying funds to specified purposes within New Zealand, *Tax Information Bulletin* Vol 30, No 10 (November 2018): 25 and **IS 18/05 FS:** *Fact sheet – Applying the "safe harbour" approach* (Inland Revenue, 2018).

101. Example | Tauira 13 illustrates the situation of a charity with a charitable purpose in New Zealand.

Example | Tauira 13 - Charity with a charitable purpose in New Zealand

The WH Homes Trust is a registered charity. Its trust deed provides that its charitable purpose is improving the lives of children in New Zealand and the Pacific Islands. It does this by helping people to build warm and healthy homes.

The trust carries on a commercial rental business. The income from this business funds its charitable purposes.

In its 2023/24 year, the WH Homes Trust derives business income of $150,000, which it accumulates.

In prior years, the trust assisted in building homes in New Zealand and the Pacific Islands.

The WH Homes Trust is working out whether the business income it derives in its 2023/24 year is exempt under s CW 42. In particular, whether it satisfies the requirement in s CW 42(1)(a) that it carries out its charitable purposes in New Zealand.

The WH Homes Trust has a charitable purpose in New Zealand and accordingly satisfies the requirement in s CW 42(1)(a). Its trust deed provides that it has a purpose of improving the lives of children in New Zealand and it has helped people to build warm and healthy homes in New Zealand.

As the charitable purposes of the WH Homes Trust are not limited to New Zealand, it needs to consider what proportion of its business income, if any, derived in the 2023/24 year is taxable. For further discussion of how a charity does this, see from [121].

102. Business income derived by a charity with only overseas charitable purposes is fully taxable.

The charity must be a "tax charity"

103. Under s CW 42(1)(b), the charity seeking to apply the exemption in s CW 42 to business income it derives must be a "tax charity". "Tax charity" is defined in s CW 41(5) and includes registered charities and non-resident charitable entities (non-resident tax charities) the Commissioner approves as tax charities:[14]

Definition

(5) **Tax charity** means,—

(a) a trustee, a society, or an institution, registered as a charitable entity under the Charities Act 2005:

(b) a trustee, a society, or an institution (the **entity**), that—

(i) has started, before 1 July 2008, to take reasonable steps in the process of preparing an application for registering the entity as a charitable entity under the Charities Act 2005; and

(ii) intends to complete the process of preparing an application described in subparagraph (i); and

(iii) has not been notified by the Commissioner that the entity is not a tax charity:

(c) a trustee, a society, or an institution, that is or are non-resident and carrying out its or their charitable purposes outside New Zealand, and which is approved as a tax charity by the Commissioner in circumstances where registration as a charitable entity under the Charities Act 2005 is unavailable:

(d) a person who is removed from the register, in the period starting with the day they are registered on the register and ending with the earlier of the following days:

(i) the day on which the person does not comply with the person's rules contained in the register:

(ii) the day of final decision.

14 For information on how to apply for an exemption as a non-resident tax charity, see **"Te tono i tētahi aweretanga hei kaupapa atawhai kainoho-tāwāhi: Apply for an exemption as a non-resident charity"** (webpage, Inland Revenue, last updated 15 November 2022).

104. For the purposes of this statement, the relevant part of the "tax charity" definition is the requirement that the trust, society or institution be registered as a charitable entity under the Charities Act 2005. This statement does not consider how s CW 42 may apply to business income derived by a non-resident tax charity. The Commissioner assumes most non-resident tax charities do not carry on business in New Zealand. If a non-resident tax charity derives New Zealand sourced business income, it is likely to be fully taxable as a result of the requirement in s CW 42(1)(aa) not being met.

Control restriction

105. Section CW 42(1)(c) requires that no person with some control over the business can direct or divert income from the business to the benefit or advantage of a person other than the charity (or charities) for whose benefit the business is carried on, except for a purpose of the charity (or charities). It follows that a charity does not breach the control restriction when it is able to divert amounts from its subsidiary's business to its own (charitable) benefit.[15]

106. Section CW 42(5) to (9) expands on the control restriction with further detail on when:

- a person is treated as having some control over the business and able to direct or divert amounts from the business; and
- a benefit or advantage arises to a person.

107. As discussed at [17] this statement does not consider the control restriction in detail. If a tax charity breaches the control restriction, all of the business income it derives is taxable. As the control restriction always applies, it is important that a tax charity that derives business income monitors its compliance with the control restriction on an ongoing basis.

15 ***Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Bill*** (Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill, June 2015), at 94.

Part Three: The territorial restriction

108. As described from [88], for a tax charity's business income to be exempt under s CW 42, it must carry out its charitable purposes in New Zealand. However, where a tax charity's charitable purposes are not limited to New Zealand, s CW 42(4) requires it to identify a basis for splitting its business income relative to its charitable purposes in New Zealand and those outside New Zealand. Only the part apportioned for tax purposes to the charitable purposes in New Zealand is exempt income.
109. Section CW 42(4) states:

> For the purposes of subsection (1)(a), if the charitable purposes of the trust, society, or institution are not limited to New Zealand, income derived from the business in a tax year is apportioned reasonably between those purposes in New Zealand and those outside New Zealand. Only the part apportioned to the New Zealand purposes is exempt income.

No apportionment required if a tax charity's charitable purposes are limited to New Zealand

110. If a tax charity's charitable purposes are limited to New Zealand, all the business income it derives is exempt from tax (subject to it satisfying the control restriction). A tax charity's charitable purposes are limited to New Zealand if:
    - its rules state its purposes are limited to New Zealand; and
    - its charitable purposes are in fact limited to New Zealand.
111. In *CIR v Dick* (2001) 20 NZTC 17,396 (HC), the court looked to the trust deed of the foundation to determine whether its charitable purposes were limited to New Zealand. The court concluded that nowhere in the trust deed was it stated that the purposes of the foundation were limited to New Zealand, so the territorial restriction applied.[16]
112. In some cases, a tax charity's rules will not contain a territorial restriction to New Zealand but 100% of its charitable purposes are directed to New Zealand. In these cases, a tax charity can treat all the business income it derives in the relevant annual period as exempt (subject to the tax charity satisfying the control restriction) if:
    - in that period and all prior periods, the tax charity has carried out its charitable purposes only in New Zealand; and
    - the tax charity does not intend to extend its charitable purposes outside New Zealand in the future.
113. While a tax charity's charitable purposes are not limited to New Zealand where it has carried out charitable purposes overseas in the past, what constitutes a reasonable apportionment of business income between charitable purposes in and outside New Zealand depends on the particular facts.

16 On appeal of *Case T50* (discussed at [98]).

114. Example | Tauira 14 illustrates a situation where a tax charity's charitable purposes are limited to New Zealand.

Example | Tauira 14 - Charitable purposes limited to New Zealand

The Ongoing Education for Good Trust (OEGT) is a registered charity. Its trust deed states its purpose is to provide guidance and emotional support to people seeking to re-enter the education system. Funding for its charitable activities comes from several sources, including a coffee van business.

