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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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Ref	Draft type	Title	Comment deadline
PUB00495	Interpretation statement	Tax residence – government service rule	11 December 2024
PUB00483	Interpretation statement	Tax residence	11 December 2024
PUB00482	Interpretation statement	Income tax – implications of a residential property moving between the standard tax rules and the mixed-use asset rules	13 December 2024
PUB00462	Question we've been asked	What is the income tax treatment of gift cards and products provided as trade rebates or promotions?	18 December 2024

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FINAL ISSUE FOR 2024

This is the final issue of the Tax Information Bulletin for 2024. The next issue will be in February 2025.

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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 24/09: Income tax – Overdrawn shareholder loan account balances

Issued | Tukuna: 5 November 2024

This interpretation statement considers common tax issues associated with overdrawn shareholder loan accounts held in New Zealand resident close companies.

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

Summary | Whakarāpopoto

1. Shareholder loan accounts are generally informal arrangements between close companies and shareholders that keep track of any advances made between them. When a shareholder draws more money from the company than they have advanced to the company, their shareholder loan account becomes overdrawn.
2. An overdrawn shareholder loan account can give rise to a range of tax issues. Where non-market terms apply to the overdrawn balance such as a low or nil interest rate, the dividend or the fringe benefit tax (FBT) rules may tax the value or benefit received by the shareholder. However, in some instances, the Act permits a retrospective repayment of the amount owing on a shareholder loan account. This concessionary treatment provides more time for companies to calculate and allocate certain shareholder remuneration or dividends towards repaying overdrawn shareholder loan accounts.
3. Alternatively, companies may enter into an agreement with their shareholders to charge interest on the amounts owed by the shareholders at the market rate or the Commissioner's prescribed interest rate, so no dividends or fringe benefits arise. However, this approach may lead to other tax consequences that companies and shareholders should be aware of.
4. Broadly, this statement discusses the following common tax issues associated with an overdrawn shareholder loan account:
    - Dividend income arises for a shareholder where they pay no or low interest on their overdrawn shareholder loan account.
    - FBT liabilities arise when a shareholder-employee pays no or low interest on their overdrawn shareholder loan account.
    - Interest income arises where a company charges interest on an overdrawn shareholder loan account. The timing and quantification of the interest income are generally determined under the financial arrangements (FA) rules, subject to certain concessionary rules for taxpayers who operate on a smaller scale.
    - Where resident withholding tax (RWT) has been withheld from interest payable to a company, the company may claim a tax credit for the RWT. The company may claim the credit in the year in which the interest is derived, provided the RWT has been withheld and paid to Inland Revenue.

- Interest paid by a shareholder on their overdrawn shareholder loan account is generally not deductible to the shareholder. This is because drawings are often applied to fund a shareholder's private or domestic expenditure and therefore the corresponding interest has no nexus to income. However, it is possible that some shareholders may draw money to apply to an income-earning activity or a business. In such cases, they may claim a deduction to the extent the interest relates to the income-earning activity or business, subject to the general limitations. Shareholders should maintain sufficient documentation to support any such interest deduction claims.
- In most cases, a shareholder paying interest on their overdrawn shareholder loan account is not required to withhold RWT from the interest. A withholding obligation may arise for a shareholder who has RWT-exempt status or pays interest in the course of carrying on a taxable activity. However, this is subject to a $5,000 de minimis threshold. In addition, a shareholder does not need to withhold RWT on interest paid to a company that has RWT-exempt status.
- Similarly, in most cases, a shareholder paying interest on their overdrawn shareholder loan account is not required to report information to Inland Revenue under the investment income reporting rules. Reporting is only required for a shareholder who has an RWT withholding obligation or who has no RWT withholding obligations on interest but to whom all of the following apply:
  - The interest is not subject to RWT because it is not paid in carrying on a taxable activity or is exempt under the $5,000 de minimis rule.
  - The shareholder is allowed an income tax deduction for the interest.
  - The interest is paid to a person (ie, the company) who does not have RWT-exempt status.
- Where a shareholder is relieved of their obligation to repay their overdrawn shareholder loan account balance, income will arise under the dividend rules or under the FA rules. Generally, the amount forgiven or remitted is an amount of dividend income for the shareholder. Both the company and the shareholder are also required to calculate a base price adjustment (BPA). This calculation generally means that:
  - the shareholder is not taxed twice under both the dividend and the FA rules; and
  - the amount the company writes off does not produce a deductible negative BPA amount.

Introduction | Whakataki

5. Small businesses that are owned and operated by family members often trade through close companies. Due to the high degree of control a shareholder may exert over a close company, it is often easy for a shareholder to draw company funds for private purposes.
6. However, a close company is a separate legal entity from its shareholders. Funds of a close company are therefore the company's own property, and a shareholder's access to that property has tax implications including those under the:
   - dividend rules;
   - financial arrangements (FA) rules;
   - fringe benefit tax (FBT) rules;
   - resident withholding tax (RWT) rules; and
   - investment income reporting rules.
7. This statement provides general information on common tax issues relating to overdrawn shareholder loan accounts that are:
   - owed to close companies that are resident in New Zealand under New Zealand tax law; and
   - **owed by** shareholders who are **natural persons** and **resident in New Zealand** under New Zealand tax law.[1]
8. Comments in this statement may not apply to overdrawn shareholder loan accounts that are part of a tax avoidance arrangement.

1 Refer to **IS 16/03: Tax residence** for guidance on the residence rules for companies and natural persons under New Zealand tax law.

Key terms

9. **Close company** means a company with five or fewer natural persons or trustees who hold more than 50% of the voting interests or market value interests in the company. All natural persons associated at the time are treated as one person.[2] Many New Zealand companies of various sizes could fall within the definition of a "close company".
10. **FA rules** mean the rules in subpart EW that require parties to a financial arrangement to spread income or expenditure from the arrangement over its term. The key purpose of the FA rules is to prevent deductions for expenditure from being accelerated and income recognition from being deferred.
11. **Shareholder-employee** in this statement means a person who holds shares in a close company of which the person is also an employee. This does not necessarily align with the meaning of "shareholder-employee" as defined in s YA 1.
12. **Shareholder loan account** means a loan between a company and a shareholder. In the context of a close company, a shareholder loan account is often made informally and the relevant transactions are recorded in a "shareholder current account".[3]

Analysis | Tātari

13. An overdrawn shareholder loan account balance arises when a shareholder draws or borrows money from a company and the total amount drawn exceeds the money the shareholder has loaned to the company. Essentially, the company is lending the amount of the overdrawn balance to the shareholder. Often, this occurs throughout the course of a year when a shareholder takes drawings from a company to fund their private expenditure (eg, living costs) in advance of receiving income from the company (eg, salary or dividends) (see Example | Tauira 1). In many cases, the income is calculated and credited to the shareholder loan account after the end of a financial year.
14. Notably, a company cannot claim an income tax deduction for drawings taken by its shareholders because the drawings are not an expense of the company. When a shareholder draws an amount from their shareholder loan account, the drawing represents either:
    - a repayment of an earlier advance by the shareholder to the company; or
    - an advance by the company to the shareholder.

Example | Tauira 1 – Overdrawing a shareholder loan account

On 1 April 2023, Nicola incorporates a company, Jungle Vibes Limited (JVL), to start an indoor plant retailing business. JVL is initially funded via nominal share capital of $100 and an advance of $10,000 from Nicola.

JVL does not require additional funds from Nicola and instead generates sufficient cashflow to allow Nicola to draw $5,000 per quarter to pay for her personal rent and other living costs.

By 31 March 2024, Nicola's shareholder loan account becomes overdrawn by $5,000 as shown below:

Date	Transaction	Money (in) / out	Balance[4]
01/04/2023	Opening balance	-	-
01/04/2023	Shareholder advance	($10,000)	($10,000)
01/07/2023	Drawings	$5,000	($5,000)
01/10/2023	Drawings	$5,000	-
01/01/2024	Drawings	$5,000	$5,000
31/03/2024	Closing balance	-	$5,000

2 See s YB 3 and meaning of "close company" in s YA 1.

3 See also *Case Q6* (1993) 15 NZTC 5,047.

4 The Act allows the retrospective crediting of a shareholder loan account under certain circumstances that could reduce an overdrawn balance. This statement discusses those rules from [40] to [41] and from [54] to [57].

The issues

15. The main income tax issues that are relevant to an overdrawn shareholder loan account are:
    - when an overdrawn shareholder loan account gives rise to a taxable dividend;
    - the interaction between the dividend rules and the FBT rules for a shareholder-employee with an overdrawn account;
    - where interest is charged on the loan:
        - how the company and the shareholder should account for the interest in their respective income tax returns;
        - whether there are any withholding tax obligations;
        - whether there are any investment income reporting obligations; and
    - what happens when the shareholder is relieved from meeting the remaining obligations under the loan.

When an overdrawn shareholder loan account gives rise to a dividend

16. Broadly, the dividend rules in subpart CD seek to identify transactions that transfer monetary value from a company to a shareholder (or a person associated with the shareholder) and treat such transactions as "dividends" that are taxable to the benefiting shareholders. These rules are relevant to an overdrawn shareholder loan account because the overdrawn balance represents a use of company property (ie, company funds) by a shareholder. This could give rise to situations where company value is transferred to the shareholder.

What gives rise to a dividend?

17. Under the Act,[5] a "dividend" is a transfer of company value from a company to a person if:
    - the cause of the transfer is a shareholding in the company; and
    - none of the exclusions in subpart CD apply.
18. The concepts of "transfer of company value" and whether the transfer is caused by a shareholding are discussed in detail in **IS 21/05: Non-cash dividends** (see [14] to [25]) and are not repeated in this statement. In summary, a "transfer of company value":
    - arises under an arrangement where a company provides money or money's worth to a person that exceeds the market value of what the person provides to the company in return;[6] and
    - is caused by a shareholding where the recipient is a shareholder in the company (or is associated with a shareholder in the company) and the company makes the transfer because of that shareholding.[7]

Transfer of company value

19. The term "money or money's worth" requires that a benefit be in money or be convertible into money, either directly or indirectly.[8] For an overdrawn shareholder loan account, the shareholder's use of company funds is "money or money's worth" provided to the shareholder. A "transfer of company value" will therefore arise where the shareholder does not provide adequate "market value" for the use of the company funds.
20. In the context of a loan, the ordinary meaning of "market value" applies.[9] Generally, the market value of something is the price that would be agreed between a willing but not anxious seller and a willing but not anxious buyer. It is determined objectively.[10]
21. The Commissioner considers the "market value" that a borrower provides for a loan like an overdrawn shareholder loan account would generally be interest payments, on top of the principal repayments. A rational lender would generally expect to be compensated for their time value of money, lending risks and other factors. The compensation is generally achieved by charging a market interest rate on the loan.

5 Section CD 4.

6 Section CD 5(1).

7 Section CD 6(1).

8 *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).

9 Section YA 1 defines "market value" only in a number of circumstances, none of which are relevant here.

10 *Hatrick v CIR* [1963] NZLR 641 (CA) at 661.

22. Therefore, if a company charges interest on an overdrawn shareholder loan account at a rate that is below the relevant market interest rate (or does not charge interest at all, see Example | Tauira 2), the shareholder has not provided adequate "market value" in return. This situation results in a "transfer of company value" to the shareholder.

Example | Tauira 2 – Transfer of company value

Following on from Example | Tauira 1, JVL provides Nicola with her overdrawn shareholder loan account on an interest-free basis.

This benefit is a "transfer of company value" because the value of the amounts advanced by JVL is worth more than the value of Nicola's repayments in the future. This is due to the time value of money and Nicola not paying interest to make up for the difference in the market value between what JVL provides to Nicola and what Nicola provides (in the future) to JVL.

23. Determining the relevant market interest rate can be challenging because there is unlikely to be a "market" for overdrawn shareholder loan accounts. It is therefore difficult to find comparable arrangements and interest rates. However, the prescribed calculation method for a dividend offers a practical solution.
24. Generally, the dividend amount for an overdrawn shareholder loan account is the excess of interest calculated using the prescribed rate over the actual interest charged. [11] As long as the actual interest rate charged on an overdrawn shareholder loan account is at least equal to Inland Revenue's prescribed rate of interest (discussed in more detail at [36] to [39]), the amount of the dividend will be nil. This result holds even if the relevant market interest rate is higher than the prescribed rate.
25. Where a taxpayer considers the market interest rate applicable to their overdrawn shareholder loan account is lower than the prescribed rate, the taxpayer should document evidence to support their position. The relevant evidence may include:
    - the terms of the loan (eg, interest rate, loan duration, repayment terms, etc),
    - any collateral, and
    - contemporaneous pricing of any comparable arrangements with similar terms (eg, personal loans with similar terms).
26. Separate to the above discussion around interest rates, a company also provides "money or money's worth" to a person where it releases the person from repaying a debt owed to it, either by agreement or by the operation of law. [12] This means a "transfer of company value" arises if a company releases a shareholder from repaying a debt.

