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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
PUB00476	Interpretation statement	GST – taxable activity	4 April 2025
PUB00488	Question we've been asked (6 items)	The bright-line test for selling residential land	11 April 2025
PUB00460	Question we've been asked	When is land acquired for a purpose or with an intention of disposal so that the amount derived from the sale is income?	11 April 2025
PUB00485	Question we've been asked	GST - Deposits a seller retains from cancelled land sale agreements	17 April 2025
PUB00400	Question we've been asked	Income tax – How do the income tax rules apply when a close company provides short-stay accommodation?	2 May 2025

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IN SUMMARY

Determinations

NSC 2025: National Standard Costs for Specified Livestock Determination 2025 2

This determination is made in terms of section EC 23 of the Income Tax Act 2007. It shall apply to any specified livestock on hand at the end of the 2024-2025 income year where the taxpayer has elected to value that livestock under the national standard cost scheme for that income year.

ITR36: 2025 International tax disclosure exemption 4

To balance the revenue forecasting and risk assessment needs of the Commissioner with the compliance costs of taxpayers providing the information, the Commissioner has issued an international tax disclosure exemption under section 61(2) of the TAA that applies for the income year corresponding to the tax year ended 31 March 2025.

Interpretation statement

IS 25/04: What an employee share scheme is, the taxing date and apportionment 10

This interpretation statement considers what an employee share scheme is, including the exclusions to the definition. The statement then explains when the share scheme taxing date arises and when shares are held by or for the benefit of an employee. It also covers the circumstances when the share scheme taxing date may be deferred. Finally, it addresses how benefits are apportioned when some of the employee's entitlement arises when they are non-resident.

Technical decision summaries

TDS 25/02: Financing arrangement to fund the refurbishment of a capital asset 35

The proposed financing arrangement is to fund the refurbishment of a capital asset. The Applicants were two companies that were unable to source finance from traditional bank lending or by way of supplier financing.

TDS 25/03: GST – Output tax deductions, shortfall penalties 48

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Income tax and GST input tax deductions: Whether expenditure incurred by the Taxpayer on educational courses, motor vehicle costs, home office costs, power, insurance, rent, advertising, website, eftpos, and stock was deductible. Some of the expenses were incurred before the business commenced and/or before the GST registration date. Whether the Taxpayer was liable for shortfall penalties for not taking reasonable care.

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Income tax: income, capital/revenue, capital contribution property

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

NSC 2025: National Standard Costs for Specified Livestock Determination 2025

The Commissioner of Inland Revenue has released a determination, reproduced below, setting the national standard costs for specified livestock for the 2024–2025 income year.

These costs are used by farmers as part of the calculation of the value of livestock on hand at the end of the income year, where they have adopted the national standard cost (NSC) scheme to value any class of specified livestock.

Farmers using the scheme apply the rising one-year NSC to stock bred on the farm each year and add the rising two-year NSC to the value of the opening young stock available to come through into the mature inventory group at year-end. The cost of livestock purchased are also factored into the valuation of the immature and mature groupings at year-end, to arrive at a valuation reflecting the enterprise's own balance of farm bred and externally purchased animals.

NSCs are developed from independent survey data of national average costs of production for each type of livestock. Only direct costs of breeding and rearing rising one-year and two-year livestock are used. Excluded from the calculation of NSC values are all costs of owning (leasing) and operating the farm business, overheads, costs of operating non-livestock enterprises (such as cropping) and costs associated with producing and harvesting dual products (wool, fibre, milk and velvet).

For bobby calves, information from spring 2024 is used while other dairy NSCs are based on the 2023-2024 income and expenditure from a DairyBase sample of owner-operated dairy farms. For sheep, beef cattle, deer and goats, NSCs are based on survey data from the 2022-2023 sheep and beef farm survey conducted by the Beef & Lamb New Zealand Economic Service. This is the most recent information available for those livestock types at the time the NSCs are calculated in January 2025.

The NSCs calculated each year only apply to that year's immature and maturing livestock. Mature livestock valued under this scheme retain their historic NSCs until they are sold or otherwise disposed of, albeit through a FIFO or inventory averaging system as opposed to individual livestock tracing. It should be noted that the NSCs reflect the national average costs of breeding and raising immature livestock and will not necessarily bear a direct relationship to either the market values (at balance date) of these livestock classes or the costs of production of any individual farmer. In particular, some livestock types such as dairy cattle, may not obtain a market value in excess of the NSC until they reach the mature age grouping.