OEGT works out of offices in Wellington. Using relationships built with local schools and through local advertising, it provides guidance and emotional support to people in Wellington and the surrounding areas.

OEGT does not intend to extend its charitable purposes outside New Zealand. The plan for the future operation of OEGT shows that it intends to continue to focus on providing guidance and emotional support to people in Wellington and the surrounding areas.

OEGT can treat all of the income it derives from its coffee van business as exempt (subject to it satisfying the control restriction) on the following basis:

- It has carried out its charitable purposes only in New Zealand.
- It does not intend to extend its charitable purposes outside New Zealand in the future.

If OEGT's intentions change, it will need to reasonably split its business income between its charitable purposes in New Zealand and those outside New Zealand. Only business income allocated to its charitable purposes in New Zealand is exempt under s CW 42.

115. Conversely, if a tax charity's charitable purposes are in fact limited to overseas purposes, despite its rules not limiting its charitable purposes to overseas, all of its business income derived in the relevant annual period is fully taxable. Example | Tauira 15 illustrates this situation.

Example | Tauira 15 - Overseas charitable purposes only

The Storylight Trust is a registered charity. Its trust deed states its purpose is to increase computer literacy by providing computers to communities in need. Funding for its charitable purpose comes from its farming business.

Since it was established, the Storylight Trust has provided computers to communities in the Pacific Islands only. Further, the Storylight Trust has no intention to provide computers to communities in New Zealand in the future.

The Storylight Trust must treat all of the income it derives from its farming business as taxable income on the following basis:

- It has carried out its charitable purpose overseas only.
- It does not intend to carry out charitable purposes in New Zealand in the future.

If the Storylight Trust's intentions change, some of its business income may be exempt in the future.

Tax charity donations for charitable purposes outside New Zealand

116. In some cases, a tax charity that previously has carried out charitable purposes only in New Zealand will carry out charitable purposes outside New Zealand. These situations often arise where a tax charity makes a donation in response to an unexpected event such as a natural disaster that occurs outside New Zealand.

117. As discussed at [99], a tax charity can carry out its charitable purposes by making a donation to a charitable object. The Commissioner considers a tax charity that donates to charitable purposes outside New Zealand is itself carrying out charitable purposes outside New Zealand and will need to reasonably split its business income between its charitable purposes in New Zealand and those outside New Zealand.

118. It has been suggested that a charity does not carry out charitable purposes outside New Zealand as a result of donating to a charity listed in sch 32 ("sch 32 entity"). The confusion arises from an incorrect assumption that the special donation tax credit status given to a sch 32 entity somehow extends to the classification of a charity's donation to those entities.[17]

17 The availability of tax benefits for a donation is limited to charities whose funds are applied wholly or mainly to charitable purposes in New Zealand (see s LD 3(2)(a)). Charities whose charitable purposes are outside New Zealand (or mostly outside New Zealand) and who want their donors to be eligible for the donation tax credit must be approved for overseas donee status and listed in sch 32.

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119. When determining whether a donation a tax charity makes is for purposes in or outside New Zealand, the charitable purposes of the recipient of the donation are relevant. Where the recipient of the donation is a sch 32 entity, its charitable purposes are likely to be carried out entirely, or mostly, outside New Zealand. It follows that in most cases where a tax charity donates to a sch 32 entity, the tax charity will be carrying out charitable purposes outside of New Zealand. However, not all donations a tax charity makes to a charity with some overseas purposes will be for those overseas purposes. For example, where the tax charity and recipient of the donation agree that the donation is for the recipient's New Zealand charitable purposes. That is, the donation is expressly "tagged" for New Zealand charitable purposes.

120. Example | Tauira 16 and Example | Tauira 17 illustrate the principles described above.

Example | Tauira 16 - Donation by a charity to a charitable object

The Forever Good Books Trust is a registered charity. Its trust deed provides that its charitable purpose is to advance education and make education more effective and accessible. It provides study materials and books to people in its local area, particularly in impoverished areas. Its trust deed permits the trustees to provide support to other registered charities whose work advances education.

In response to a humanitarian crisis in Tonga, the Forever Good Books Trust makes a $10,000 donation to Learning for Good Ltd. Learning for Good Ltd is a New Zealand incorporated company and a registered charity. Learning for Good Ltd's charitable purpose is to advance education in Tonga.

It follows that the Forever Good Books Trust carries out charitable purposes in and outside New Zealand. This outcome arises because the Forever Good Books Trust has donated for a charitable purpose outside New Zealand. Even though the Forever Good Books Trust has donated to a New Zealand company that is a registered charity, the donation is to advance education in Tonga.

Example | Tauira 17 - Donation by a charity to a sch 32 entity

The GAP Trust is a registered charity. Its charitable purpose is to promote religion, and its activities include providing religious services to its local community in New Zealand.

In response to an overseas humanitarian crisis the GAP Trust donates an amount to an overseas charity listed in sch 32. The purposes of the overseas charity are limited to outside New Zealand.

That the GAP Trust's donation is to a charity listed in sch 32 does not prevent the conclusion that the GAP Trust is, as a result of the donation, carrying out charitable purposes outside of New Zealand.

It follows that the GAP Trust carries out charitable purposes outside New Zealand. This outcome arises because the GAP Trust has donated for a charitable purpose outside New Zealand.

General principles for splitting business income

121. Where a tax charity's charitable purposes are not limited to New Zealand, the income derived from the business in the relevant annual period must be "apportioned reasonably between those purposes in New Zealand and those outside New Zealand".

122. The Commissioner considers that the purpose of s CW 42 is to exempt business income a tax charity derives to the extent that the income can be apportioned, on a reasonable basis, to the tax charity's charitable purposes carried out in New Zealand.

123. A tax charity is required to identify a basis for splitting its business income relative to its charitable purposes in New Zealand and outside New Zealand. Section CW 42(4) does not provide any guidance on how a tax charity's business income should be reasonably split between its charitable purposes in New Zealand relative to those outside New Zealand. In the absence of any specific guidance, a tax charity should be guided by the following general principles:

- A tax charity's split of its business income between charitable purposes in and outside New Zealand does not need to be exact to the last dollar, but it must reflect what an objective person would consider is reasonable in the circumstances (*Buckley & Young v CIR* (1978) 3 NZTC 61,271 (CA) and *Omihi Lime Co Ltd v CIR* [1964] NZLR 731 (HC)).
- Whether the split of business income in the relevant annual period is reasonable depends on the relevant facts and circumstances.

- All relevant factors need to be considered when determining a reasonable basis for splitting business income. The taxpayer has the burden of proving the split of its business income is reasonable (*Buckley & Young*).

124. Accordingly, a tax charity has some flexibility in how it approaches splitting its business income.

Approaches to splitting business income

125. A number of possible approaches to splitting business income are described from [127]. A tax charity can take an approach that is different to those described, provided that approach results in business income being apportioned, on a reasonable basis, between its charitable purposes in and outside New Zealand.