Caused by a shareholding

27. As to whether a "transfer of company value" is caused by a shareholding, which is another test for determining whether an amount is a dividend (as noted at [17] and [18]), the relevant considerations are the following:
    - Whether the "transfer of company value" is received by a shareholder. [13]
    - Whether the "transfer of company value" is caused by the shareholding of the relevant shareholder.
28. It is clear that benefits associated with an overdrawn shareholder loan account are received by a shareholder. The focus is therefore on whether the company makes the transfer of value because of that shareholding.
29. One indication that a transfer is caused by a shareholding is where the terms of the arrangement that results in the transfer are different from the terms on which the company would enter into a similar arrangement if no shareholding were involved. [14]

11 Note, if the shareholder loan account is in a currency that is not the New Zealand Dollar, the relevant rate would not be the prescribed rate of interest. Instead the relevant rate would be the Commissioner's benchmark rate for that currency (if any).

12 Section CD 5(2). For completeness, a transfer of company value may not arise where the lender and the borrower are members of the same wholly owned group of companies; see s CD 5(2)(a) and (b) but such a situation is outside the scope of this statement.

13 Under s CD 6(1)(a)(ii), a transfer of company value can also arise if the recipient is associated with the shareholder. However, as this item discusses overdrawn shareholder loan accounts, it is aimed at loans lent directly to shareholders as opposed to associates of shareholders.

14 Section CD 6(2), *Case V9* (2001) 20 NZTC, 10,101 (TRA) and *Campbell v CIR* [1968] NZLR 1 (HC).

30. As noted at [20] and [21], in a commercial setting, it is generally expected that a loan between unrelated arm's length persons would be repaid in full and that the lender is fairly compensated for the borrower's use of the lender's money. Therefore, the Commissioner considers the benefit is caused by the shareholder's shareholding if any of the following benefits is provided under an overdrawn shareholder loan account:
    - The loan is provided on an interest-free basis (see Example | Tauira 3).
    - The interest charged on the loan is below the prevailing market interest rate for a loan issued on similar terms.
    - The shareholder does not need to repay their loan account.
31. It is possible that, in certain cases, some or all of the above benefits are provided to unrelated borrowers as well as a shareholder, such that the benefits (ie, the transfer of value) are not caused by a shareholding. In such cases, the company will need to be able to demonstrate that it would provide lending to unrelated parties with terms and benefits similar to the shareholder loan account.

Example | Tauira 3 – Transfer caused by shareholding

> Following on from Example | Tauira 2, Nicola's interest-free overdrawn shareholder loan account is caused by her shareholding in JVL. This is because JVL is in the business of retailing indoor plants and would not provide a loan to unrelated parties on an interest-free and on-call basis.

32. In summary, a dividend arises in respect of an overdrawn shareholder loan account when the loan leads to a transfer of company value to the shareholder that is caused by the shareholder's shareholding. The most common attributes that lead to a dividend in this context are charging a low interest rate or no interest on the loan and the forgiveness of the loan [15]. Therefore, in certain situations, multiple dividends could arise from an overdrawn shareholder loan account. For example, where a company does not charge interest on an overdrawn shareholder loan account and then, at a later date, forgives the overdrawn balance, dividends would arise from both the interest forgone (assessed quarterly, see [35]) and the amount of the debt forgiven (see [93]).
33. Although specific dividend exclusions set out in subpart CD exclude certain transactions from the meaning of "dividend", most of those exclusions do not apply to benefits provided under an overdrawn shareholder loan account. The exception is that a fringe benefit provided to a shareholder-employee that is subject to FBT is treated as not being a dividend. [16] Benefits provided to a shareholder-employee are discussed from [44].
34. The above is consistent with IS 21/05, which explains that an interest-free or low-interest overdrawn shareholder loan account gives rise to a non-cash dividend (see [38] to [42] and Example 22 of IS 21/05).

Dividend calculation for interest-free or low-interest loans

35. The amount of a dividend from an overdrawn shareholder loan account is calculated for each quarter during which the account is overdrawn. The dividend is treated as being paid 6 months after the end of the company's income year, unless the company gives the shareholder earlier notice of the amount of the dividend. [17]
36. There are two ways to calculate the amount of the dividend at the company's option. [18] The amount is the difference between either:
    - the benchmark interest and the actual amount of interest accruing on the loan; or
    - the benchmark interest and the amount of income accruing to the company in the quarter calculated under the yield to maturity method.

INTERPRETATION STATEMENT

15 Loan forgiveness is discussed later from [92].

16 Section CD 32(1)(a).

17 Section CD 39(2) and (3).

18 Section CD 39(5).

37. The benchmark interest[19] is the interest calculated for the quarter on the daily balance of the loan calculated using:
    - where all amounts are expressed in **New Zealand dollars** and the borrower is not a company, the "**prescribed rate of interest**" declared by regulations (see Example | Tauira 4); or[20]
    - where all amounts are expressed in a single **currency other than New Zealand dollars** and the borrower is not a company, the **benchmark rate** the Commissioner **set for that currency** (if any).[21]
38. In all other cases, the benchmark interest can be calculated using a market rate determined at the end of the quarter for a loan made on the same terms between persons at arm's length. However, this market rate method is generally not available for an overdrawn shareholder loan account of a natural person shareholder in New Zealand. The market rate method is only available if the "prescribed rate of interest" or the Commissioner's benchmark rate for a foreign currency do not apply. As stated at [37], where the borrower (ie, the shareholder) is not a company and the loan is in New Zealand dollars, the benchmark rate of interest is the "prescribed rate of interest".
39. Therefore, the "prescribed rate of interest" is likely the most relevant rate for a close company resident in New Zealand. The rate is set from time to time by the Governor-General[22] and is available from **Prescribed interest rates for fringe benefit tax (FBT)** on the Inland Revenue website.

Example | Tauira 4 – Calculating a dividend using the prescribed rate of interest

Following on from Example | Tauira 3, and assuming Nicola is not an employee of JVL, she is deemed to have received a dividend equal to the difference between the benchmark interest and the actual amount of interest accruing on the loan.

As the loan is in New Zealand dollars and the borrower (Nicola) is not a company, the prescribed interest rate is the benchmark interest rate used to calculate Nicola's dividend.

Nicola's loan account becomes overdrawn on 1 January 2024 and therefore the applicable prescribed interest rate is 8.41%.

For the quarter 1 January 2024 to 31 March 2024, the amount of the dividend is calculated as follows:

$$Dividend = outstanding\ loan \times prescribed\ rate \times \frac{days\ in\ quarter}{365}$$

$$Dividend = \$5{,}000 \times 8.41\% \times \frac{91}{365}$$

$$Dividend = \$104.84$$

40. For the purpose of calculating a dividend, a repayment made during the tax year may retrospectively reduce the overdrawn balance of a shareholder loan account.[23] This applies if all of the following requirements are met:
    - the amount is repaid using salary, wages, extra pay, dividends or interest payable by the company to the shareholder;
    - the amount payable by the company is income of the shareholder in the tax year or an earlier tax year; and
    - the amount payable by the company is payable without any amount of tax being withheld under the PAYE, RWT or non-resident withholding tax (NRWT) rules, or is a fully imputed dividend.
41. Where the requirements at [40] are met, the repayment is applied retrospectively to the **later** of:
    - the day the loan was made (eg, when the shareholder loan account became overdrawn, see Example | Tauira 5**); or**
    - the start of the company's tax year (see Example | Tauira 6**).**

19 Section CD 39(6) to (8).

20 For completeness, the "prescribed rate of interest" can also be used when the borrower is a company if an election to use that rate is made and the Commissioner is notified of the election in accordance with s CD 39(12).

21 If the borrower is another company, the benchmark rate is the rate set by the Commissioner if the company making the loan has notified the Commissioner in accordance with s CD 39(12) that the Commissioner's rate is to apply.

22 Section YA 1 – meaning of "prescribed rate of interest" – and s RA 21(3).

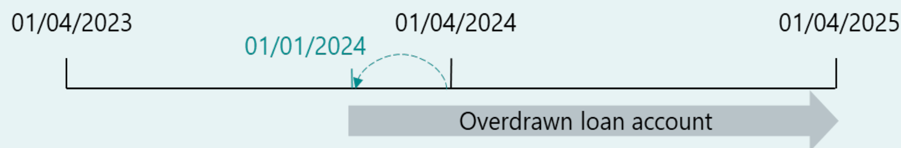
23 Section CD 39(9).

Example | Tauira 5 – Retrospective crediting of shareholder loan account

This example follows on from Example | Tauira 4.

On 31 March 2024, JVL declares and pays a fully imputed dividend of $2,985.07 (consisting of $835.82 imputation credits, $149.25 RWT and $2,000 cash dividend). Nicola directs JVL to apply the cash dividend in repaying her overdrawn shareholder loan account.

The $2,000 can be applied retrospectively to 1 January 2024 when the account first became overdrawn, as shown below:



For the purpose of calculating Nicola's deemed dividend from the overdrawn shareholder loan account balance, the following transactions will be taken into account:

Date	Transaction	Money (in) / out	Balance
01/04/2023	Opening balance	-	-
01/04/2023	Shareholder advance	($10,000)	($10,000)
01/07/2023	Drawings	$5,000	($5,000)
01/10/2023	Drawings	$5,000	-
01/01/2024	Drawings	$5,000	$5,000
01/01/2024	**Dividend**	**($2,000)**	**$3,000**
31/03/2024	Closing balance	-	$3,000

The calculation of Nicola's dividend from the interest-free overdrawn shareholder loan account for the quarter ending 31 March 2024 would then be as follows:

$$Dividend = outstanding\ loan \times prescribed\ rate \times \frac{days\ in\ quarter}{365}$$

$$Dividend = \$3{,}000 \times 8.41\% \times \frac{91}{365}$$

$$Dividend = \$62.90$$

The calculations reflect the reduction of Nicola's outstanding loan from $5,000 (as shown in Example | Tauira 4) to $3,000 due to the retrospective crediting of the $2,000 cash dividend effective 1 January 2024.

Example | Tauira 6 – Resolving to pay a fully imputed dividend before year end but not quantifying the dividend amount until after year end

Vivien is a shareholder of Automate That Process Limited (ATP). Her interest-free shareholder loan account becomes overdrawn on 1 April 2023.

On 31 March 2024, the directors of ATP resolve to pay a dividend, with the exact amount to be confirmed once ATP finalises its accounts for the year ending 31 March 2024.

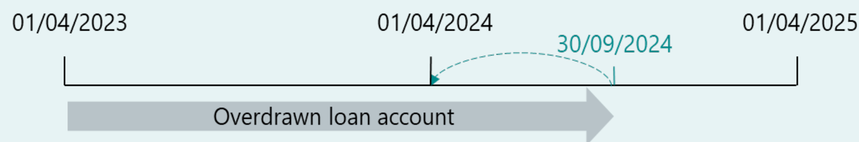
On 30 September 2024, ATP finalises its accounts and confirms the dividend amount. The dividend, which is fully imputed, is less than the amount owed by Vivien on her overdrawn shareholder loan account.

Vivien treats the dividend as income in the 2025 income year (under s CD 1(2)). She agrees with ATP to use the dividend to repay her overdrawn loan account. Consequently, ATP makes a journal entry on 30 September 2024 to credit the dividend to Vivien's shareholder loan account. This is the date ATP pays the dividend, not 31 March 2024 (when the dividend is first declared), because an amount cannot be considered "paid" if it is not quantified until later.

However, for the purpose of calculating the non-cash dividend arising from the overdrawn loan account balance, the backdating rule in s CD 39(9) applies. Under this rule, the dividend "paid" on 30 September 2024 can be retrospectively credited to Vivien's loan account on the **later** of:

- the date the loan was made (ie, when Vivien's loan account became overdrawn), being 1 April 2023; or
- the start of ATP's tax year, being 1 April 2024.

As 1 April 2024 is the later date, this is the date the dividend can be credited back to.