One-off movements in expenditure items are effectively smoothed within the mature inventory grouping, by the averaging of that year's intake value with the carried forward values of the surviving livestock in that grouping. For the farm-bred component of the immature inventory group, the NSC values will appropriately reflect changes in the costs of production of those livestock in that particular year.

The NSC scheme is only one option under the current livestock valuation regime. The other options are market value, replacement value, the herd scheme, and the self-assessed cost scheme (SAC) option. SAC is calculated on the same basis as NSC but uses a farmer's own costs rather than the national average costs. There are restrictions in changing from one scheme to another and before considering such a change, farmers may wish to discuss the issue with their accountant or other adviser.

This determination may be cited as "The National Standard Costs for Specified Livestock Determination 2025".

This determination is made in terms of section EC 23 of the Income Tax Act 2007. It shall apply to any specified livestock on hand at the end of the 2024-2025 income year where the taxpayer has elected to value that livestock under the national standard cost scheme for that income year.

For the purposes of section EC 23 of the Income Tax Act 2007 the national standard costs for specified livestock for the 2024-2025 income year are as set out in the following table.

Table

Kind of Livestock	Category of Livestock	National Standard Cost
		$
Sheep	Rising 1 year	43.30
	Rising 2 year	30.50
Dairy Cattle	Purchased bobby calves	228.60
	Rising 1 year	709.60
	Rising 2 year	489.00
Beef Cattle	Rising 1 year	455.90
	Rising 2 year	258.10
	Rising 3-year male non-breeding cattle (all breeds)	258.10
Deer	Rising 1 year	119.80
	Rising 2 year	59.90
Goats (Meat and Fibre)	Rising 1 year	35.80
	Rising 2 year	24.50
Goats (Dairy)	Rising 1 year	256.70
	Rising 2 year	42.50
Pigs	Weaners to 10 weeks of age	126.20
	Growing pigs 10 to 17 weeks of age	102.50

This determination is signed by me on the 20 February 2025.

Rob Falk

Technical Specialist

Technical Standards, Legal Services

ITR36: 2025 International tax disclosure exemption

Issued: 31 March 2025

Introduction

Section 61 of the Tax Administration Act 1994 ("TAA") requires taxpayers to disclose interests in foreign entities.

Section 61(1) of the TAA states that a person who has a control or income interest in a foreign company or an attributing interest in a foreign investment fund ("FIF") at any time during the income year must disclose the interest held. In the case of partnerships, disclosure needs to be made by the individual partners in the partnership. The partnership itself is not required to disclose.

Section 61(2) of the TAA allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of the international tax rules (as defined in section YA 1) contained in the Income Tax Act 2007 ("ITA").

To balance the revenue forecasting and risk assessment needs of the Commissioner with the compliance costs of taxpayers providing the information, the Commissioner has issued an international tax disclosure exemption under section 61(2) of the TAA that applies for the income year corresponding to the tax year ended 31 March 2025. This exemption may be cited as "International Tax Disclosure Exemption ITR36 "("the 2025 disclosure exemption") and the full text appears at the end of this item.

Scope of exemption

The scope of the 2025 disclosure exemption is the same as the 2024 disclosure exemption.

Application date

This exemption applies for the income year corresponding to the tax year ended 31 March 2025.

Summary

In summary, the 2025 disclosure exemption **removes** the requirement of a resident to disclose:

a. An interest in a foreign company if the resident has an income interest of less than 10% in that company and either that income interest is not an attributing interest in a FIF or it falls within the $50,000 de minimis exemption (see section CQ 5(1)(d) and section DN 6(1)(d) of the ITA). The de minimis exemption does not apply to a person that has opted out of the de minimis threshold by including in the income tax return for the income year an amount of FIF income or loss.

b. If the resident is not a widely-held entity, an attributing interest in a FIF that is a direct income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country or territory, and the fair dividend rate or comparative value method of calculation is used.

c. If the resident is a widely-held entity, an attributing interest in a FIF that is a direct income interest of less than 10% (or a direct income interest in a foreign PIE equivalent) if the fair dividend rate or comparative value method is used for the interest. The resident is instead required to disclose the end-of-year New Zealand dollar market value of all such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

The 2025 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

Commentary

Generally, residents who hold an income interest or a control interest in a foreign company, or an attributing interest in a FIF are required to disclose these interests to the Commissioner. These interests are considered in further detail below.