126. In the absence of a material change in a tax charity's operations the Commissioner's view is that once a tax charity determines an approach that is reasonable that same approach can be used each year. A tax charity might change its apportionment approach. For example, in response to a material change in the way it operates. Where a tax charity changes its approach, the new approach must also be one that results in business income being apportioned, on a reasonable basis, between its charitable purposes in and outside New Zealand.

Level of support provided to each purpose

127. In *CIR v Dick*, the court concluded that one reasonable basis for splitting business income is to examine the actual level of support provided to each purpose during the relevant annual period. In that case, the court examined the application of the foundation's funds to its charitable purposes.

128. However, a tax charity can determine the level of support provided to each purpose in several ways. For example, it could determine the level of support based on time spent on each purpose or the level of resources dedicated to each purpose. Example | Tauira 18 illustrates one way of splitting business income based on the application of a tax charity's funds to its charitable purposes.

Example | Tauira 18 - Splitting business income based on donated funds

The Feeding the World Trust is a registered charity. Its trust deed states that its charitable purpose is to reduce food poverty among children. It does this by providing donations to charitable entities that run programmes to produce food for or provide it to children in areas where children are receiving inadequate food. Funding for its charitable activities comes from its second-hand clothing business and donations from the public.

Its trust deed does not restrict its business income for charitable purposes in New Zealand.

At the end of each year, the Feeding the World Trust donates its surplus funds (business income and donations) to various other charities.

The Feeding the World Trust works out that in the current year, it donated 75% of its funds to an organisation that runs a school breakfast club for several New Zealand schools. It donated the remaining 25% of its funds to an organisation that runs school breakfast clubs in Australia.

One reasonable way of splitting its business income in the current year is to treat 75% of the business income as exempt and 25% as taxable, on the basis that 75% of its donations were for charitable purposes in New Zealand and 25% for overseas purposes.

Application of funds to charitable purposes in New Zealand

129. As described at [127], in *CIR v Dick* the court examined the application of the foundation's funds to its charitable purposes. Interestingly, the extent to which a registered charity applies its funds to its charitable purposes within New Zealand is also relevant in the context of s LD 3(2)(a).

130. To qualify as a donee organisation under s LD 3(2)(a), an entity must be:

> a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable … purposes within New Zealand:[18]

18 The scope of s LD 3(2) is not limited to organisations whose funds are applied wholly or mainly to charitable purposes within New Zealand. Section LD 3(2) also applies to organisations whose funds are applied wholly or mainly to benevolent, philanthropic or cultural purposes within New Zealand. However, as s CW 42 is limited to business income derived by a tax charity, this interpretation statement focuses on how the test in s LD 3(2)(a) applies to charities.

131. Some registered charities deriving business income will have "donee organisation" status and will be familiar with s LD 3(2)(a) and the Commissioner's position on how this section applies. The Commissioner's position on what is the meaning of "wholly or mainly" applying funds to specified purposes within New Zealand is set out in IS 18/05.
132. Broadly, to determine if the "wholly or mainly" requirement in s LD 3(2)(a) is satisfied, an entity following the approach in IS 18/05 looks at the funds (cash on hand) it applies over a discrete period of time, such as a year, and then from year to year to determine what percentage of those funds is applied to, in this case, charitable purposes in New Zealand.
133. A tax charity applying the approach in IS 18/05 is required to consider how its funds are put to use. Tax charities commonly apply funds by spending them on goods or services in the course of carrying on some activities, accumulating them for future spending or donating them to another organisation. A tax charity must identify objectively whether a sufficient relationship exists between the purposes served by the actual or proposed activity and advancing charitable purposes in New Zealand.
134. In the Commissioner's view, a tax charity can use the current year calculation of the proportion of funds applied to New Zealand (not the revised calculation based on the current year and 2 preceding years which a tax charity is able to use in the context of s LD 3(2)(a) in certain circumstances) to determine the extent to which its charitable purposes are carried out in New Zealand, thereby providing a reasonable basis to split its business income relative to its charitable purposes in and outside New Zealand. Example | Tauira 19 illustrates this approach.

Example | Tauira 19 - Splitting business income based on the percentage of funds calculated to satisfy the "wholly or mainly" requirement

ASJ Hope Ltd is a company established to provide food to people who need assistance following disasters. ASJ Hope Ltd provides food parcels in New Zealand, Australia and the Pacific Islands. ASJ Hope Ltd is a registered charity and is on Inland Revenue's list of approved charities.

ASJ Hope Ltd funds its operations through donations from the public, funds from the investment of donations and income from its bookshop business. In its 2023/24 year, based on the approach outlined in IS 18/05 it determines that it has applied 79% of its total funds to charitable purposes in New Zealand.

ASJ Hope Ltd derives business income of $18,000 in its 2022/23 year.

ASJ Hope Ltd treats 79% of its business income ($14,220, being 79% of $18,000) as exempt and 21% ($3,780, being 21% of $18,000) as assessable income. The outcome of this approach is that in 2022/23, $14,220 of its $18,000 business income will be exempt.

Split based on historical purposes

135. Section CW 42 is a test applied annually to business income derived in the relevant annual period. However, a tax charity carries out its charitable purposes on a continuing basis over its lifetime.
136. There may be situations where a tax charity can, based on an analysis of where it has carried out its charitable purposes in the past (New Zealand versus overseas), determine a percentage split that reasonably reflects the extent to which it carries out its charitable purposes in New Zealand. The tax charity could then use the same percentage to split business income it derives in future years.
137. A tax charity that took this approach would need to assess, annually and over time, whether the percentage it was using remained reasonable.

Funding overseas purposes with amounts not subject to the test in s CW 42

138. A tax charity that derives business income in the relevant annual period may, in that same period, derive other amounts that are not subject to the test in s CW 42 (eg non-business income and capital amounts). In some cases, these other amounts are equal to or more than the amount a tax charity directs to its charitable purposes outside New Zealand in the relevant annual period.
139. A question arises as to whether the territorial restriction applies to a tax charity in this situation. The Commissioner's view is that the territorial restriction does apply in this situation because the tax charity's charitable purposes are not limited to New Zealand.
140. The question then is what is a reasonable split of the tax charity's business income between its charitable purposes in and outside New Zealand?