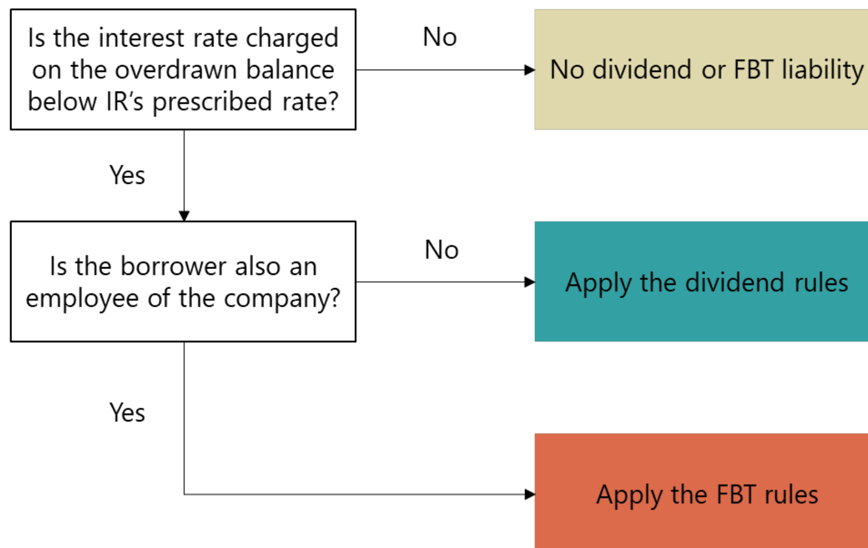


42. IS 21/05 addresses several other issues that are relevant when considering the dividend rules, as follows:
    - rules around attaching imputation credits – see [43] to [46];
    - dividend reversal when a debt is later repaid – see [47] and [48]; and
    - the non-deductibility of dividends for the paying company – see [49].
43. Companies should also consider their withholding tax (eg, RWT) obligations for any dividends arising from overdrawn shareholder loan accounts.

Overdrawn shareholder loan accounts for shareholder-employees

44. The dividend rules described from [16] do not apply to an overdrawn shareholder loan account for a shareholder-employee where the benefit is an interest-free or low-interest loan. Instead, the FBT regime applies, and the company needs to pay FBT on the benefit.
45. A "shareholder-employee" in this context simply refers to an employee who holds shares in the company. In the context of a close company, shareholder-employees are often the working owners of the company.
46. Figure | Hoahoa 1 steps through the process of determining whether the dividend or the FBT rules apply to benefits provided in the form of an interest-free or low-interest loan.

Figure | Hoahoa 1: Application of tax rules on interest-free or low-interest overdrawn shareholder loan account [24]



Meaning of "fringe benefit"

47. A "fringe benefit" is a benefit that an employer provides to an employee in connection with their employment.[25] It is either:[26]
    - a classified benefit under ss CX 6, CX 9, CX 10, or CX 12 to CX 16; or
    - an unclassified benefit.
48. An overdrawn shareholder loan account is a classified benefit under s CX 10, which relates to employment-related loans. Under that section, a fringe benefit arises when an employer provides a loan to an employee in a tax year in which the loan is owing. A fringe benefit does not arise for a loan made:
    - as an employee share loan;
    - under an exempt employee share scheme;
    - as an overpayment of PAYE; or
    - as an advance of salary and wages of up to $2,000 in certain circumstances.
49. In most cases, an overdrawn shareholder loan account would not be any of the excluded loans at [48] and should therefore give rise to a "fringe benefit" subject to FBT for the shareholder-employee.
50. For a non-cash benefit such as an overdrawn shareholder loan account of a shareholder-employee, the FBT rules treat the benefit as being provided in connection with the shareholder's employment.[27] Therefore it is not necessary to consider whether the benefit is more connected to the person's shareholding or to their employment.
51. Although a specific rule[28] allows a company to choose whether to apply the dividend or FBT rules to a benefit provided to a shareholder-employee, that discretion applies only to "unclassified benefits".[29] An employment-related loan, such as an overdrawn shareholder loan account, is not an "unclassified benefit" as it is classified as a fringe benefit specifically in s CX 10. **This means a benefit provided in the form of a low-interest or interest-free loan to a shareholder-employee is taxable under the FBT rules and not the dividend rules** (see Example | Tauira 7).

24 Figure | Hoahoa 1 applies only to loan accounts denominated in New Zealand Dollars. As noted at [37], where the loan account is expressed in a single foreign currency, the applicable benchmark interest is calculated using the benchmark rate that the Commissioner has set for that currency, if any.

25 For completeness, a fringe benefit can also arise when the benefit is provided to an associate of an employee, see ss GB 32 and CX 18.

26 Section CX 2(1).

27 Section CX 17(1).

28 Section CX 17(2).

29 Section CX 17(4)(b) and the meaning of "unclassified benefit" in ss YA 1 and CX 37.

Example | Tauira 7 – Dividend or fringe benefit

Brock is a shareholder-employee of Onyx Club Limited (OCL), which operates a gym business. Instead of being paid a set regular salary, Brock is allowed to take reasonable monthly drawings from OCL and, as a result, his shareholder loan account is overdrawn during the course of the year. At the end of the financial year, OCL's accountant calculates Brock's annual salary, which is credited to his shareholder loan account and offset against his drawings.

OCL does not charge interest on the overdrawn shareholder loan account.

Brock's interest-free loan is an "employment-related loan", which is deemed to be provided in connection with his employment with OCL. This gives rise to a "fringe benefit" for Brock and the FBT rules (instead of the dividend rules) apply.

FBT calculation

52. In most cases, the value of a fringe benefit arising from an overdrawn shareholder loan account for a period is either:[30]
    - the difference between the interest calculated on the daily balance of the employment-related loan using the prescribed interest rate (see [39]) and the actual interest accrued on the loan (see Example | Tauira 8); or
    - the difference between the interest calculated on the daily balance of the loan using the prescribed interest rate and the income that would have accrued to the employer's benefit under the yield to maturity spreading method in the FA rules.
53. Employers who are in the business of lending money or are in a group of companies with a member that is in such business may choose not to apply the prescribed interest rate. Instead, these employers may use "market interest"[31] to calculate the value of fringe benefits provided.[32]
54. Similar to the dividends rules, a retrospective crediting of shareholder income to an overdrawn shareholder loan account is possible for FBT purposes. This applies to an amount that:
    - is salary or wages, an extra pay, a dividend or interest; and
    - is payable by the employer without any tax being withheld and paid under the PAYE, RWT or NRWT rules, or is a fully imputed dividend; and
    - is income of the shareholder-employee in the tax year in which it is applied to repay the loan, or in an earlier income year.
55. Where a shareholder-employee is allocated income that meets the requirements at [54], that income can be treated as having been retrospectively credited to the overdrawn shareholder loan account. The retrospective credit arises either on the first day of that income year or on the day the balance of the loan account first became overdrawn during that income year, whichever is later.[33]
56. A shareholder-employee may also elect to treat income as having been derived in an earlier year for the purpose of retrospectively crediting their overdrawn shareholder loan account. That is, where a shareholder-employee is allocated income by the company after the end of a particular year, the person may nevertheless elect to apply that income to the earlier year, provided that the requirements listed at [54] are met and the Commissioner is notified of this treatment.[34] The effects of the election are that:
    - the income is treated as having been derived by the shareholder in the earlier year; and
    - the income is credited retrospectively to the overdrawn shareholder loan account in the earlier year (see Example | Tauira 9).

30 Section RD 34.

31 Specific requirements apply to demonstrate an amount is "market interest"; see s RD 35(5).

32 Section RD 35(1) and (2).

33 Section RD 36(1) and (2).

34 Section RD 36(3) and (4).

57. The notification must be made within the time for filing the employer's return of income for the earlier year in which the employment-related loan is owed, although the Commissioner has a discretion to allow further time to lodge the notice.
58. Some companies have the option of filing annual or income year FBT returns while others need to file quarterly returns.[35] If the company files income year returns, it will have to work out the interest on the loan account and pay any FBT by the applicable due date. However, if the company has already filed quarterly returns, it must work out the correct interest and FBT payable on the loan account for each quarter in the year. The company may have to amend filed returns. Late payment penalties, interest or shortfall penalties may be imposed on any extra FBT owing. However, the ability to retrospectively credit the overdrawn shareholder loan account should reduce the earlier FBT assessments in most cases, rather than causing extra FBT to arise.

Example | Tauira 8 – Taxable value of fringe benefit

Following on from Example | Tauira 7, OCL wishes to calculate the value of the fringe benefit of Brock's overdrawn shareholder loan account for the 30 June 2023 quarter. Brock's loan account balance for the quarter is as follows:

Date	Transaction	Money (in) / out	Balance
01/04/2023	Opening balance	-	-
01/04/2023	Drawings	$2,000	$2,000
01/05/2023	Drawings	$2,000	$4,000
01/06/2023	Drawings	$2,000	$6,000
30/06/2023	Closing balance	-	$6,000

The prescribed interest rate between 1 April 2023 and 30 June 2023 is 7.89%. Interest calculated using the prescribed interest rate for the quarter is as follows:

$$\textit{April interest} = \$2{,}000 \times 7.89\% \times \frac{30}{365} = \$12.97$$

$$\textit{May interest} = \$4{,}000 \times 7.89\% \times \frac{31}{365} = \$26.80$$

$$\textit{June interest} = \$6{,}000 \times 7.89\% \times \frac{30}{365} = \$38.91$$

The value of the fringe benefit on Brock's loan account for the quarter is $78.68 ($12.97 + $26.80 + $38.91). The loan is provided on an interest-free basis and therefore the difference between the prescribed interest and the actual interest accrued equals the whole amount of the prescribed interest. FBT is payable on this amount.

Example | Tauira 9 – Retrospective crediting of overdrawn shareholder loan account

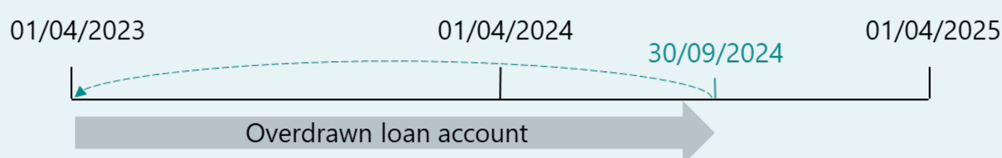
Maggie is a shareholder-employee of Simply Magginificent Limited (SML).

On 1 April 2023, Maggie draws money from SML to buy a new electric vehicle for her own use. As a result, her interest-free shareholder loan account with SML becomes overdrawn by $50,000 on the same day.

On 30 September 2024, SML finalises its accounts for the 31 March 2024 year and resolves to pay a shareholder salary of $50,000 to Maggie. The salary is also credited to Maggie's shareholder loan account on 30 September 2024.

Maggie elects to treat the salary as having been derived in the year ending 31 March 2024 in order to clear her overdrawn shareholder loan account in the earlier year.

For the purpose of calculating the fringe benefit arising from the loan, the salary can be treated as having been retrospectively credited to Maggie's loan account on 1 April 2023.



35 See **Fringe benefit tax guide – IR409**, page 6.

59. Example | Tauira 9 seeks to demonstrate the backdating rule under ss RD 36(3) and (4) only. In practice, there will be return filing implications to consider. As noted at [58], some companies file quarterly FBT returns and may have to amend previously filed returns to account for a backdated credit. However, many close companies with shareholder-employees have the option to file FBT returns on an income year basis if they meet the requirements in s RD 60. This option allows these companies to file their FBT returns for the entire income year and to return the FBT by the terminal tax due date for income tax. Therefore, these companies are able to calculate the remuneration to allocate to a shareholder-employee, the amount of a backdated credit and the associated FBT liability for the year at the same time (and after year end), without having to amend prior FBT assessments.
60. For more information on FBT generally or how to return FBT on an overdrawn shareholder loan account, refer to the **Fringe benefit tax guide – IR409**.

Charging interest on an overdrawn shareholder loan account

61. To relieve or eliminate both the dividend and FBT liability, some close companies and shareholders or shareholder-employees agree in advance that interest will be charged on any overdrawn shareholder loan account balance. Generally, they agree that interest will be charged at the prescribed rate. In this case, the value of the dividend or fringe benefit is reduced by the interest accrued on the loan as noted at [36] and [52]. This means that no dividend arises or that no FBT is payable. However, charging and paying interest has other tax consequences. These include that:
    - the shareholder has an interest expense (which raises issues around deductibility, withholding tax obligations and investment income reporting obligations); and
    - the company has interest income (and maybe a tax credit if withholding tax obligations have arisen for the shareholder).

Interest expense for shareholder

Interest deductibility

62. Money drawn from a shareholder loan account is often used to fund the shareholder's private or domestic expenditure. In such cases, any interest the shareholder incurs on the overdrawn shareholder loan account will not be deductible because the interest would not be incurred in carrying on an income-earning activity or a business of the shareholder (see Example | Tauira 10).[36]
63. It is conceivable that in some cases, a shareholder may draw money from a shareholder loan account for use in an income-earning activity or a business that they carry on separately. Where such drawings cause a shareholder loan account to become overdrawn and interest is charged on this debt, the interest may be deductible in the shareholder's personal tax return, provided that:
    - the shareholder applies the amount borrowed from the company:
        - in deriving assessable or excluded income (or a combination of both), or
        - in the course of carrying on a business for the purpose of deriving assessable income or excluded income (or a combination of both); and
    - the general limitations (other than the capital limitation[37]) in s DA 2 do not apply.
64. By its nature, a shareholder loan account may often involve a constant inflow and outflow of funds that are applied to different uses (including the funding of non-deductible private or domestic expenditure). For this reason, it is important to maintain sufficient records to support any deduction claimed in a shareholder's tax return for interest on an overdrawn shareholder loan account.