Attributing interest in a FIF

A resident is required to disclose an attributing interest in a FIF if FIF income or a FIF loss is calculated using one of the following calculation methods:

- attributable FIF income, deemed rate of return or cost methods; or
- fair dividend rate or comparative value methods, if the resident is a "widely-held entity"; or
- fair dividend rate or comparative value methods, if the resident is not a "widely-held entity" and either the foreign entity is incorporated or otherwise tax resident in a country or territory with which New Zealand does not have a double tax agreement in force as at 31 March 2024
- or the resident has a direct income interest of 10% or more.

For the purpose of this disclosure exemption, the term "double tax agreement" does not include tax information exchange agreements or collection agreements and is limited to the double tax agreements in force as at 31 March 2025 with the 40 countries or territories listed below.

Australia	Indonesia	Slovak Republic
Austria	Ireland	Singapore
Belgium	Italy	South Africa
Canada	Japan	Spain
Chile	Korea	Sweden
China	Malaysia	Switzerland
Czech Republic	Mexico	Taiwan
Denmark	Netherlands	Thailand
Fiji	Norway	Turkey
Finland	Papua New Guinea	United Arab Emirates
France	Philippines	United Kingdom
Germany	Poland	United States of America
Hong Kong	Russian Federation	Viet Nam
India	Samoa	

For the purpose of this disclosure exemption, a "widely-held entity" is an entity which is a:

- portfolio investment entity (this includes a portfolio investment-linked life fund); or
- widely-held company; or
- widely-held superannuation fund; or
- widely-held group investment fund ("GIF").

Portfolio investment entity, widely-held company, widely-held superannuation fund and widely-held GIF are all defined in section YA 1 of the ITA.

The disclosure required, by widely-held resident entities, of attributing interests in FIFs in which the resident has a direct income interest of less than 10% (or a direct income interest in a foreign PIE equivalent) and for which they use the fair dividend rate or the comparative value method of calculation is that, for each calculation method, they disclose the end-of-year New Zealand dollar market value of investments split by the jurisdiction in which the attributing interest in a FIF is held, listed, organised or managed.

In the event the jurisdiction is not easily determined, a further option of a split by currency in which the investment is held will also be accepted as long as it is a reasonable proxy - that is at least 90-95% accurate - for the underlying jurisdiction in which the FIF is held, listed, organised or managed. Investments denominated in euros will not be able to meet this test and so euro denominated investments will need to be split into the underlying jurisdictions.

FIF interests

The types of interests that fall within the scope of section 61(1) of the TAA are:

- rights in a foreign company (a company includes any entity deemed to be a company for the purposes of the ITA (e.g. a unit trust))
- rights in a foreign superannuation scheme held by a person as a beneficiary or member, if the person acquired the interest before 1 April 2014 and treated the interest as a FIF interest in a return of income filed before 20 May 2013 and for all subsequent income years
- rights in a foreign superannuation scheme held by a person as a beneficiary or member, if the person's interest in the scheme was first acquired whilst the person was tax resident of New Zealand
- rights to benefit from a life insurance policy offered and entered into outside New Zealand
- rights in an entity specified in schedule 25, part A of the ITA.

However, interests that are exempt (under sections EX 31 to EX 43 of the ITA) from being an attributing interest in a FIF do not have to be disclosed. The following is a summary of these exemptions:

- certain interests in Australian resident companies included on the official list of the Australian Stock Exchange and required to maintain a franking account (refer to Inland Revenue's website ird.govt.nz (keyword: other exemptions))
- certain interests in Australian unit trusts that have a New Zealand RWT proxy and either a high turnover or high distributions
- interests held by a natural person in foreign superannuation schemes that are an Australian approved deposit fund, Australian exempt public sector superannuation scheme, Australian regulated superannuation fund or Australian retirement savings account
- income interests of 10% or more in controlled foreign companies ("CFCs") (although separate disclosure is required of these as interests in foreign companies – refer below)
- certain interests of 10% or more in foreign companies that are treated as resident, and subject to tax, in Australia (although separate disclosure is required of these as interests in foreign companies – refer below)
- interests in certain unlisted grey-list companies which have migrated out of New Zealand for a year which begins within 10 years of that migration, where the person has held the interests continuously since the migration and the company has retained a significant presence in New Zealand through a fixed establishment
- interests in certain unlisted grey-list companies which hold more than 50% of a New Zealand company for a year which begins within 10 years of the company first holding that 50%, where the New Zealand company has retained a significant presence in New Zealand
- certain interests in grey-list companies resulting from shares acquired under a venture investment agreement
- interests in certain grey-list companies resulting from the acquisition of shares under certain employee share schemes
- certain interests held by natural persons in FIFs located in a country where exchange controls prevent the person deriving amounts from the interests, or from disposing of the interests, in New Zealand currency or consideration readily convertible to New Zealand currency.
- certain interests in foreign superannuation schemes or life insurance policies (offered and entered into outside New Zealand) held by natural persons who acquired the interests when a non-resident or transitional resident
- beneficial interests in foreign superannuation schemes which are not FIF superannuation interests
- certain interests in pensions or annuities provided by FIFs and held by natural persons who acquired the interests when a non-resident (or in certain cases, a resident) (see Inland Revenue's guide Overseas pensions and annuity schemes (IR257) for more information)

De minimis

Interests of less than 10% in foreign companies which are attributing interests in a FIF held by a natural person not acting as a trustee also do not have to be disclosed if the total cost of the interests is $50,000 or less at all times during the income year. This disclosure exemption is made because no FIF income under section CQ 5 of the ITA or FIF loss under section DN 6 of the ITA arises in respect of these interests.

This de minimis exemption does not apply to a person who has included in the income tax return for the year a FIF income or loss. Please note that a person opting out of the de minimis threshold is generally required to continue to apply the FIF rules in each subsequent tax year. Where a person has included FIF income or loss from attributing interests in FIFs where the total cost was $50,000 or less in 1 of the preceding 4 income years, they will be required to apply the FIF rules in the current year.

Format of disclosure

The forms for the disclosure of FIF interests are as follows:

- IR443 form for the deemed rate of return method
- IR447 form for the fair dividend rate method (for individuals or non-widely-held entities)
- IR448 form for the comparative value method (for individuals or non-widely-held entities)
- IR449 form for the cost method
- IR458 spreadsheet form (this spreadsheet form can be used to make electronic disclosures for all methods)
- myIR income tax return attachment form (this form can be used to make electronic disclosures for all methods)

The IR458 spreadsheet and myIR income tax return attachment forms, which are the only disclosure options for the fair dividend rate and comparative value methods for widely-held entities, must be filed online. Disclosure of FIF interests by widely-held entities using the fair dividend rate or comparative value methods may be made by country rather than by individual investment where the direct income interests are less than 10% (or are direct income interests in a foreign PIE equivalent).

If you choose the spreadsheet option you will be able to save the form as a working paper on your computer. When completed, submit the form by logging into your myIR account and uploading it as part of the electronic income tax return filing process, or by logging into your myIR account and attaching it to a web message with 'FIF disclosure' in the subject line.

Alternatively, you can complete the myIR income tax return attachment disclosure form online when preparing your income tax return electronically in myIR.

The IR443, IR447, IR448, IR449 and IR458 forms can be found at ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/types-of-business-income/foreign-investment-funds-fifs/file-a-foreign-investment-fund-disclosure. Click 'Other ways to do this' on this web page to access the IR458 spreadsheet form.

Income interest of 10% or more in a foreign company

A resident is required to disclose an income interest of 10% or more in a foreign company. This obligation to disclose applies to all foreign companies regardless of the country of residence. For this purpose, the following income interests need to be considered:

a. an income interest held directly in a foreign company

b. an income interest held indirectly through any interposed foreign company

c. an income interest held by an associated person (not being a CFC) as defined by subpart YB of the ITA.

To determine whether a resident has an income interest of 10% or more for CFCs, sections EX 14 to EX 17 of the ITA should be applied. To determine whether a resident has an income interest of 10% or more in any entity that is not a CFC, for the purposes of this exemption, sections EX 14 to EX 17 should be applied to the foreign company as if it were a CFC.