141. It has been suggested that it is reasonable for a tax charity to allocate all its business income to its charitable purposes in New Zealand where its non-business income or capital receipts equal or exceed the amount the tax charity directs to its charitable purposes outside New Zealand in the relevant annual period. The arguments in support of this approach are that it reduces compliance costs and provides greater certainty.
142. The Commissioner's view is that the mere existence of non-business income or capital receipts does not mean that such an apportionment would be reasonable. However, there may be situations where it is reasonable to allocate all of a tax charity's business income to charitable purposes in New Zealand despite the tax charity carrying on charitable purposes in and outside New Zealand.
143. Two examples of situations where in the Commissioner's view it would be reasonable to allocate all of a tax charity's business income to charitable purposes in New Zealand, are discussed below.
144. The first situation is where **both** of the following requirements are satisfied:
    - A tax charity's trust deed or other rules restrict (ring fence) its business income for its charitable purposes in New Zealand.
    - There is appropriate tracking of a tax charity's business income to demonstrate that it is restricted to charitable purposes in New Zealand.
145. A tax charity might demonstrate the tracking of business income by having it in a separate account (or sub account). Example | Tauira 20 illustrates a charity's business income that is restricted to charitable purposes in New Zealand.
146. The second situation is where a tax charity carries out its charitable purposes in New Zealand but also donates overseas from time to time or occasionally and it can identify that the donations were sourced from amounts other than business income. Example | Tauira 21 illustrates this situation.

Example | Tauira 20 - Charity's business income is restricted to charitable purposes in New Zealand

The Panther Trust is a registered charity. Its trust deed provides that its charitable purpose is to benefit youth in the community by providing financial assistance to further education through team sporting activities. Further, its trust deed provides that any business income it derives is to be used for its New Zealand charitable purposes only.

The Panther Trust tracks its business income by holding it in an account separate from the account that contains other amounts it receives such as non-business income and capital amounts.

In the 2023/24 year, the Panther Trust derives business income of $200,000 and a non-taxable capital gain on the sale of one of its buildings of $150,000.

In 2023/24 it provides grants to several New Zealand schools and donates $100,000 to an organisation that provides grants to schools in Fiji to purchase sporting equipment. The donation is made from a different account to the account holding its business income.

In this case it is reasonable for the Panther Trust to treat all of its business income as exempt on the basis that all its business income is for charitable purposes in New Zealand.

Example | Tauira 21 - Charity's overseas purposes sourced from amounts other than business income

The Onward Trust is a registered charity. It provides religious services and pastoral care to its local community in New Zealand. Its trust deed does not limit its charitable purposes to New Zealand.

The Onward Trust derives business income. Its trust deed does not provide for its business income to be ring-fenced for its charitable purposes in New Zealand.

The Onward Trust carries out its charitable purposes in New Zealand. Occasionally it donates overseas in response to natural disasters that occur outside New Zealand. It does not carry out other overseas charitable purposes.

The funds for the donation come from the local community who donate to the Onward Trust in response to the particular natural disaster. The Onward Trust keeps records of the donation amounts received from the community and donates this amount to the overseas charitable purposes.

In this case it is reasonable for the Onward Trust to treat any business income it derives as exempt on the basis that all its business income is for charitable purposes in New Zealand.

However, in the Commissioner's view this approach will not result in business income being apportioned on a reasonable basis between the Onward Trust's charitable purposes in and outside New Zealand if it also had other overseas charitable purposes. This is the case even if the only overseas charitable purpose carried out by the Onward Trust in the relevant annual period is an overseas donation funded from amounts received from the community for that purpose.

147. The same principles illustrated in Example | Tauira 21 might apply in other situations. For example, where a tax charity's overseas purposes are funded from grants.

Change in charitable purposes

148. In some cases, a tax charity will split its business income based on its intention to carry out charitable purposes in or outside New Zealand. An issue arises as to what a tax charity should do if that intention changes.

149. For example, the Commissioner understands it is common for a tax charity to accumulate money with the intention of directing that money towards charitable purposes in the future. The reason for accumulating money varies; for example, it may be to:

- build up money to carry out a large project;
- establish a pool of money that the tax charity will use to make donations or grants in the future; or
- re-invest into the business so the tax charity potentially has more money available to carry out its charitable purposes in the future.

150. The High Court in *CIR v Dick* recognised that the retention of funds is a complicating factor when a charity's method for splitting its business income between charitable purposes in and outside New Zealand is based on the charity's historical application of its funds (see the discussion of that decision at [127]). The High Court states that if the charity made an apportionment based on the historical distribution pattern but applied the trust funds in the future for purposes outside New Zealand, an apportionment would be justified to take that changed position into account. This could be apportionment of either current income or "(to the extent possible) the reopening of returns and apportionment of past business income".

151. A question arises as to the circumstances in which a change of intention would require a prior period return to be re-opened (or if the tax charity did not file a return in the prior period, would require it to file a return).

152. A tax charity has the burden of proving that its split of business income in the relevant annual period is reasonable. If the split of business income is not reasonable the split may be adjusted by Commissioner (with resulting use of money interest and penalties, if applicable).

153. The Commissioner's view is that a change of intention does not necessarily mean a split of business income in a prior period is no longer "reasonable".

154. Where a tax charity treats some or all of its business income as exempt on the basis of its intention to carry out charitable purposes in New Zealand and this intention changes, the outcome is that the tax charity is carrying out charitable purposes outside of New Zealand. If the original split of business income was reasonable the Commissioner expects that following the change of intention the amount of business income not exempted under s CW 42 will increase.

Splitting deductible business expenses between taxable and exempt business income

155. As this part has described, a tax charity must split its business income based on its charitable purposes in and outside New Zealand (and only that part apportioned for tax purposes to the charitable purposes in New Zealand is exempt income). Under s DA 2(3), a deduction is denied for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income.

156. The outcome of applying the territorial restriction is that a proportion of a tax charity's business income (but not particular income amounts) is assessable income and a proportion is exempt income. A question arises as to how a tax charity determines whether it has incurred its deductible business expenditure in deriving its assessable income or exempt income. Before considering this issue, it is useful to discuss what is meant by "deductible business expenditure".

Deductible business expenditure

157. Under s DA 1(1)(b), a person is allowed a deduction for an amount of expenditure or loss to the extent they incur it in the course of carrying on a business for the purpose of deriving income. For expenditure or loss to be incurred in the course of carrying on a business a sufficient relationship must exist between the expenditure and the business that is being carried on (*CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young*). The type of expenditure and its relevance to the income-earning process are significant factors to consider in deciding whether that relationship exists. This includes looking at how the tax charity earns its business income and the factual situation at the time the expenditure is incurred.

158. A tax charity that derives taxable business income must first determine if there is a sufficient nexus between expenditure or loss it incurs and the carrying on of its business.

159. Section DA 1 allows for deductibility only "to the extent" expenditure is incurred in carrying on a business for the purpose of deriving assessable income. Expenditure or loss incurred by a tax charity that serves both business and other purposes should be apportioned. The general principles for splitting business income discussed at [123] are also relevant here. Apportionment must be reasonable and not arbitrary. The circumstances of a particular case determine the most appropriate method of apportionment.

160. Even where a deduction is available under s DA 1, it may be disallowed under the limitations to deductibility. The limitation most likely to apply to business expenditure is for capital expenditure in s DA 2(1). A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. Whether expenditure is of a capital nature is a factual question that will need to be considered in each case.

161. Example | Tauira 22 illustrates where expenditure is not sufficiently related to a tax charity's business.

Example | Tauira 22 - Expenditure that is not deductible business expenditure

The Triple C Trust is a registered charity. To raise funds for its charitable purposes (the relief of poverty in New Zealand and Australia) it runs a sports equipment rental business.