36 Sections DA 1, DA 2(1) and (2) and DB 6.

37 Section DB 6 overrides the capital limitation in s DA 2(1).

Example | Tauira 10 – Private expenditure

Jin is a shareholder-employee of Jin's Video Editing Services Limited (JVES).

Jin holds a shareholder loan account with JVES. The shareholder loan account is for Jin to draw money to fund his personal living costs.

JVES has agreed with Jin in advance that, to the extent Jin's shareholder loan account is still overdrawn at year end, after crediting the account with his shareholder salary, interest will accrue at the applicable prescribed rate so that the company will not need to file FBT returns for the loan account.

For the year ending 31 March 2024, Jin has taken more in drawings than the salary allocated to him. The accountant calculates that interest of $88 is payable on the overdrawn balance to 31 March 2024. Jin cannot claim this $88 interest expense as a deduction in his income tax return because it is a cost of funding his private expenses.

65. Further, where funds are drawn and applied simultaneously for both income-earning and private purposes, apportionment is required and any interest deduction available is disallowed to the extent of the private use.[38]

66. If a shareholder is entitled to deduct interest incurred on their shareholder loan accounts, they will have to allocate the interest deduction to an income year. This depends on whether the shareholder returns their income on an accrual basis or cash basis.[39] If the FA rules apply (subject to the concessionary rules discussed from [67]), those rules will determine the income year to which the deductions are allocated.

Concessionary rules

Variable principal debt instruments

67. A person may be excluded from the requirement to apply the FA rules to an overdrawn shareholder loan account where:
    - the loan account is a variable principal debt instrument (VPDI); and
    - the total value of all the person's VPDIs does not exceed $50,000 at any point in the year.[40]

68. A VPDI is a financial arrangement that contemplates that a party may advance further amounts to the other party on demand or on call.[41] Examples of a VPDI are:
    - a shareholder loan account;
    - a revolving credit facility where the borrower can borrow or repay principal at any time;
    - a credit card account; and
    - an everyday banking cheque account.

69. Because the threshold for the VPDI is relatively low and includes the value of all the VPDIs that a person is party to at any point in a year, it is expected that few taxpayers will be eligible to rely on this exclusion.

Cash basis persons

70. Where a person meets certain requirements, they may be a "cash basis person"[42] for the purposes of the FA rules. This treatment allows them to account for an amount of financial arrangements income or expenditure (eg, interest) when it is received or paid.[43]

38 See **IS 23/10: Deductibility of holding costs for land** (from [101] to [111]) for more detailed commentary on the requirement to apportion costs (in particular, interest) between income-earning use and private use.

39 Section BD 4(3).

40 Section EW 5(25).

41 Section YA 1 – para (a)(i) of the meaning of "variable principal debt instrument".

42 **IS 22/05: Cash basis persons under the financial arrangements rules** explains in detail when a person or entity may be a cash basis person as well as the implications of being a cash basis person.

43 The Commissioner may treat a cash basis person as not being a cash basis person for a class of financial arrangements if there has been structuring and promotion of the class to defer a tax liability. This also may apply where the parties to a financial arrangement are associated and calculate different amounts of income and expenditure: s EW 59.

Withholding obligations

71. In most cases, a shareholder who pays interest on an overdrawn shareholder loan account should not have an obligation to withhold RWT from that interest. Such obligation will **only** arise (subject to the de minimis rule discussed at [74]) for a shareholder who:
    - has been granted RWT-exempt status by the Commissioner;[44] or
    - pays the interest as part of a taxable activity (see Example | Tauira 11).[45]

72. A "taxable activity"[46] generally requires all of the following to apply:
    - There must be an activity, which is a broad concept involving a combination of tasks undertaken, or a series of acts or course of conduct pursued by a person.
    - The activity must be carried on continuously or regularly.
    - The activity must involve or be intended to involve the supply of goods and services to any other person.
    - The supply or intended supply of goods and services must be for consideration.

73. Given the nature of an overdrawn shareholder loan account, it is expected that the corresponding interest would **not** be paid as part of a taxable activity in most cases (see Example | Tauira 12).

74. Even if a shareholder meets the above requirements for withholding RWT from interest, a de minimis threshold of $5,000 is in place to relieve them from withholding where they pay only small amounts of interest each year.[47] This applies to a shareholder who:
    - pays $5,000 or less in total interest[48] in each of the current year and the year before the current year; and
    - is granted RWT exempt status because they have no net income for the period or are expecting to have an RWT refund of $500 or more.[49]

75. Further, for a shareholder who pays interest as part of a taxable activity and who does not have RWT-exempt status, the threshold amount counts only the interest that relates to the taxable activity. This means the liability to withhold RWT only arises for such a shareholder if the amount of interest relating to the taxable activity is more than $5,000 for the year.[50]

44 Section RE 4(3)(a).

45 Section RE 4(3)(b).

46 See s YA 1 – meaning of "taxable activity" and s 6 of the Goods and Services Tax Act 1985.

47 Section RE 10(1) and (2).

48 The total interest amount does not include interest derived by a person who has RWT-exempt status. This means that the total interest amount would not include interest paid to most New Zealand financial institutions (who should have RWT-exempt status). For example, interest on a mortgage with a New Zealand bank would not be counted towards the $5,000 de minimis threshold.

49 Section RE 10(1)(b); and s 32I of the TAA.

50 Section RE 10(3).

Example | Tauira 11 – RWT withholding obligations

Following on from Example | Tauira 10, this example assumes JVES does not have RWT-exempt status.

On 1 April 2023, Jin borrows $200,000 (the Business Loan) from JVES to set up a side business of composting and worm farming from his lifestyle block. As part of this side business, he collects organic waste from his neighbours to turn into compost using vermiculture techniques and he sells his compost and compost worms regularly on online platforms. He carries out this side business in his personal capacity.

The Business Loan is repayable on demand, and interest equal to the applicable Inland Revenue prescribed rate is to be charged on the daily outstanding balance of the loan on a simple (non-compounding) basis. Jin and JVES also agree that the Business Loan and Jin's shareholder loan account should be recorded in different accounts to make it easier to identify interest on the respective loans.

Jin is entitled to claim a deduction for interest incurred on the Business Loan. This is because the loan is applied to a business and therefore meets the general permission. None of the general limitations apply.

Between 1 April 2023 and 31 March 2024, Jin does not make any repayments towards the Business Loan and does not apply any income from JVES for the year towards repaying the loan.

On 8 June 2024, JVES finalises its accounts for the year ended 31 March 2024, which includes finalising the quantum of the interest accrued on the Business Loan (being over $5,000).

On 10 June 2024, Jin pays the interest accrued to 31 March 2024. His accountant advises him that because he applied the Business Loan towards a "taxable activity" and the interest amount exceeds the $5,000 de minimis threshold, he needs to deduct RWT from the interest paid to JVES and return it to Inland Revenue by 20 July 2024. Jin instructs his accountant to proceed with this and the accountant returns the RWT to Inland Revenue on 20 July 2024.

Jin's composting business is a "taxable activity" because:

- it involves an activity of turning waste into compost and raising compost worms;
- the activity is carried on continuously and regularly, as is evidenced from his constant collection of organic waste, the composting processes and then his selling of the resulting compost and worms; and
- there is a supply of goods for consideration (ie, money).

Jin applied the Business Loan towards the composting taxable activity. The interest obligation arises from that taxable activity and so he makes the payment of interest in carrying on the taxable activity.

Example | Tauira 12 – No RWT withholding obligation

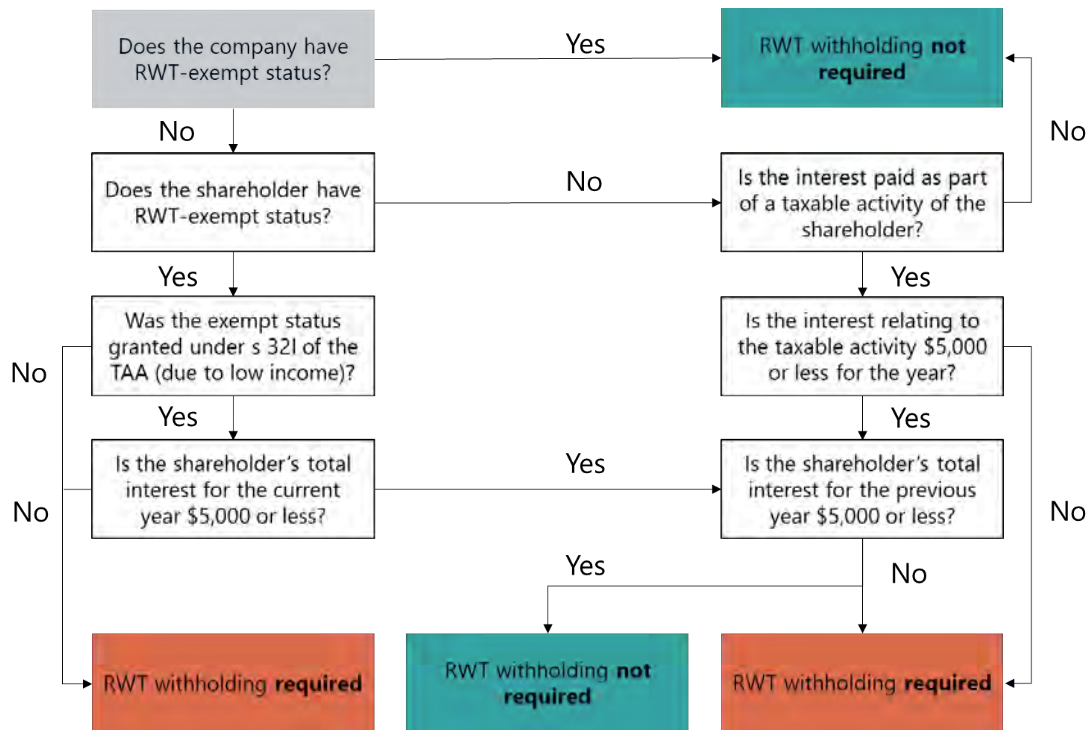
Kim is a shareholder-employee of Tax Titans Advisory Limited (TTA). She draws funds regularly from her shareholder loan account in TTA to help pay for her personal mortgage and groceries.

For the year ending 31 March 2024, Kim's shareholder salary is not enough to repay all the drawings she took prior to year end. As agreed in advance between TTA and Kim, TTA charges interest at the Inland Revenue prescribed rate on the daily overdrawn balance of Kim's shareholder loan account.

As Kim does not have RWT-exempt status and does not apply her drawings towards a taxable activity, there is no obligation to withhold RWT when the interest is paid (or credited via journal entries) to TTA.

76. Shareholders are not required to deduct RWT from interest paid to a company that has RWT-exempt status. Figure | Hoahoa 2 steps through the questions that are relevant when determining whether or not a shareholder needs to withhold RWT from what they pay on an overdrawn shareholder loan account.

Figure | Hoahoa 2: Is a shareholder required to withhold RWT from interest they have paid?



77. For more information on how to calculate and return RWT, please refer to the **Resident withholding tax on interest (RWT) payer's guide – IR283**.

Investment income reporting rules

78. Certain people who pay interest to another person have an obligation to report information to Inland Revenue under the investment income reporting rules. However, as with the RWT withholding rules discussed from [71], it is expected that most shareholders with an overdrawn shareholder loan account would not have such an obligation.

79. The few shareholders who have an obligation to withhold RWT on interest paid on their overdrawn shareholder loan accounts will need to report specified information to Inland Revenue.[51] Please refer to **Payers of interest – reporting requirements** on the Inland Revenue website for more information on the requirements as well as how to report electronically.

80. Reporting of the required information is due by the 20th of the month following the month in which the interest is paid to or derived by the company (see Example | Tauira 13).[52] The month of payment is generally more relevant in practice than the month when the company derives the interest. This is because RWT is also due by the 20th of the month following the month of payment.

Example | Tauira 13 – Reporting when RWT is required to be deducted

This example follows on from Example | Tauira 11.

Jin is required to report information on the interest and the interest recipient (ie, JVES) to Inland Revenue because he has an RWT obligation in respect of interest paid to JVES on the Business Loan.

As the interest is paid on 10 June 2024, Jin needs to report this information by 20 July 2024, which is also the due date for the payment of the RWT deducted from the interest.