Format of disclosure

The forms for disclosure of all interests in a CFC are:

- IR458 spreadsheet form, or
- myIR income tax return attachment form

If you choose the spreadsheet option you will be able to save the form as a working paper on your computer. When completed, submit the form by logging into your myIR account and uploading it as part of the electronic income tax return filing process.

Alternatively, you can complete the myIR income tax return attachment disclosure form online when preparing your income tax return electronically in myIR.

The IR458 spreadsheet form must be accessed online at www.ird.govt.nz (keyword: IR458).

Please note that electronic filing is a mandatory requirement for CFC disclosure

Overlap of interests

It is possible that a resident may be required to disclose an interest in a foreign company which also constitutes an attributing interest in a FIF. For example, a person with an income interest of 10% or greater in a foreign company that is not a CFC is strictly required to disclose both an interest held in a foreign company and an attributing interest in a FIF.

To meet disclosure requirements, only one form of disclosure is required for each interest. If the interest is an attributing interest in a FIF, then the appropriate disclosure for the calculation method, as discussed previously, must be made.

In all other cases, where the interest in a foreign company is not an attributing interest in a FIF, the IR458 spreadsheet form or myIR income tax return attachment form for CFCs must be filed.

Interests held by non-residents and transitional residents

Interests held by non-residents and transitional residents in foreign companies and FIFs do not need to be disclosed.

This would apply for example to an overseas company operating in New Zealand (through a branch) in respect of its interests in foreign companies and FIFs; or to a transitional resident with interests in a foreign company or an attributing interest in a FIF.

Under the international tax rules, non-residents and transitional residents are not required to calculate or attribute income under either the CFC or FIF rules. Therefore, disclosure of non-residents' or transitional residents' holdings in foreign companies or FIFs is not necessary for the administration of the international tax rules and so an exemption is made for this group.

Persons not required to comply with section 61 of the Tax Administration Act 1994

This exemption may be cited as "International Tax Disclosure Exemption ITR35".

1 Reference

This exemption is made under section 61(2) of the Tax Administration Act 1994 ("TAA"). It details interests in foreign companies and attributing interests in foreign investment funds ("FIFs") in relation to which any person is not required to comply with the requirements in section 61 of the TAA to make disclosure of their interests, for the income year ended 31 March 2025.

2 Interpretation

For the purpose of this disclosure exemption:

- to determine an income interest of 10% or more in a foreign company, sections EX 14 to EX 17 of the Income Tax Act 2007 ("ITA") apply for interests in controlled foreign companies ("CFCs"). In the case of attributing interests in FIFs, those sections are to be applied as if the FIF were a CFC, and
- "double tax agreement" means a double tax agreement in force as at 31 March 2024 in one of the 40 countries or territories as set out in the commentary.

The relevant definition of "associated persons" is contained in subpart YB of the ITA.

Otherwise, unless the context requires, expressions used have the same meaning as in section YA 1 of the ITA.

LEGISLATION AND DETERMINATIONS

3 Exemption

i. Any person who holds an income interest of less than 10% in a foreign company, including interests held by associated persons, that is not an attributing interest in a FIF, or that is an attributing interest in a FIF in respect of which no FIF income or loss arises due to the application of the de minimis exemption in section CQ 5(1)(d) or section DN 6(1)(d) of the ITA , is not required to comply with section 61(1) of the TAA for that person's interests in the foreign company and that income year.

ii. Any person who is a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct income interest of 10% or more in a foreign company that is not a foreign PIE equivalent, and uses the fair dividend rate or comparative value calculation method for that interest, is not required to comply with section 61(1) of the TAA in respect of that interest and that income year, if the person discloses the end-of-year New Zealand dollar market value of investments, in an electronic format prescribed by the Commissioner, split by the jurisdiction in which the attributing interest in a FIF is held, organised, managed or listed.

iii. Any person who is not a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct income interest of 10% or more in a foreign company, and uses the fair dividend rate or comparative value calculation method is not required to comply with section 61(1) of the TAA in respect of that interest and that income year, to the extent that the FIF is incorporated or tax resident in a country or territory with which New Zealand has a double tax agreement in force at 31 March 2024.

iv. Any non-resident person or transitional resident who has an income interest or a control interest in a foreign company or an attributing interest in a FIF in the income year corresponding to the tax year ending 31 March 2024, is not required to comply with section 61(1) of the TAA in respect of that interest and that income year if either or both of the following apply:

   - no attributed CFC income or loss arises in respect of that interest in that foreign company under sections CQ 2(1)(d) or DN 2(1)(d) of the ITA; and/or
   - no FIF income or loss arises in respect of that interest in that FIF under sections CQ 5(1)(f) or DN 6(1)(f) of the ITA.