The Triple C Trust also seeks donations from the public. It does this via a website which explains who the Triple C Trust is and what its charitable purposes are. People who wish to donate are able to do so via the website by pushing the "Donate Now" button. The Triple C Trust does not use the website for its sports equipment rental business.

In the 2023/2024 income year the Triple C Trust incurs $60,000 of expenses in running its sports equipment rental business and website hosting costs of $600.

The $60,000 of expenses incurred by the Triple C Trust in running its sports equipment rental business are deductible business expenditure. However, as the Triple C Trust did not incur the website hosting costs in the course of carrying on its sports equipment rental business, those costs are not deductible business expenditure.

The split of Triple C Trust's deductible business expenditure between its charitable purposes in and outside New Zealand is considered at **Example | Tauira 23**.

If the Triple C Trust had also used the website for its sports equipment business, it would need to work out how much of the website hosting cost is attributable to the business and how much is attributable to seeking donations from the public.

Splitting deductible business expenditure

162. The Commissioner considers that a tax charity can split its deductible business expenses on the same basis that it split its business income between its charitable purposes in and outside New Zealand. Example | Tauira 23 illustrates this approach.

Example | Tauira 23 - Splitting deductible business expenditure on the same basis as business income

The Triple C Trust from **Example | Tauira 22** needs to work out how much tax it should pay on its business income.

The Triple C Trust derived business income of $85,000 in its 2023/24 year and works out that a reasonable basis for splitting its business income between its charitable purposes in and outside New Zealand is 50:50.

The Triple C Trust works out that it incurred deductible business expenses of $60,000 in its 2023/24 year.

The Triple C Trust splits its business income of $85,000 between its charitable purposes in New Zealand ($42,500, being 50% of $85,000) and those outside New Zealand ($42,500, being 50% of $85,000). It splits its deductible business expenses of $60,000 on the same basis. The Triple C Trust can claim deductible expenses of $30,000 (50% of $60,000) against its assessable business income of $42,500 which, results in:

- $12,500 of taxable income; and
- $42,500 of exempt income for which no expense deductions are available.

163. Depending on the level of a tax charity's deductible business expenditure in a relevant annual period, a tax charity might have net income or a net loss from its business activities.[19]

INTERPRETATION STATEMENT

19 In certain circumstances and if particular criteria are met, the losses from a tax charity's business income can be carried forward and offset against taxable business income arising in a subsequent income year.

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https://www.ird.govt.nz/roles/not-for-profits-and-charities/types-of-nfps/charities/tax-exemptions-non-res/apply

TECHNICAL DECISION SUMMARY

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TDS 24/18: Restructuring a group of companies

Decision date | Rā o te Whakatau: 15 March 2024

Issue date | Rā Tuku: 10 October 2024

Subjects | Kaupapa

The establishment of a limited partnership to hold the shares in a holding company. The longform amalgamation of the holding company and one of its subsidiaries under Part 13 of the Companies Act 1993, with the subsidiary remaining as the amalgamated company. The distribution by the holding company of cash and shares in subsidiary companies on amalgamation as consideration for the cancellation of its shares.

Taxation laws | Ture take

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Summary of facts | Whakarāpopoto o Meka

1. The arrangement was the restructure of a group of companies (the Group). The restructure included:
   - The establishment of a limited partnership (LP) to hold the shares in the Group's holding company (Hold Co).
   - The long-form amalgamation of Hold Co and one of its subsidiaries (Sub 1) under Part 13 of the Companies Act 1993 (CA 93), with Sub 1 remaining as the amalgamated company.
   - The distribution by Hold Co of cash and shares in subsidiary companies to the LP on amalgamation as consideration for the cancellation of its shares.
2. The shareholders of the Group decided to move from a holding company structure to a limited partnership structure. Hold Co had investments in a number of companies. Those shareholdings were long term investments. However, the shareholders of the Group wished to be able to access capital gains should any of the investment companies be sold or wound up. The shareholders considered this was not possible without the liquidation of Hold Co.

Issues | Take

3. The main issues considered in this ruling were:
   - Whether an amalgamation is a "liquidation" as defined in s YA 1.
   - What was the first step "on liquidation" for the purpose of s CD 26.
   - On amalgamation of Sub 1 and Hold Co, whether the issue of Sub 1 shares to the LP was a dividend.
   - Whether the s CD 26 exclusion applied to cash and shares distributed by Hold Co on amalgamation.
   - Whether Sub 1's subscriptions amount at the time of the amalgamation under s CD 43(15) would be equal to Hold Co's available subscribed capital (ASC) at the time of amalgamation.
   - Whether s BG 1 applied.
   - Whether s GB 1 applied.

Decisions | Whakatau

4. TCO decided that:
   - The removal of Hold Co from the NZ register of companies under the CA 93 on amalgamation of Hold Co and Sub 1, was a "liquidation" as defined in s YA 1.
   - For the purposes of s CD 26, the first step "on liquidation" of Hold Co was the date the shareholders resolved to accept the proposal to amalgamate Hold Co and Sub 1.
   - On amalgamation of Hold Co and Sub 1, the issue of Sub 1 shares to LP was not a distribution of Sub 1 shares by Hold Co or dividend paid by Sub 1 to LP under s CD 4.
   - Under s CD 26, the cash and shares paid in relation to each Hold Co share on amalgamation was not a dividend provided that the amount distributed did not exceed:
     - the "available subscribed capital" per share calculated under the "ordering rule" (as those terms are respectively defined in s YA 1); and
     - the "available capital distribution amount" (as defined in s YA 1) for that share calculated under s CD 44.
   - Sub 1's subscription amount at the time of the amalgamation under s CD 43(15) was equal to the amount of ASC of Hold Co at the time of amalgamation.
   - Section BG 1 did not apply.
   - Section GB 1 did not apply.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Whether an amalgamation was a "liquidation" as defined in s YA 1

5. The issue was whether the amalgamation of Hold Co and Sub 1 was a "liquidation" as defined in s YA 1. This issue was relevant as s CD 26 contains an exclusion from the dividend rules for amounts paid to a shareholder on the liquidation of a company.

Section YA 1 definition of "liquidation"

6. The Tax Counsel Office (TCO) considered that the definition of "liquidation" in s YA 1, paragraph (a), was not exhaustive and it simply referred to the fact that a liquidation included:
   - removal of the company from the register of companies under the CA 93, and
   - termination of the company's existence under any other procedure of NZ or foreign law.
7. In TCO's view, it was not necessary to meet the requirements of both subparagraphs (i) and (ii) of paragraph (a) of the definition of "liquidation". Accordingly, TCO concluded the amalgamation of Hold Co and Sub 1 would result in the "liquidation" of Hold Co (as defined in s YA 1) if Hold Co were removed from the register of companies.