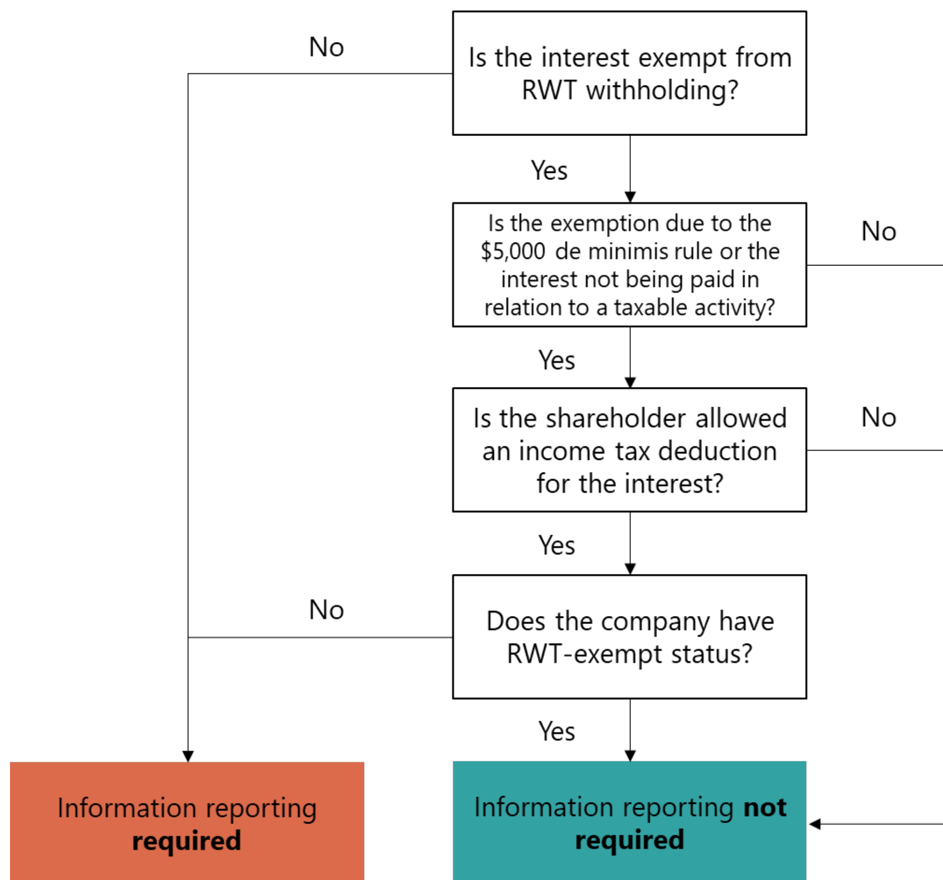
51 Section 25E(1)(a) of the TAA.

52 Section 25F(1) of the TAA.

81. A shareholder also has a reporting obligation [53] where they have no RWT withholding obligations on interest but all of the following apply:
    - The interest is not subject to RWT because it is not paid in carrying on a taxable activity or is exempt under the $5,000 de minimis rule.
    - The shareholder is allowed an income tax deduction for the interest.
    - The interest is paid to a person (ie, the company) who does not have RWT-exempt status.

82. Again, it is expected that only a few shareholders will meet all of the criteria at [81] for their overdrawn shareholder loan accounts. Particularly given the income tax deduction criterion would not apply to shareholders who merely draw funds for private or domestic purposes. **Figure | Hoahoa 3** steps through the questions that are relevant in determining whether a shareholder needs to report information under the investment income reporting rules.

Figure | Hoahoa 3: Is the shareholder required to report information under the investment income reporting rules?



83. For the few shareholders who meet the listed criteria, please refer to **Interest payers not required to withhold – reporting requirements** on the Inland Revenue website. This provides more information on the requirements as well as on how to report electronically.

84. The required information is due with the shareholder's income tax return for the corresponding year (see Example | Tauira 14).[54]

53 Section 25E(1)(j) and (2) of the TAA.

54 Section 25N(b) of the TAA.

Example | Tauira 14 – Reporting obligation when not required to withhold

Dave is a shareholder of Rocket To The Moon Limited (RTTM). He is not an employee of RTTM and does not take regular drawings from the company. Neither Dave nor RTTM has RWT-exempt status.

In late 2023, Dave catches wind of a "hot" new New Zealand share investment, Envy-Dia. Short on funds, Dave approaches the director of RTTM for a loan to buy shares in Envy-Dia to make a quick profit.

On 1 March 2024, Dave draws $40,000 from RTTM and uses the full amount to buy Envy-Dia shares. He agrees to apply any dividends he receives from RTTM towards the repayment of this loan. Dave also agrees to pay interest at the Inland Revenue prescribed rate on the daily outstanding balance of his loan (simple method, as opposed to compounding), and to treat the backdating rule in s CD 39(9) (see [40]) as if it also backdates the repayment for the purpose of calculating the actual interest payable on the loan.

On 31 May 2024, RTTM declares and pays a dividend. Dave's share is $20,000 and is applied to repay his loan. Under s CD 39(9) as well as the agreed loan terms, the repayment is backdated to 1 April 2024. On the same day, Dave sells his Envy-Dia shares for a profit and repays the balance of his loan plus the interest accrued to 31 May 2024 of $566.81, calculated as follows:

From 1 March 2024 to 31 March 2024: $\$40{,}000 \times 8.41\% \times \frac{31}{365} = \$285.71$

From 1 April 2024 to 31 May 2024: $\$20{,}000 \times 8.41\% \times \frac{61}{365} = \$281.10$

Dave does not need to withhold RWT on the interest payable to RTTM because the one-off share transaction does not amount to a "taxable activity"[55] and he does not have RWT-exempt status.

However, Dave does have a reporting obligation under the investment income reporting rules as he will claim a deduction for the interest he incurs on the loan. This is because the share sale gives rise to taxable income (as he bought the shares for the purpose of disposal) and therefore interest incurred to acquire the shares is deductible.

Assuming Dave is required to account for financial arrangements income and expenditure on an accrual-basis,[56] the required information is due:

- when Dave files his income tax return for the year ending 31 March 2024, on interest incurred between 1 March 2024 and 31 March 2024; and
- when Dave files his income tax return for the year ending 31 March 2025, on interest incurred between 1 April 2024 and 31 May 2024.

Alternatively, if Dave is a cash basis person, he will need to report the required information when he files his income tax return for the year ending 31 March 2025. This is because, as a cash basis person, he accounts for the interest when the interest is paid. As the date of interest payment is 31 May 2024, which falls in the year ending 31 March 2025, the required information is due when Dave files his tax return for that year.

Interest income for company

85. Where a company charges interest on an overdrawn shareholder loan account, the interest is taxable income for the company. The company will generally need to apply the FA rules, which determine when it derives interest income from a loan.

86. The FA rules essentially require parties to a financial arrangement to spread income or expenditure from the arrangement over its term using specified methods, instead of recognising the income or expenditure as it is received or paid. The key purposes of the rules are to prevent deductions for expenditure from being accelerated and income recognition from being deferred.

55 Note – this does not mean proceeds from Dave's share disposal are not taxable. Refer to [71] for the meaning of "taxable activity".

56 To be consistent with RTTM's FA basis under s EW 59(b).

87. A number of spreading methods in the FA rules may apply based on a company's particular circumstances. One common method for smaller companies is the straight-line method.[57] This method requires only simple calculations and should generally produce the same result as would come from applying the relevant interest rate to the daily outstanding balance of the overdrawn shareholder loan account for each day of the relevant income year (as shown in Example | Tauira 14).[58]

88. A company may use the straight-line method if it meets all of the following criteria:
    - The total value of all the financial arrangements to which the company is a party in an income year has been $1,850,000 or less on every day in the income year.
    - The straight-line method is used for all financial arrangements to which the company is party at the end of the year and for which it can use the method.
    - The company does not use IFRS[59] rules to prepare financial statements and to report for financial arrangements.

89. Separately, a company may qualify for the concessionary rules as discussed at [67]. That is, some companies may be able to be exempt from applying the FA rules to an overdrawn shareholder loan account if the $50,000 VPDI exception applies.[60] However, given the low threshold, it is expected that few companies would qualify for this exception.

90. In addition, some companies may be able to qualify as cash basis persons for the purpose of the FA rules. Where they qualify, they do not need to spread financial arrangements income or expenditure under the FA rules.

Claiming RWT credits

91. Where RWT is deducted from interest received from a shareholder, the company can claim a tax credit for that RWT in its income tax return for the year in which it derives the interest,[61] provided that the shareholder has withheld the RWT and paid it to Inland Revenue.

Example | Tauira 15 – Interest and RWT calculated after year end

This example follows on from Example | Tauira 13.

On 30 November 2024, JVES's accountant prepares the company's tax return for the year ending 31 March 2024. JVES returns its income on an accrual basis. The accountant therefore includes the interest income accrued on Jin's loan to 31 March 2024 in the tax return, even though the interest is only paid in June 2024.

The accountant also claims a tax credit for the RWT that Jin paid to Inland Revenue on 20 July 2024 as the RWT relates to interest income included in the 31 March 2024 tax return and has been returned at the time of filing the return.

Relieving a shareholder from repaying overdrawn balance

92. Because the affairs of close companies and their shareholders are intimately linked, sometimes a company may agree that the shareholder does not need to repay the balance of their overdrawn loan account. If a shareholder is relieved of their obligation to repay their overdrawn shareholder loan account balance, income will arise under the dividend rules or the FA rules.

57 Section EW 17.

58 See **DET G24: Straight line method**, which sets out the principles and calculation methods of the straight-line method (in particular "Method B"), and **DET G1A: Apportionment of income and expenditure on a daily basis**, which requires financial arrangements income and expenditure for a period to be apportioned on a straight-line basis among the income years in which the period falls, according to the number of days in the period.

59 As defined in s YA 1 to mean "a New Zealand Equivalent to International Financial Reporting Standard, in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place".

60 Another exception in s EW 5(10) excludes a lender from applying the FA rules to an interest-free New Zealand-denominated loan that is repayable on demand. However, that is not relevant to this discussion of interest-bearing loans.

61 Section LB 3(1).

Application of the dividend rules

93. Under the dividend rules, a "transfer of company value" occurs when a company releases a shareholder from repaying a loan without receiving adequate value from the shareholder in return.[62] As discussed from [30], in most cases the Commissioner considers such transfers would be caused by the shareholder's shareholding in the company, giving rise to a dividend.[63] This is because the company is unlikely to release other debtors from paying amounts they owe it, meaning the release occurred because the debtor is a shareholder. The amount of the dividend is the market value of the loan forgiven (see Example | Tauira 16).[64] This applies regardless of whether the shareholder is an employee of the company.

Example | Tauira 16 – Dividend from debt forgiveness

> Shingi is a shareholder in Travel The World In Luxury Limited (TTWIL), which operates a travel advisory business.
>
> In the 2024 income tax year, Shingi's shareholder loan account is overdrawn by $5,000 and TTWIL agrees to release Shingi from having to repay this balance.
>
> The release of debt results in a transfer of company value from TTWIL to Shingi. This is because TTWIL has provided money or money's worth to Shingi but Shingi has not provided anything in return.
>
> Shingi's shareholding in TTWIL has caused the transfer of company value as the company would not have provided this value to an unrelated third party.
>
> A dividend therefore arises for Shingi unless one of the dividend exclusions[65] applies.

94. If the debt forgiveness occurs in the course of a company's liquidation,[66] the dividend amount may be reduced by any available capital distribution amount and any available subscribed capital in the company.[67]

Application of the FA rules

95. In most cases,[68] a base price adjustment (BPA) must also be calculated under the FA rules (in addition to applying the dividend rules above) when a specified event[69] occurs, including when one of the following applies:
    - The shareholder is discharged from making all remaining payments owed on their overdrawn shareholder loan account without fully adequate consideration.
    - The shareholder is released from making all remaining payments owed on their overdrawn shareholder loan account under the Insolvency Act 2006 or the Companies Act 1993.
    - All remaining payments owed on the shareholder's overdrawn shareholder loan account become irrecoverable or unenforceable through the lapse of time.

96. Where a company forgives the outstanding balance on an overdrawn shareholder loan account, the shareholder is considered to have been discharged from making the remaining payments they owe on the account without fully adequate consideration. This means the two parties are required to calculate a BPA.

97. Another circumstance requiring a BPA calculation is where the outstanding debt becomes irrecoverable or unenforceable through the lapse of time. This can arise through the application of the Limitation Act 2010 where the 6-year limitation period[70] for a creditor to recover a debt has expired.

62 Section CD 5(2).

63 See also *Campbell* and *Davis v Commissioner of Inland Revenue* (1983) 6 NZTC 61,655.

64 Section CD 38(1) and (2).

65 See ss CD 22 to CD 37.

66 For information on when a company is considered to be in "liquidation", refer to **BR Pub 14/09: Income tax – meaning of "anything occurring on liquidation" when a company requests removal from the register of companies**, which relates to short-form liquidations, or **QB 20/03: First step legally necessary to achieve liquidation when a liquidator is appointed**.

67 Section CD 26(1)(a) and (2).

68 A BPA is not required if the overdrawn shareholder loan account is an "excepted financial arrangement" under s EW 5 – for example, if the VPDI exception (as discussed from [58]) applies. However, it is expected that only on rare occasions a shareholder loan account would be an excepted financial arrangement.