This exemption is made by me acting under delegated authority from the Commissioner of Inland Revenue pursuant to section 7 of the TAA.

This exemption is signed on 31 March 2025.

Glen Holbrook

Technical Specialist

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 25/04: What an employee share scheme is, the taxing date and apportionment

Issued | Tukuna: 10 March 2025

This interpretation statement considers what an employee share scheme is, including the exclusions to the definition. The statement then explains when the share scheme taxing date arises and when shares are held by or for the benefit of an employee. It also covers the circumstances when the share scheme taxing date may be deferred. Finally, it addresses how benefits are apportioned when some of the employee's entitlement arises when they are non-resident.

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

START DATE | RĀ TĪMATA

Tax Information Bulletin Vol 30, No 5 (June 2018) explains the legislative changes to the employee share scheme regime. At page 55 it states "[t]here is no change to the share scheme taxing date for straight-forward employee share options, which already reflects this principle, in that the employee is not taxed until the option is exercised." To the extent taxpayers can demonstrate they have reasonably relied on this statement of principle and the position set out in this interpretation statement gives rise to a different result, it will apply from the issue date above.

Introduction | Whakataki

1. The employee share scheme (ESS) tax regime changed in 2018. The objective of the changed rules is to treat ESS benefits neutrally so that, to the extent possible, whether remuneration for labour is paid in cash or shares the tax position does not change for either the employer or the employee.
2. Following the changes to the rules, we have received various questions about how the law applies in certain scenarios. This statement addresses some of those questions by explaining what constitutes an ESS, when the share scheme taxing date (SSTD) arises and how benefits are apportioned. While each case will need to be considered on its on facts, examples at the end of this interpretation statement show how the rules may apply.
3. This interpretation statement does not consider the implications of any anti-avoidance provisions. The outcomes set out may not apply where the general anti-avoidance provision (s BG 1) or the specific ESS anti-avoidance provision (s GB 49B) applies.

What is an employee share scheme?

4. Section CE 7 defines an ESS as follows:

> **CE 7 Meaning of employee share scheme**
>
> **Employee share scheme** means—
>
> (a) an arrangement with a purpose or effect of issuing or transferring shares in a company (**company A**) to a person—
>
> (i) who will be, is, or has been an employee of company A or of another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (ii) who will be, is, or has been a shareholder-employee in relation to company A or in relation to another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:
>
> (iii) who is an associate of a person described in subparagraph (i) or (ii) (**person A**), if the arrangement is connected to person A's employment or service; but
>
> (b) does not include an arrangement that—
>
> (i) is an exempt ESS:
>
> (ii) requires market value consideration to be paid by a person described in paragraph (a) for the transfer of shares in the company on the share scheme taxing date:
>
> (iii) requires a person described in paragraph (a) to put shares, acquired by them for market value consideration, at risk, if the arrangement provides no protection against a fall in the value of the shares and none of the consideration for acquiring the shares is provided to the person under an agreement that it is used for acquiring the shares.

5. The requirements of s CE 7(a) are discussed below in [6] to [31] followed by discussion of the exclusions set out in s CE 7(b) in [32] to [46].