Removal of a company from the register of companies

8. Part 13 of the CA 93 deals with company amalgamations. Sections 225(a) and (c) provide that the amalgamation is effective on the date shown in the certificate of amalgamation and the Registrar must remove the amalgamating company from the NZ register.
9. Part 17 of the CA 93 deals with the removal of companies from the NZ register. Section 318 of the CA 93 sets out the grounds for removal from the register. In particular, s 318(1)(a) provides that the Registrar must remove a company from the NZ register if the company is an amalgamating company, other than the amalgamated company.
10. TCO considered that the removal of a company from the register of companies pursuant to ss 225(c) and 318(1)(a) of the CA 93 would be a "liquidation" as defined in s YA 1.

Conclusion

11. Accordingly, TCO concluded the removal of Hold Co from the NZ register of companies on amalgamation of Hold Co and Sub 1, was a "liquidation" as defined in s YA 1, being the "removal of the company from the register of companies under the Companies Act".

Issue 2 | Take tuarua: What was the first step "on liquidation" for the purpose of s CD 26?

12. The issue was whether, for the purposes of s CD 26, the first step "on liquidation" of Hold Co would be the date the shareholders resolved to accept the proposal to amalgamate Hold Co and Sub 1.
13. TCO had already concluded that the amalgamation fell within paragraph (a)(i) of the s YA 1 definition of "liquidation". The second part of the definition of "liquidation" described when the period of "liquidation" would begin for tax purposes. Among other things, this was important because the Act allowed a company to make taxfree distributions of capital gains to its shareholders "on liquidation" under s CD 26.
14. Paragraph (b)(i) of the s YA 1 definition of "liquidation" states that liquidation includes (in references in this Act to anything occurring on liquidation) anything occurring:
    - during the period that starts with a step that is legally necessary to achieve liquidation, including the appointment of a liquidator or a request of the kind referred to in section 318(1)(d) of the CA 93, and
    - for the purpose of enabling liquidation.
15. In TCO's view, the definition in s YA 1(b) was an inclusive rather than an exhaustive definition of "anything occurring on liquidation".
16. In the circumstances of this case, TCO considered that the first step "on liquidation" of Hold Co was the date the shareholders resolved to accept the proposal to amalgamate Hold Co and Sub 1.
17. There were two potential views on what was the first step legally necessary to achieve a long-form amalgamation:
    - A possible view was that the first step legally necessary to achieve a longform amalgamation was the board of each amalgamating company resolving under s 221(1) of the CA 93 that in its opinion the amalgamation was in the best interest of the company, and it was satisfied on reasonable grounds that the amalgamated company would, immediately after the amalgamation became effective, satisfy the solvency test.
    - An alternate view was that the first step legally necessary was the approval referred to in s 221(5) of the CA 93 by:
        - the shareholders of each amalgamating company, under s 106, and
        - if a provision in the amalgamation proposal would, if contained in an amendment to an amalgamating company's constitution or otherwise proposed in relation to that company, require the approval of an interest group, by a special resolution of that interest group.
18. Arguably the step contained in the first possible view was preparatory and did not achieve amalgamation. The fact that the board of directors have passed the resolution referred to in s 221(1) and signed the certificate referred to in s 221(2) of the CA 93, did not guarantee that the amalgamation would commence/proceed as the necessary resolutions referred to in s 221(5) may not actually pass.
19. TCO considered the alternative view was more likely to be the first step legally necessary to achieve a long-form amalgamation. In terms of the sequence of events described in s 221 of the CA 93, the approval referred to in s 221(5)) necessarily occurred after the resolution by the board of each amalgamating company under s 221(1). Further, the shareholder resolution to accept the amalgamation proposal was made to achieve the amalgamation and not for any other purpose.
20. Accordingly, TCO concluded that, for the purposes of section CD 26, the first step "on liquidation" of Hold Co would be the date the shareholders resolved to accept the proposal to amalgamate Hold Co and Sub 1.

Issue 3 | Take tuatoru: Whether the issue of Sub 1 shares to the LP was a dividend

21. The issue was whether the issue of Sub 1 shares to the LP was either:
    - a distribution of Sub 1 shares by Hold Co; or
    - a dividend paid by Sub 1 to LP
22. Sections CD 4 to CD 6 are relevant in determining whether a dividend has been paid under the arrangement. TCO considered the following in its analysis:
    - how the shares in the amalgamating companies were treated on amalgamation under the CA 93,
    - whether a transfer of value had taken place,
    - if a transfer of value was found to have occurred, whether it was caused by a shareholding in the company, and
    - whether any of the exclusions in ss CD 22 to CD 37 or variations under the amalgamation rules would apply to the transfer.

Company law – treatment of new Sub 1 shares issued to LP

23. The Taxpayer advised that under the amalgamation, the Sub 1 shares that Hold Co held would be cancelled without consideration under s 220(3) of the CA 93 and new shares would be issued by Sub 1 to LP under s 41 of the CA 93.
24. TCO was satisfied that this appeared to be consistent with s 220(3) of the CA 93 which required the cancellation of shares which an amalgamating company (Hold Co) held in another amalgamating company (Sub 1), without payment or the provision of other consideration.

Transfer of company value

25. Section CD 4(1) provides that a transfer of company value to a person is a dividend if the cause of the transfer is a shareholding in the company. "Transfer of company value" is defined in s CD 5 as occurring when:
    - a company provides money or money's worth to a person, and
    - if the person provides any money or money's worth to the company under the same arrangement, the market value of the what the company provides is more than the market value of what the person provides.
26. In TCO's view, case law indicated that the expression "money or money's worth" required that a benefit be in money or be convertible into money, either directly or indirectly.[1] A benefit would be directly convertible into money where the benefit could be exchanged for a monetary equivalent.[2] For example, shares that were capable of being sold for money would be money's worth.
27. TCO considered Sub 1's new shares would be money's worth. The next step was to determine whether money's worth was provided to LP by either Hold Co or Sub 1.

Was money's worth provided to LP (s CD 5(1)(a))?

28. As Hold Co's shares in Sub 1 were cancelled on amalgamation pursuant to s 220(3) of the CA 93, TCO accepted that factually Hold Co had not provided money's worth in the form of Sub 1 shares to LP. It followed that the issue of new Sub 1 shares was not a transfer of value from Hold Co to LP.
29. The cases reviewed by TCO suggested that an issue of shares involved something leaving the company and being provided to the shareholder. Accordingly, TCO concluded that by issuing shares, Sub 1 was providing money's worth to LP.

Did LP provide money or money's worth (s CD 4(1)(b))?