69 Section EW 29, in particular, subss (9), (10) and (12).

70 Section 11(1) of the Limitation Act 2010.

98. Notably, the fact that a party to the loan may be a cash basis person for the purpose of the FA rules does not affect their obligation to perform a BPA calculation. However, if they qualify for the VPDI exception in respect of the overdrawn shareholder loan account, they will not need to perform a BPA calculation.
99. It is also possible that a company may not need to apply the FA rules to an overdrawn shareholder loan account if the loan is:
    - in New Zealand dollars; and
    - interest-free; and
    - repayable on demand.[71]
100. Accordingly, where an overdrawn shareholder loan account meets the above criteria, the company will not need to perform a BPA calculation for that loan. This, however, does not affect the relevant shareholder's obligations under the FA rules, which are assessed independently from the obligations of the company.

BPA calculation

101. Under a debt forgiveness scenario, both the lender (eg, the company) and the borrower (eg, the shareholder) will need to separately calculate their own BPA.
102. A BPA is calculated using the following prescribed formula:[72]

consideration − income + expenditure + amount remitted

103. Each of the components in the BPA formula is discussed in further detail below:
    - Consideration – see [105] to [110] and Example | Tauira 17.
    - Income – see [111] to [113] and Example | Tauira 18.
    - Expenditure – see [114] to [116] and Example | Tauira 19.
    - Amount remitted – see [117] and [118], and Example | Tauira 20.
104. The BPA calculation and outcomes are also discussed from [119] to [123] and illustrated in Example | Tauira 20, Example | Tauira 21 and Example | Tauira 22.

Consideration

105. The **consideration** component[73] of the formula is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, **minus** all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement.
106. The consideration for a shareholder calculating a BPA would generally be all amounts that they have received or will receive from the company in their shareholder loan account (eg, all the drawings taken by the shareholder) **minus** all amounts they have paid or will pay to the company in respect of the shareholder loan account (eg, any principal repayments or interest).
107. Consideration paid or payable by the shareholder to the company does not include the amount of debt that the company forgives. At the point in time it forgives the debt, that debt is no longer payable by the borrower.
108. A BPA that a shareholder calculates when their overdrawn shareholder loan account balance is forgiven will generally result in a positive consideration figure. This is because, when a loan is forgiven, the borrower has received more than they have paid.
109. The consideration for a company calculating a BPA would generally be all amounts it has received or will receive from a shareholder on their shareholder loan account (eg, any repayments or interest) **minus** all amounts it has paid to the shareholder in respect of the shareholder loan account (eg, all drawings taken by the shareholder).
110. Again, consideration paid or payable to the company does not include the amount of debt that the company forgives. Therefore, a BPA that a company calculates when it forgives an overdrawn shareholder loan account balance of a shareholder will generally result in a negative consideration figure (see Example | Tauira 17).

71 Section EW 5(10).
72 Section EW 31(5).
73 Section EW 31(7).

Example | Tauira 17 – BPA consideration when debt forgiven

Mark is a shareholder-employee of Give Me That Tripple Shot Limited (Tripple Shot). He is allowed to take drawings from Tripple Shot to fund his living costs. Over the course of the year ending 31 March 2023, he takes drawings totalling $50,000.

Tripple Shot's accountant prepares the company's 2023 accounts in June 2023. A shareholder salary of $35,000 is allocated to Mark for the year and is applied to repay the loan. Interest is charged at the applicable Inland Revenue prescribed rate on the outstanding balance, which works out to be $400 and is added to the loan balance.

In December 2023, Mark decides to part ways with Tripple Shot and asks the company to remit his overdrawn shareholder loan account balance. By this time, the overdrawn balance has increased by another $25,000 to $40,000, including the $400 interest. The directors of Tripple Shots agree to remit the full balance of $40,000.

Aside from the fact that a dividend of $40,000 will arise for Mark, both Mark and Tripple Shot need to calculate a BPA.

Under the prescribed BPA formula, Mark's consideration component is calculated as:

Consideration = *total consideration paid to Mark* – *total consideration paid by Mark*

Consideration = (50,000 + 25,000) – 35,000

Consideration = 40,000

Tripple Shot's consideration component is calculated as:

Consideration = *total consideration paid to Tripple Shot*
– *total consideration paid by Tripple Shot*

Consideration = 35,000 – (50,000 + 25,000)

Consideration = –40,000

Income

111. In the context of an overdrawn shareholder loan account, the **income** component [74] of the formula comprises both:
- the income the person derived under the financial arrangement in earlier income years; and
- dividends the person derived from the release of the obligation to repay the amount loaned.

112. For a shareholder, this component will likely comprise any dividend arising from the company forgiving their loan (as discussed at [93]). The reason for including such dividends is to ensure the shareholder is not taxed again on the same amounts under the FA rules.

113. For a company, this component will likely comprise any interest that it derived in the years before the year in which it is required to calculate the BPA (eg, in the year in which the loan is forgiven) (see Example | Tauira 18).

Example | Tauira 18 – Income component

Following on from Example | Tauira 17, Mark's income component is $40,000, which represents his dividend income from the debt forgiveness. He has not derived any other income from his shareholder loan account to include in this component.

Tripple Shot's income component is $400 (assuming it returns income on an accrual basis), which represents the interest income it derives to 31 March 2023.

Expenditure

114. The **expenditure** component [75] is the expenditure the person incurs under the financial arrangement in earlier income years.

115. For most shareholders, this component will mostly represent the interest charged on their overdrawn shareholder loan account, if any.

74 Section EW 31(9).
75 Section EW 31(10).

116. For a company, this component is likely to be nil as the company would generally not incur expenditure on a shareholder loan account (see Example | Tauira 19).

Example | Tauira 19 – Expenditure component

Following on from Example | Tauira 18, Mark's expenditure component is the $400 of interest he incurs on the overdrawn shareholder loan account in the year ending 31 March 2023.

Tripple Shot's expenditure component is nil as it has not incurred any expenditure on the loan account.

Amount remitted

117. The **amount remitted** component[76] is an amount that is not included in the consideration paid or payable to the person because it has been remitted by the person or by law.

118. This component is generally only relevant to the lender (eg, a company forgiving an overdrawn shareholder loan account balance) and represents the amount of debt that has been remitted by the lender or by law. Therefore, this component should be nil for a shareholder benefitting from a debt forgiveness (see Example | Tauira 20).

Example | Tauira 20 – Amount remitted component

Following on from Example | Tauira 19, Mark's amount remitted component is nil as the amount remitted was not payable to him.

Tripple Shot's amount remitted component is $40,000, which is the amount it forgives on Mark's overdrawn shareholder loan account.

Mark's BPA is therefore calculated as:

BPA = consideration − income + expenditure + amount remitted

BPA = 40,000 − 40,000 + 400 + 0

BPA = 400

Tripple Shot's BPA is calculated as:

BPA = −40,000 − 400 + 0 + 40,000

BPA = −400

BPA outcome

119. Where the outcome of a BPA calculation is positive, it is generally financial arrangements income for the person in the year for which the calculation is made. However, the positive BPA is not income to the extent to which it arises from expenditure the person incurred under the relevant financial arrangement in earlier income years and for which a deduction was denied in those income years (see Example | Tauira 21).[77]

Example | Tauira 21 – Positive BPA outcome

Following on from Example | Tauira 20, although Mark has a positive BPA of $400, the BPA is not income because the entire $400 arises from interest incurred on his overdrawn shareholder loan account, which represents expenditure Mark incurred under the financial arrangement. Additionally, he is denied a deduction for interest in the 2023 income year because the interest does not have a nexus to income and therefore does not meet the general permission.

This means that Mark's BPA produces no income (or deduction). As the BPA formula takes into account the income he is already required to return under the dividend rules, he is not further subject to debt remission income under the FA rules.

76 Section EW 31(11).

77 Section EW 31(3).

120. Where the outcome of a BPA calculation is negative, the amount is expenditure the person incurred in the income year for which the calculation is made.[78] Expenditure incurred under the FA rules is deemed to be interest.[79]
121. A deduction may be available for the person in respect of the deemed interest. Where the person is not a company, the person may be allowed a deduction if the relevant requirements for deduction of an interest expense (as discussed at [63]) are met.
122. Where the person is a company, the company is allowed a deduction for interest expenditure incurred whether or not the expenditure satisfies the general permission.[80] The general limitations in s DA 2 may still apply, other than the capital limitation, the exempt income limitation and the withholding tax limitation. However, in the context of an overdrawn shareholder loan account, it is unlikely that the relevant general limitations would apply to a company.
123. Where the above deduction rules do not apply, a deduction is allowed for the negative BPA amount to the extent the amount arises from assessable income that the person derived under the financial arrangement in earlier income years.[81]

Example | Tauira 22 – Negative BPA outcome

Following on from Example | Tauira 21, Tripple Shot has a deduction of $400 in the 2024 income year. The −$400 negative BPA is deemed to be interest and a deduction is allowed under s DB 7.

Notably, the BPA calculation does not allow a deduction for the $40,000 that Tripple Shot forgives as the amount is added back under the amount remitted component.

78 Section EW 31(4).

79 See para (c) of the definition of "interest" in s YA 1.

80 Section DB 7.

81 Section DB 11.

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TECHNICAL DECISION SUMMARIES

Technical decision summaries (TDS) are summaries of technical decisions made by the Tax Counsel Office. As this is a summary of the original technical decision, it may not contain all the facts or assumptions relevant to that decision. A TDS is made available for information only and is not advice, guidance or a "Commissioner's official opinion" (as defined in s 3(1) of the Tax Administration Act 1994). **You cannot rely on this document as setting out the Commissioner's position more generally or in relation to your own circumstances or tax affairs**. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest).

TDS 24/19: Income tax and GST deductions

Decision date | Rā o te Whakatau: 3 May 2024

Issue date | Rā Tuku: 15 October 2024

Subjects | Kaupapa

Residency; income tax deductions; GST input tax deductions; shortfall penalties

Taxation laws | Ture tāke

The applicable legislation is noted at the start of each issue.

Summary of facts | Whakarāpopoto o Meka

1. The Taxpayer arrived in New Zealand in October 2020 and registered for GST. The Taxpayer left New Zealand permanently in January 2022.
2. The Taxpayer did not file their GST return for the period ended 30 November 2021 by the due date and a default assessment was issued. The Taxpayer subsequently filed the outstanding GST return in March 2022.
3. The Taxpayer also did not file their GST return for the period ended 31 May 2022 by the due date and a default assessment was issued.
4. The Taxpayer filed an income tax return for the year ended 31 March 2022 in April 2022.
5. Following an audit of the Taxpayer, Customer Compliance Services, Inland Revenue (CCS) issued a Notice of Proposed Adjustment (NOPA) proposing to:
    - disallow all GST expenses claimed in the November 2021 GST return and include additional income in the default assessment for the May 2022 GST return;
    - impose shortfall penalties for gross carelessness for the November 2021 GST return and the May 2022 GST return;
    - disallow all expenses claimed in the income tax return for the year ended 31 March 2022, which were incurred after the Taxpayer left New Zealand; and
    - impose a shortfall penalty for not taking reasonable care for the tax shortfall resulting from the filing of the 2022 income tax return.
6. The Taxpayer emailed CCS rejecting the NOPA. CCS advised the Taxpayer that their email did not meet the requirements of a valid Notice of Response (NOR).
7. CCS issued a Statement of Position and the Taxpayer responded with their Statement of Position and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

8. The main issues considered in this dispute were:
   - When was the Taxpayer resident in New Zealand
   - Whether the Taxpayer was entitled to income tax deductions as a non-resident.
   - Whether the Taxpayer was entitled to GST input tax deductions for the November 2021 period.
   - Whether shortfall penalties for gross carelessness, reduced by 50% for previous compliant behaviour, applied to the tax positions taken by the Taxpayer in filing the GST return for the period ended 30 November 2021 and for not filing the GST return for the period ended 31 May 2022. Alternatively, did shortfall penalties for not taking reasonable care apply to those periods.
   - Whether shortfall penalties for not taking reasonable care, reduced by 50% for previous compliant behaviour, apply to the tax position taken by the Taxpayer in filing their 2022 income tax return.
9. There were also preliminary issues concerning, firstly, which GST assessments were in dispute and, secondly, whether the Taxpayer's NOR was valid.

Decisions | Whakatau

10. TCO concluded that:
    - The Taxpayer was resident in New Zealand until the date of departure from the country in January 2022.
    - The Taxpayer was not entitled to deduct expenses incurred outside New Zealand from the date of departure from the country in January 2022 to 31 March 2022 for the income year ended 31 March 2022.
    - The Taxpayer was not entitled to input tax deductions for the GST period ended 30 November 2021.
    - The Taxpayer was liable for shortfall penalties for gross carelessness for tax positions taken in relation to both GST periods in dispute, reduced by 50% under s 141FB of the TAA for previous compliant behaviour.
    - The Taxpayer was not liable for a shortfall penalty for not taking reasonable care in respect of the tax shortfall for the income year ended 31 March 2022.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue 1 | Take tōmua tuatahi: Which GST assessments were in dispute

11. The Taxpayer did not file their GST return for the period ended 30 November 2021 by the due date and a default assessment was issued. Subsequently the Taxpayer filed the GST return for the period ended 30 November 2021 in March 2022.
12. CCS issued a NOPA in respect of the GST period ended 30 November 2021 proposing to disallow the GST input tax deductions claimed in the return. The NOPA started the disputes resolution process, and the November 2021 GST period was part of the dispute.
13. The Taxpayer did not file the GST return for the period ended 31 May 2022. A default assessment was issued in respect of this period. To start a dispute in a period where a default assessment has been issued by the Commissioner, a taxpayer must file the applicable return and also issue a NOPA in accordance with s 89D(2) of the Tax Administration Act 1994. The Taxpayer did not file the GST return for the period ended 31 May 2022 or issue a NOPA. Therefore, they cannot dispute or challenge the default assessment for the period ended 31 May 2022. The GST return for the period ended 31 May 2022 was not part of the dispute.

Preliminary Issue 2 | Take tōmua tuarua: Was the NOR valid

14. TCO considered that the Taxpayer's email rejecting the NOPA was not a valid NOR as it did not meet the requirements of s 89G(2) of the Tax Administration Act 1994 (TAA 1994).
15. However, whether the Taxpayer's email is a valid NOR is a matter for the Taxation Review Authority (TRA) or a court to decide.[1] If the TRA or a court finds that the Taxpayer's rejection email is an invalid NOR, the Taxpayer is deemed to have accepted CCS's proposed adjustments.

1 *CIR v Alam and Begum* [2009] NZCA 273, (2009) 24 NZTC 23,564; *Riccarton Construction Limited v CIR* (2010) 24 NZTC 24,191 (HC) at 24,202.

Issue 1 | Take tuatahi: When was the Taxpayer resident in New Zealand

16. All references in this part of the summary are to the Income Tax Act 2007 (ITA 2007) unless otherwise stated.

The residency provisions in ITA 2007

17. Section YD 1(2) provides that a person is resident in New Zealand for tax purposes if they have a permanent place of abode (PPOA) in New Zealand. This applies regardless of whether the person also has a PPOA somewhere else or is absent for 325 days. The PPOA test is the overriding residency rule for individuals in New Zealand.
18. Where a person does not have a PPOA in New Zealand the relevant tests are set out in ss YD 1(3), (4), (5), (6) and (8).
19. Under s YD 1(3) and (4) a natural person is a New Zealand resident if they are personally present in New Zealand for more than 183 days in a 12-month period (183-day test). The person is treated as resident from the first of the 183 days.
20. When a person is only resident under the 183-day test they are treated as not resident if they are personally absent from New Zealand for more than 325 days in total in a 12- month period under s YD 1(5). Section YD 1(6) treats the person as not resident from the first of the 325 days.
21. When a person is present in New Zealand for part of a day, such as the day of arrival or departure from New Zealand, they are treated as being present in New Zealand for the entire day pursuant to s YD 1(8).

When did the Taxpayer become a New Zealand resident

22. The Taxpayer did not have a PPOA in New Zealand after they left the country in January 2022. On that basis PPOA was not considered in detail by TCO.
23. The evidence showed that the Taxpayer was personally present in New Zealand more than 183 days after they arrived in New Zealand in October 2020. Therefore, they were resident from the day they arrived in New Zealand under ss YD 1(3), (4) and (8).
24. The Taxpayer left New Zealand in January 2022. New Zealand Customs information showed that the Taxpayer did not return to New Zealand within the 325-day period.
25. Therefore, the Taxpayer was not tax resident in New Zealand from the day after departure in January 2022 and was absent from New Zealand for more than 325 days. Sections YD 1(5), (6) and (8) apply.

Issue 2 | Take tuarua: Was the Taxpayer entitled to income tax deductions as a non-resident?

26. All references in this part of the summary are to the Income Tax Act 2007 unless otherwise stated.
27. Under s DA 1(1) a person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is incurred by them in deriving their assessable income.
28. Under s BD 1(5) “assessable income” does not include “non-residents’ foreign-sourced income”.
29. For income to be “non-residents’ foreign-sourced income” of a person the following requirements must be satisfied (s BD 1(4)):
    - The income must be a foreign-sourced amount.
    - The person must be a non-resident when the income is derived.
30. The Taxpayer in their 2022 income tax return claimed expenditure or losses from an online trading platform incurred after the date that they ceased to be a New Zealand tax resident.
31. The online trading platform was run by an overseas company. Once the Taxpayer ceased to be a New Zealand tax resident, income from the overseas company would be classed as non-residents’ foreign-sourced income and that would not be assessable income under s BD 1(4). In addition, none of the source rules in s YD 4 applied to make the income derived (or losses sustained) after the Taxpayer ceased being a New Zealand tax resident have a source in New Zealand.
32. It followed then that any expenditure incurred in deriving non-residents’ foreign-sourced income cannot meet the general permission under s DA 1 because there was no nexus with the derivation of assessable income. Further, there is a specific limitation under s DA 2(6) that prohibits a deduction for expenditure or loss incurred in deriving non-residents’ foreign-sourced income.
33. Therefore, the deductions for expenditure after the date that the Taxpayer ceased to be a New Zealand tax resident should be denied in the income year ended 31 March 2022 because they were incurred in deriving non-residents’ foreign-sourced income.

Issue 3 | Take tuatoru: Whether the Taxpayer was entitled to GST input tax deductions for the November 2021 period.

34. All references in this part of the summary are to the Goods and Services Tax Act 1985 (GSTA) unless otherwise specified.
35. To claim GST input tax deductions:
    - A person must be GST registered and carrying on a taxable activity.
    - The goods and services must have been used for, or available for use in, making taxable supplies.
    - Tax invoice requirements must have been met.
36. These requirements are cumulative; to deduct input tax all of them must be met. They are strict requirements.
37. The registered person must hold a tax invoice to claim GST paid on supplies acquired unless the amount of the consideration for the supplies is $50 or less under s 24(5).
38. Even if the other statutory requirements for a deduction from output tax are satisfied, the Commissioner may deny an input tax deduction if the associated tax invoice, debit note, or credit note is not retained (proviso to s 20(2) in accordance with s 75).
39. In addition, s 149A of the TAA 1994 places the onus of proof on the taxpayer and not the Commissioner. Case law confirms this approach.[2] The onus is on the taxpayer to show that an assessment is wrong and why it is wrong.
40. The courts have also held that the standard of proof needed is the balance of probabilities.[3]
41. The Taxpayer did not have tax invoices which were required for an input tax deduction or copies of the relevant invoices or any factual evidence about what made up the claim for purchases or even whether an amount was incurred. The Taxpayer stated that the relevant records were lost. The Taxpayer had not made any attempt obtain copies of the tax invoices, or to provide the GST workings which were prepared after departure from New Zealand.
42. There was no evidence that any of the purchases were for $50 or less but, even if they were, the required information was not provided or held to enable an input tax deduction. The Commissioner can, in rare circumstances, exercise his discretion that a tax invoice was not required if there was sufficient evidence to establish an audit trail under s 24(6)(b). That evidence did not exist in the dispute and the Commissioner did not exercise his discretion before the GST return was filed. Given the lack of tax invoices and lack of evidence about the expenses the Taxpayer was not entitled to input tax deductions.
43. Therefore, it was concluded that the Taxpayer was not entitled to any input tax deductions in respect of the GST return period ended 30 November 2021.

Issue 4 | Take tuawhā: Shortfall penalty for gross carelessness

44. All references in this part of the summary are to the Tax Administration Act 1994 (TAA) unless otherwise stated.
45. Section 141C imposes a shortfall penalty for gross carelessness on a taxpayer if the following requirements are satisfied:[4]
    - The taxpayer has taken a tax position.
    - Taking the tax position has resulted in a tax shortfall.
    - The taxpayer has been grossly careless in taking the taxpayer's tax position. Gross carelessness means doing or not doing something in a way that, in all the circumstances, suggests or implies a complete or high level of disregard for the consequences (s 141C(3)):
        - Gross carelessness is characterised by conduct which creates a high risk of a tax shortfall occurring where that risk and its consequences would have been foreseen by a reasonable person in the circumstances.[5]

2 *Case V17* (2002) 20 NZTC 10,192; *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC); *Vinelight Nominees Ltd v CIR* (No 2) (2005) 22 NZTC 19,519 (HC).

3 *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Case Y3* (2007) 23 NZTC 13,028; *Case X16* (2005) 22 NZTC 12,216.

4 The shortfall penalty for gross carelessness is considered in the Interpretation Statement: Shortfall Penalty for Gross Carelessness as published in *Tax Information Bulletin* Vol 16, No 8 (September 2004).

5 *Case W4* (2003) 21 NZTC 11,034 at [44].

- The test for gross carelessness is not whether the taxpayer actually foresaw the probability that their act or omission would cause a tax shortfall but whether a reasonable person would have foreseen that probability. Whether the taxpayer has acted intentionally is not a consideration.[6]
  - A person who takes reasonable care is not grossly careless.[7]

46. The penalty payable for gross carelessness is 40% of the resulting tax shortfall.
47. TCO concluded that a reasonable person in the Taxpayer's position would have foreseen the risk of a tax shortfall by claiming the input tax deductions in their GST return for the GST period ended 30 November 2021 because:
    - The law was relatively straightforward that tax invoices were needed. The Taxpayer was also given advice by CCS when they registered for GST that expenses on meals and home to work travel were personal and not claimable.
    - Given the misplaced tax invoices, it appears the Taxpayer filed their GST return with very limited information as to their expenses. There had not been any attempt to cross check with their bank statements or to obtain replacement tax invoices. In addition, the Taxpayer had received guidance from Inland Revenue about claiming expenses. It was considered that the Taxpayer showed a complete disregard for the consequences of making input tax claims without sufficient records or connection to making of taxable supplies and was grossly careless.
    - The Taxpayer was also liable for not taking reasonable care under s 141A for the same reasons. However, the higher penalty for gross carelessness applied, reduced by 50% for previously compliant behaviour (ss 141C, 141FB and 149).
48. In respect of the GST return for the period ended 31 May 2022 TCO concluded that a reasonable person in the Taxpayer's position would have foreseen the risk of a tax shortfall arising as a result of not filing the return because:
    - The value of supplies made by the Taxpayer during the period was sufficiently large to be material. The Taxpayer would have been aware that they received payments for consulting services. These payments were subject to GST but no return containing the output tax had been filed.
    - The law was not complicated. The Taxpayer had been contacted shortly after they registered for GST and had been informed of their GST obligations. The GST return was never filed despite repeated reminders from Inland Revenue. The Taxpayer had ample opportunity to find tax invoices or get copies, but this did not occur.
    - The Taxpayer would also be liable for not taking reasonable care under for the same reasons. However, the higher penalty for gross carelessness applied, reduced by 50% for previously compliant behaviour.

Issue 5 | Take tuarima: Shortfall penalty for not taking reasonable care

49. All references in this part of the summary are to the Tax Administration Act 1994 unless otherwise stated.
50. Section 141A imposes a shortfall penalty for not taking reasonable care on a taxpayer if the following requirements are satisfied:[8]
    - The taxpayer has taken a tax position.
    - Taking the tax position has resulted in a tax shortfall.
    - The taxpayer has not taken reasonable care in taking the taxpayer's tax position:[9]
      - The test of "reasonable care" is whether a reasonable person in the taxpayer's circumstances would have foreseen a tax shortfall as a reasonable probability. It is not a question of whether the taxpayer actually foresaw the probability.
      - Taking reasonable care includes exercising reasonable diligence to determine the correctness of a return. It also includes keeping adequate books and records to properly substantiate a return and, generally, making a reasonable attempt to comply with the tax law.
      - The "reasonable care" test does not require the commitment of unlimited time and money or other resources. The effort required of the taxpayer is commensurate with the reasonable person in the taxpayer's circumstances.[10]

6 *Case W4* at [60]; *Case 9/2014* (2014) 26 NZTC 2-019 at [88].

7 *Case W4*; *Re Carlaw and FCT* 95 ATC 2166 (AAT); *Re Sparks and FCT* [2000] AATA 28 and see also *Pech v Tilgals* [1994] ATC 4206.

8 The shortfall penalty for not taking reasonable care is considered in the Interpretation Statement: Shortfall penalty for not taking reasonable care as published in *Tax Information Bulletin* Vol 17, No 9 (November 2005).

9 *Case W4* (2003) 21 NZTC 11,034.

10 See also *Case W3* (2003) 21 NZTC 11,014 and *TRA 007/12* [2014] NZTRA 08, (2014) 26 NZTC 2018.

51. The penalty payable for not taking reasonable care is 20% of the resulting tax shortfall.
52. TCO concluded that the Taxpayer took reasonable care in taking their tax position in respect of the 2022 income year because:
    - They took steps that a reasonable person in their circumstances would have taken to confirm their residence status at the time they filed their income tax return for the period ended 31 March 2022 because they consulted Inland Revenue's published guidance.
    - It appeared that the Taxpayer did not appreciate that once 325 days had elapsed, they would be retrospectively treated as a non-resident from the day after they left New Zealand.
    - The losses were actually incurred and supported by evidence from the online trading platform they were using.