30. The Taxpayer submitted the issue of shares was not a transfer of value from Sub 1 to LP because it compensated LP for the cancellation of shares in Hold Co. The Taxpayer submitted that s 220(1)(f) and (g) of the CA 93 referred to the process as a conversion of shares. That is, a conversion of LP's shares in Hold Co to shares in Sub 1.
31. However, it was not clear to TCO how the conversion resulted in LP providing money's worth to Sub 1. That is, whether by agreeing to the amalgamation proposal, LP as shareholder of Hold Co has provided Sub 1 with money's worth. Further, TCO considered that under s CD 5(2B), the value of the cancelled Hold Co shares would be zero. Therefore, LP would not be treated as having provided any money or money's worth to Sub 1.
32. Accordingly, TCO considered that the issue of shares by Sub 1 was a transfer of company value from Sub 1 to LP under s CD 5. It followed that the issue of shares would be a dividend if the transfer of company value were caused by a shareholding relationship and none of the dividend exclusion provisions applied.

Is the transfer caused by a shareholding relationship?

33. Section CD 6 provides a transfer of company value will be caused by a shareholding if the recipient holds shares in the company or is associated with a shareholder, and the company makes the transfer because of that shareholding. In this case, the recipient (being LP) did not hold shares in Sub 1 prior to the issue of new shares.
34. Therefore, the issue was whether LP was associated with a shareholder of Sub 1 at the time of the transfer of company value (being the issue of shares).
35. On the basis that Hold Co's shares in Sub 1 would be cancelled, at the time Sub 1's shares were issued, LP would not be associated with a shareholder of Sub 1. Therefore, the transfer of value would not be caused by an existing shareholding in Sub 1.

1 *Tennant v Smith* (1892) 3 TC 158 (HL), *Stagg v CIR* [1959] NZLR 1,252 (HC), *Abbott v Philbin (Inspector of Taxes)* [1960] 2 All ER 763 (HL), *Heaton (Inspector of Taxes) v Bell* [1969] 2 All ER 70 (HL) and *Dawson v CIR* (1978) 3 NZTC 61,252 (SC).

2 *Dawson* at 61,257.

Conclusion

36. TCO concluded that as the transfer of company value (the issue of new shares) by Sub 1 was not caused by a shareholding relationship, the issue of new shares by Sub 1 was not a dividend under s CD 4. As such, TCO did not need to consider whether any of the dividend exclusions contained in ss CD 22 to CD 37 applied.

Issue 4 | Take tuawhā: Whether s CD 26 exclusion applies to cash and shares distributed by Hold Co?

37. Hold Co held investments in a few companies and the issue was how s CD 26 dividend exclusion applied to the cash and shares distributed by Hold Co on amalgamation.

38. Section CD 26 applied when a shareholder was paid an amount in relation to a share on the liquidation of the company. The amount paid was a dividend only to the extent to which it was more than:

    - the available subscribed capital (ASC) per share calculated under the ordering rule; and
    - the available capital distribution amount (ACDA) calculated under s CD 44.

39. As noted above, TCO concluded that the removal of Hold Co from the NZ register of companies under the CA 93 on amalgamation of Hold Co and Sub 1, was a "liquidation" as defined in s YA 1.

40. Given that s CD 26 applied when a shareholder was paid an amount in relation to a share "on the liquidation" of the company, TCO's conclusion above meant that, on the face of it, s CD 26 applied to the distributions that would be made to Hold Co's shareholders on its amalgamation with Sub 1. Under s CD 26 those distributions would not be a dividend in the hands of Hold Co's shareholders to the extent of:

    - the ASC per share calculated under the ordering rule; and
    - the ACDA calculated under s CD 44.

Issue 5 | Take tuarima: Whether Sub 1's subscriptions amount under s CD 43(15) would be equal to Hold Co's ASC at the time of amalgamation

41. As noted above, a company's ASC represents the amount that could be returned to the shareholders free of tax when shares were repurchased (provided certain requirements and a bright line test are met) or the company was liquidated. ASC was calculated for a share in a company at any relevant time (as defined in s CD 43(2)).

42. The ASC was calculated using the formula:

    1 July 1994 balance + subscriptions – returns – look-through company returns

43. All the terms in the formula were defined, but of relevance to this arrangement was the definition of "subscriptions". "Subscriptions" was defined as:

    subject to subsections (6) to (21), is the total amount of consideration that the company received, after 30 June 1994 and before the calculation time, for the issue of shares of the same class (the **class**) as the share, ignoring section HB 1 (Look-through companies are transparent), and including consideration for the issue of shares by the company as a result of the application of section CE 6 (Trusts are nominees)

44. Section CD 43(15) was relevant when calculating the total "subscriptions" amount for an amalgamated company. However, a taxpayer's "subscriptions" amount as determined under s CD 43(15) may not be the taxpayer's total subscriptions amount as defined in s CD 43(2)(b).

Section CD 43(15) "subscriptions amount" for an amalgamated company

45. The "subscriptions" amount in the ASC formula consisted of the consideration received for shares issued, under the definition of "subscriptions" in s CD 43(2)(b). Section CD 43(15) added an additional amount to the "subscriptions" amount of an amalgamated company.

46. Section CD 43(15) provided that the "subscriptions" amount of an amalgamated company included an amount equal to the ASC of all shares in the amalgamating companies except:

    - shares in the amalgamating companies that were held (directly or indirectly) by another amalgamating company (s CD 43(15)(a)(ii)); and
    - shares in the amalgamated company (s CD 43(15)(a)(iii)).

47. As Hold Co was the parent of Sub 1, s CD 43(15)(a)(ii) applied. The effect was that Sub 1's (an amalgamating company where the shares were held by another amalgamating company) ASC was not double counted as it was already included in the subscriptions amount in s CD 43(2)(b). Therefore, assuming the shares in the other amalgamating companies (Hold Co) were of an equivalent class to the Sub 1 shares, s CD 43(15) provided that the subscriptions amount for Sub 1 was uplifted by an amount equal to the ASC of Hold Co at the time of amalgamation.

Conclusion

48. TCO concluded that Sub 1's subscription amount at the time of the amalgamation under s CD 43(15) would be equal to an amount the equivalent of the ASC of Hold Co at the time of amalgamation.

Issue 6 | Take tuaono: Whether s BG 1 applied

49. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. Section GA 1 enables the Commissioner to make an adjustment to counteract a tax advantage obtained from or under a tax avoidance arrangement.
50. The Supreme Court in *Ben Nevis* considered it desirable to settle the approach to applying s BG 1.[3] This approach is referred to as the Parliamentary contemplation test, which is an intensely fact-based inquiry. *Ben Nevis* has been followed in subsequent judicial decisions.
51. TCO's approach in making this decision is consistent with Interpretation Statement: IS 23/01 *Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007* (3 February 2023) (IS 23/01). IS 23/01 will not be replicated in this TDS but in summary the steps are as follows:
    - Understanding the legal form of the arrangement. This involves identifying and understanding the steps and transactions that make up the arrangement, the commercial or private purposes of the arrangement and the arrangement's tax effects.
    - Determining whether the arrangement has a tax avoidance purpose or effect. This involves:
        - Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
        - Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts. Artificiality and contrivance are significant factors.
        - Considering the implications of the preceding steps and answering the ultimate question under the Parliamentary contemplation test: Does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?
    - If the arrangement has a tax avoidance purpose or effect that is not the sole purpose or effect of the arrangement, consider the merely incidental test. The merely incidental test considers many of the same matters that are considered under the Parliamentary contemplation test.
52. Taking into account all of the relevant facts and circumstances (noting that as this is a summary it may not contain all the facts or assumptions relevant to the decision and, therefore, cannot be relied on) the TCO concluded as follows.