TDS 24/20: Permanent establishment

Decision date | Rā o te Whakatau: 24 July 2024

Issue date | Rā Tuku: 12 November 2024

Subjects | Kaupapa

The provision of services by a New Zealand company to an overseas company. Whether the overseas company had a permanent establishment in New Zealand.

Taxation laws | Ture tāke

All legislative references in this summary are to the Income Tax Act 2007 (Act) unless otherwise stated.

Facts | Meka

1. The Arrangement was that an overseas resident company (OS Co) had engaged a New Zealand resident company (NZ Co) to undertake work in New Zealand. Some of OS Co's employees would:
   - take a leave of absence from OS Co;
   - temporarily move to New Zealand; and
   - be employed directly by NZ Co on fixed term contracts.
2. OS Co would pay NZ Co a fee on a costs plus basis for the services NZ Co provided to OS Co. The terms of the contract (including the service fee) would be on an arm'slength basis.
3. OS Co did not have:
   - its head office in New Zealand;
   - its centre of management in New Zealand; or
   - its directors, in their capacity as directors, exercising control of OS Co in New Zealand.
4. Unless they were on a leave of absence from OS Co, none of OS Co's employees would be present in New Zealand performing services for OS Co under the Arrangement.
5. For the purposes of the Act OS Co and NZ Co are not associated.
6. OS Co would not:
   - have any use, access, or authority over, NZ Co's premises;
   - be using or carrying on business through NZ Co's premises; and
   - have a place of management or branch in New Zealand at NZ Co's premises.
7. NZ Co would have a fixed place of business in New Zealand (office premises). As noted above, NZ Co's initial employees would be staff who temporarily moved to New Zealand and who entered into fixed term employment contracts with NZ Co. NZ Co and its employees would have no authority to enter into contracts on behalf of OS Co.

Issues | Take

8. The main issues considered in this ruling were whether entering and performing the Arrangement:
   - resulted in OS Co being "resident in New Zealand" as defined in s YA 1;
   - created a "permanent establishment" for OS Co as that term is defined in s YD 4B;
   - resulted in s GB 54 applying to OS Co;
   - resulted in OS Co having income that was treated as having a source in New Zealand under s YD 4;
   - gave rise to "assessable income" for OS Co for the purposes of s BD 1(5).
9. In addition, the Tax Counsel Office (TCO) considered whether the Arrangement was a "tax avoidance arrangement" under s BG 1.

Decisions | Whakatau

10. TCO decided that entering and performing the Arrangement did not:
    - result in OS Co being "resident in New Zealand" as defined in s YA 1;
    - create a "permanent establishment" as defined in s YD 4B for OS Co;
    - result in s GB 54 applying to OS Co;
    - result in OS Co having income that was treated as having a source in New Zealand under s YD 4;
    - give rise to "assessable income" for OS Co under s BD 1(5).
11. TCO also decided that s BG 1 did not apply to the Arrangement.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Residence

12. The issue was whether entering into and performing the Arrangement resulted in OS Co being "resident in New Zealand" as defined in s YA 1.
13. Section YA 1 relevantly states that "New Zealand resident" means a person resident in New Zealand under sections YD 1 to YD 3B.
14. Section YD 2(1) provides that a company is a New Zealand resident for the purposes of the Act if one of the following four elements is satisfied:
    - it is incorporated in New Zealand;
    - its head office is in New Zealand;
    - its centre of management is in New Zealand;
    - its directors, in their capacity as directors, exercise control of the company in New Zealand, even if the directors' decision-making also occurs outside New Zealand.
15. TCO considered the description of the Arrangement (see above at [1]-[7]) and concluded that OS Co was not New Zealand resident under s YD 2 because, none of the four elements was satisfied.

Issue 2 | Take tuarua: Permanent establishment

16. The issue was whether entering and performing the Arrangement created a "permanent establishment" for OS Co as that term is defined in s YD 4B.
17. Section YD 4B(2)(a) relevantly states that "permanent establishment", for an enterprise that is resident in a country or territory with which New Zealand has a double tax agreement (DTA) that includes a definition of permanent establishment, has the meaning given by the DTA. TCO noted that there was a DTA between New Zealand and the country where OS Co was resident.
18. TCO considered the OECD Model Commentary when interpreting article 5 of the DTA:[1]
    - *Article 5(1) – general definition of permanent establishment*: Means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
    - *Article 5(2) – examples of permanent establishments such an office or branch*: This paragraph contains an inclusive list of examples of places of business, each of which could be regarded as constituting a permanent establishment under paragraph 1.

      The facts show that NZ Co established an office in New Zealand. However, OS Co would not:
      - have any use, access, or authority over, NZ Co's premises;
      - be using or carrying on its business through NZ Co's premises; and
      - have a place of management or branch at NZ Co's premises.

      Therefore, OS Co would not have a permanent establishment under art 5(2).
    - *Article 5(3) – building sites, construction or installation project:* This provision did not apply to OS Co.

1 *CIR v JFP Energy Inc* [1990] 3 NZLR 536.

- *Article 5(4) – exclusions from permanent establishment:* The exclusion did not apply to OS Co.
- *Article 5(5) – authority to conclude contracts:* Article 5(5) deems a permanent establishment to exist if a dependent agent has the authority to conclude contracts on behalf of the non-resident.

  NZ Co did not have the authority to conclude contracts on behalf of OS Co.
- *Article 5(6) – independent agent:* This provision did not apply to OS Co.
- *Article 5(7) – subsidiary:* This provision did not apply to OS Co.

19. Accordingly, TCO concluded that OS Co would not have a permanent establishment under the DTA. Therefore, OS Co would not have a permanent establishment under s YD 4B(2)(a).

Issue 3 | Take tuatoru: Section GB 54

20. The issue was whether entering and performing the Arrangement resulted in s GB 54 applying to OS Co.
21. The Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 (BEPS Act 2018) introduced s GB 54, a permanent establishment specific anti-avoidance rule for large multinational groups supplying goods or services into New Zealand. If s GB 54 applied (and in very broad terms), a non-resident supplier of goods or services to a person in New Zealand would be deemed to have a permanent establishment in New Zealand.
22. TCO observed that the provisions operated in the following way:
    - Section GB 54 deems a permanent establishment to exist under the Act.
    - The non-resident person is deemed to have a permanent establishment for the purposes of any applicable double tax agreement.
    - If there is an applicable double tax agreement, the business profits article of the double tax agreement will allow New Zealand to tax the profits attributable to that permanent establishment.
    - Different rules apply if there is no double tax agreement with New Zealand.
23. TCO summarised that s GB 54 requires all the following requirements to be met before deeming a permanent establishment to exist:
    - The non-resident makes a supply of goods or services to a person in New Zealand either directly or through an intermediary.
    - A person (the "facilitator") carries out an activity in New Zealand for the purpose of bringing about that particular supply.
    - The facilitator is associated with the non-resident, is an employee of the nonresident, or is commercially dependent on the non-resident.
    - The facilitator's activities are more than preparatory or auxiliary to the nonresident's supply.
    - The non-resident's income from the supply is subject to a double tax agreement that does not include the OECD's latest permanent establishment article.
    - A more than merely incidental purpose or effect of the arrangement is to avoid New Zealand tax, or a combination of New Zealand tax and foreign tax.
    - The non-resident is part of a large multinational group. The OECD has defined a "large multinational group" as a group with at least €750m of consolidated global turnover for the purpose of filing Country-by-Country reports. The same revenue threshold is used for s GB 54.
24. TCO noted that, on the face of it, OS Co was not intentionally making any supplies to a New Zealand recipient. The services OS Co supplied occurred in the overseas jurisdiction. However, unknown to OS Co, one of OS Co's customers (or a representative) could potentially be in New Zealand when OS Co made supplies under the first requirement of s GB 54.
25. In addition, TCO considered that NZ Co did not carry out an activity in New Zealand for the purpose of bringing about a particular supply under the second requirement of s GB 54. At no point did NZ Co know whether the services it provided OS Co were for a particular customer (of OS Co) or whether that customer had a physical presence in New Zealand. TCO concluded that s GB 54 would not apply to OS Co.

Issue 4 | Take tuawhā: Source under s YD 4

26. The issue was whether entering and performing the Arrangement resulted in OS Co having income that was treated as having a source in New Zealand under s YD 4.
27. In reaching its conclusion TCO considered the following elements of s YD 4:
    - Whether OS Co was carrying on a business in New Zealand (s YD 4(2)).
    - Whether contracts were made or performed by OS Co in New Zealand (s YD 4(3)).
    - Whether OS Co had income through a permanent establishment (s YD 4(17C)).
    - Whether OS Co had income under a double tax agreement (s YD 4(17D)).
    - Whether OS Co were deriving income from any other source in New Zealand (s YD 4(18)).
28. TCO noted that:
    - OS Co carried on a business in an overseas jurisdiction.
    - OS Co's only connection to New Zealand was that it had subcontracted NZ Co to perform services for it.
    - This in turn enabled OS Co to perform services its customers in an overseas jurisdiction.
    - OS Co did not receive or earn any payments from New Zealand under the Arrangement, nor did any of its employees perform services in New Zealand while on OS Co's payroll.
    - OS Co was paying NZ Co under the Arrangement and incurring an expense, not deriving income.
29. Therefore, TCO concluded OS Co did not derive any income from the Arrangement in New Zealand, as it was paying NZ Co to perform services for it (rather than receiving income). There was no income with a source in New Zealand for OS Co under section YD 4.

Issue 5 | Take tuarima: Assessable income under s BD 1(5)

30. The issue was whether entering and performing the Arrangement gave rise to "assessable income" for OS Co for the purposes of s BD 1(5).
31. An amount of income will not be assessable income if it is "non-residents' foreign sourced income".[2] "Non-residents' foreign sourced income" is an amount that:
    - is foreign-sourced (it does not have a New Zealand source);
    - is derived by a non-resident; and
    - is not income of a trustee to which s HC 25(2) applies.[3]
32. OS Co derived "non-residents' foreign sourced income", because:
    - OS Co was a non-resident of New Zealand.
    - OS Co did not derive any New Zealand sourced income under the Arrangement.
    - There was no income of a trustee to which s HC 25(2) applies. Section HC 25(2) applies to trusts with a New Zealand settlor and a non-resident trustee.
33. Therefore, TCO considered that OS Co would not have "assessable income" under s BD 1(5). Entering and performing the Arrangement did not give rise to "assessable income" for OS Co under s BD 1(5).

Issue 6 | Take tuaono: Section BG 1

34. The issue was whether s BG 1 applied to the Arrangement.
35. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. The approach to s BG 1 was settled by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289, which has been followed in subsequent judicial decisions.

2 Section BD 1(5).

3 Section BD 1(4).

36. 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 is not 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:
        - o Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
        - o Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts.
        - o Considering the implications of the preceding two 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 does have a tax avoidance purpose or effect, consider the merely incidental test.
37. 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) TCO concluded as follows.

The "arrangement"

38. An arrangement is defined widely and includes enforceable contracts, unenforceable understandings, and all steps and transactions carrying the arrangement into effect.[4] TCO considered this involved the steps outlined above at [1]-[2], which include:
    - OS Co engaging NZ Co to undertake work in New Zealand.
    - Some of OS Co's employees taking a leave of absence from OS Co, temporarily moving to New Zealand, and being employed directly by NZ Co on fixed term contracts.
    - OS Co paying NZ Co a fee on a costs plus basis for services.

Tax Effects

39. TCO considered that the Arrangement would give rise to the following tax effects:
    - NZ Co was taxable in New Zealand on its profit from the Arrangement.
    - Entering and performing the Arrangement would not result in OS Co deriving any assessable income in New Zealand. This was because OS Co did not have a permanent establishment in New Zealand, were not resident in New Zealand and did not derive any New Zealand sourced income.

Whether the arrangement has a tax avoidance purpose or effect

40. TCO concluded that s BG 1 did not apply to the Arrangement because the Arrangement did not have a tax avoidance purpose or effect. A key consideration was that OS Co did not have assessable income in New Zealand as:
    - It did not have a permanent establishment in New Zealand.
    - It was not a resident in New Zealand.
    - It did not derive any New Zealand sourced income.
41. Further, NZ Co derived assessable income under the subcontract by performing activities in New Zealand on a cost-plus basis.
42. TCO considered that the Arrangement made use of the relevant provisions in a manner that is consistent with Parliament's purpose for those provisions.
43. Therefore, it was not necessary for TCO to consider the merely incidental test.

4 Section YA 1 of the Act.

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Tax Counsel Office

The Tax Counsel Office (TCO) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The TCO also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

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