Application to the facts – brief overall summary

53. The Arrangement was the steps by which:
    - the shareholders of Hold Co would contribute their shares in Hold Co to LP in exchange for an interest in LP; and
    - Hold Co and Sub 1 would undertake a long-form amalgamation with Sub 1 surviving as the amalgamated company.
54. The relevant tax effects from the Arrangement are:
    - The issue of Sub 1 shares to LP was not a distribution of Sub 1 shares by Hold Co, or a dividend distributed by Sub 1 to LP under section CD 4.
    - On amalgamation Hold Co would distribute to LP its capital gains and shares in its subsidiaries. As an amalgamation fell within the s YA 1 definition of "liquidation", s CD 26 would apply to the distribution.
    - Sub 1's ASC amount on the amalgamation would be equal to the ASC of Hold Co on amalgamation.
    - LP was a transparent entity for income tax purposes and any income, expenditure and capital gains / losses were allocated to the limited partners in accordance with their interest in LP.

3 *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289.

55. TCO noted that Parliament expected that net transfers of value from a company to its shareholders (or those associated with its shareholders) because of the shareholding relationship should be treated as a dividend. There were a limited number of exceptions and restrictions relating to dividends that show Parliament's concern that arrangements could be entered into to recharacterise revenue gains as capital gains and artificially remove the capital gains without genuinely deriving the capital gain or in substance liquidating the company.
56. Following an extensive review of the Taxpayer's submissions, in TCO's view the arrangement did not use the Act in a manner that was contrary to Parliament's purpose for the dividend and liquidation provisions.
57. The commercial reasons for the restructure provided by the Taxpayer were somewhat general in nature. However, TCO considered Parliament's purpose did not appear to have been circumvented.
58. TCO noted the arrangement did not involve a third party and was entirely internally generated. However, TCO considered that the arrangement, when viewed in a commercially and economically realistic way, made use of the liquidation and amalgamation provisions in a manner that was consistent with Parliament's purpose. TCO based its view on the following:
    - Capital gains can be transferred tax free on the liquidation of a company. Parliament has enacted several provisions with the aim of preventing taxpayers from artificially recharacterising retained earnings as capital gains. However, as the arrangement did not result in any uplift in Sub 1's ASC, the arrangement did not appear to provide an advantage and allow for the artificial recharacterisation of retained earnings in the future.
    - The use of a limited partnership as a holding entity in a group structure was not in itself inconsistent with Parliament's intention. The establishment of LP and timing of the restructure appears to some extent driven by a need to overcome a tax issue and not any specific commercial or external activities. The tax issue related to a specific provision (the share for share exchange) that was targeted at preventing companies artificially increasing their ASC. When looking at the arrangement as a whole, the share for share exchange provision had not, in TCO's view, been circumvented as there had not been an ASC uplift.
    - A taxpayer could choose how to undertake a transaction, but the use of the tax provisions must be within what Parliament would have contemplated. An amalgamation was treated as a liquidation for tax purposes. TCO considered it unlikely that Parliament would have intended that applying the amalgamation and liquidation rules would have the effect of circumventing the ASC limitation on share for share exchanges. However, due to the ASC limitation under s CD 43(15), the amalgamation had not resulted in an increase in Sub 1's ASC. It followed that the ASC limitation on share for share exchanges had not been circumvented.
59. The above analysis indicated that it was likely that Parliament would consider that the arrangement made use of the relevant provisions in a manner that was consistent with Parliament's purpose for those provisions. Therefore, TCO considered the arrangement did not have a tax avoidance purpose or effect.
60. As TCO concluded that there was no tax avoidance purpose or effect of this arrangement, it was not necessary to go on to consider whether the arrangement was a "tax avoidance arrangement". Accordingly, TCO concluded that s BG 1 did not apply to the arrangement. It was therefore not necessary to go on to consider the merely incidental test.

Conclusion

61. TCO concluded that s BG 1 would not apply to the arrangement.

Issue 7 | Take tuawhitu: Whether s GB 1 applied

62. Section GB 1 is a specific anti-avoidance rule relating to arrangements involving dividend stripping. The section counteracts tax avoidance arrangements where the vendor of shares in a company can convert future dividends receivable from the company, typically represented by accumulated profits, into a capital gain. The sale of the shares provides the vendor with a tax-free way to extract value from the company.
63. Section GB 1(1) specifies three requirements for the application of the provision:
    - a disposal of shares;
    - the disposal is part of a "tax avoidance arrangement";
    - some or all of the consideration derived from the disposal is in substitution for a dividend.
64. If one (or more) of the three requirements specified in s GB 1(1) was not satisfied, s GB 1 would not apply.

Disposal part of a tax avoidance arrangement

65. In considering whether a "tax avoidance arrangement" existed for the purposes of s GB 1, TCO noted the following factors would be relevant to determining whether a transaction was within the contemplation of Parliament:
    - Parliament expected that an amount would be treated as a dividend where shares were disposed of for a consideration which was in substitution for a dividend that the company would have otherwise paid.
    - This was particularly the case where a company had significant retained earnings or an outstanding shareholder current account (although was not limited to these situations).
    - Even where there were no retained earnings, there might still be future dividend avoidance. This could include situations where a company was expected to be profitable, and a structure was established to ensure that future profits were paid out as capital debt repayments.
    - This was particularly the case where the ultimate holders of shares remained the same and were still enjoying the same economic benefits as before.
66. In TCO's view the arrangement considered for the purpose of s BG 1 was also the appropriate arrangement to consider when applying s GB 1.
67. TCO was of the view that the arrangement was not a "tax avoidance arrangement" for the purposes of s GB 1. In TCO's view, the arrangement did not exhibit any of the usual features that were of concern in the context of s GB 1, or the mischief that s GB 1 sought to address.
68. The arrangement involved forming a limited partnership, LP, as a holding vehicle and the removal of Hold Co from the Group structure.
69. Under the arrangement Hold Co's shareholders would continue to hold economic control over Sub 1. There was no debt back to Hold Co that could be used to extract capital debt repayments. The transaction had not been structured to convert dividends (yet to be) receivable from Sub 1 / Hold Co.
70. Based on the arrangement, the analysis in this Issue of this Summary and the s BG 1 analysis above, it was TCO's view that the arrangement was not a "tax avoidance arrangement". Accordingly, it was TCO's view that the requirement in s GB 1(1)(b) was not met.
71. Given that all three requirements in s GB 1(1) must be met for s GB 1 to apply, it was TCO's view that s GB 1 did not apply to the arrangement.

Conclusion

72. TCO concluded that s GB 1 did not apply to the arrangement.

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