Arrangement to issue or transfer shares in a company: s CE 7(a)

6. Broadly, an ESS is:
   - an arrangement with a purpose or effect of issuing or transferring shares in a company
   - to a person who will be, is or has been an employee (or shareholder-employee) of that company or another company in the same group
   - if it is connected to the employee's (or shareholder-employee's) employment or service.
7. An employee and shareholder-employee are persons described in s CE 7(a)(i) and (ii) and are both referred to as the "employee" in this interpretation statement for ease of reference.
8. An ESS also includes providing shares to an associate of an employee (being a person described in s CE 7(a)(iii)), if the arrangement is in connection with the employee's employment or service.
9. Accordingly, the person who might receive shares under an ESS could be the employee or an associate. This interpretation statement refers to such a person as the "ESS beneficiary" (as also defined in s CE 7C). Regardless of whether the employee or an associate receives the shares or related rights, it is the employee that derives any employment income from the ESS as set out in s CE 1(1)(d) and s CE 2 (see at [47] and [48]). This is because s CE 2(1) provides that a person who is described in s CE 7(a)(i) or (ii) (being the employee or the shareholder-employee) receives the benefit calculated under s CE 2 and therefore the income under s CE 1(1)(d).
10. An "arrangement" is defined in s YA 1 to mean "an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect". It includes all aspects of a scheme, such as direct transfers of shares, loans to buy shares, bonuses, put and call options and transfers to trusts. Terms of the arrangement may be included in ancillary documents, such as shareholders' agreements.
11. Example | Tauira 1 shows when an arrangement involving an employee's shares might not have a purpose or effect of transferring shares to an employee.
12. Three key aspects are discussed in further detail below. These are:
   - What is a "share" in a "company" for income tax purposes?
   - Who is an "employee" for income tax purposes?
   - When is an arrangement "connected to" the person's employment or service?

What is a "share" in a "company" for income tax purposes?

13. An ESS involves the issue or transfer of "shares in a company".
14. For the purposes of the Income Tax Act (Act), a "company" is defined in s YA 1 to mean a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere. The definition has further inclusions and exclusions for income tax purposes – for example, a unit trust is a company for income tax purposes.
15. A "share" is defined broadly in s YA 1 as follows:

> **share**—
> (a) includes any interest in the capital of a company:
> (b) includes a debenture to which section FA 2 (Recharacterisation of certain debentures) applies:
> (bb) includes a stapled debt security to which section FA 2B(2) (Stapled debt securities) applies:
> (c) includes a unit in a unit trust:
> (d) includes an investor's interest in a group investment fund if—
> (i) the fund is not a designated group investment fund; and
> (ii) the interest does not result from an investment from a designated source; and
> (iii) the investor's interest does not result from an investment made in the fund on or before 22 June 1983, including an amount treated as invested at that date as pre-1983 investments under section HR 3(8) (Definitions for section HR 2: group investment funds):
> (e) does not include a withdrawable share in a building society, except in the definitions of investment society dividend and withdrawable share:
> (f) [Repealed]
> (g) is further defined in section CW 26F (Meaning of share) for the purposes of section CW 26C (Meaning of exempt ESS)

16. Often, a share will be issued under the relevant jurisdiction's companies' legislation, such as the Companies Act 1993 (CA 1993) in New Zealand. However, the definition in s YA 1 has various inclusions and exclusions for income tax purposes.
17. Paragraph (a) of the definition is often applied, being "any interest in the capital of a company". This phrase reflects the common law meaning of a "share" rather than the meaning under the CA 1993.
18. In *IRC v Woolf* [1962] 1 Ch 35, the English Court of Appeal was considering whether debenture holders were "members" of a company, which was defined with reference to whether they had "an interest in the capital or profits or income" of the company. Upjohn LJ said at 46 and 47:

> The share or interest of a member in the capital of a company has no precise legal signification. In the context it may refer to the share or interest of the member in the issued share capital, or it may refer to his ultimate right to receive a dividend in liquidation after all creditors have been discharged…
>
> …
>
> … Further, the debenture-holder has no interest in the capital of the company. If "capital" refers to the share capital, that is obviously so. If it refers to the surplus in a winding-up, the debenture-holder will have been paid off before the surplus can be ascertained.

19. Similarly, Donovan LJ said at 45:

> The word "capital", where it occurs as part of the definition of "member", may mean issued share capital or the net capital, being the difference between assets and liabilities, or it may mean both. …

20. In *Woolf* then, a reference to "capital" of a company was taken to mean share capital and/or net capital (assets less liabilities) and included the right to receive distributions on a winding up, after all creditors have been paid.
21. Accordingly, "any interest in the capital of a company" for the purposes of the definition of a "share" in s YA 1 may refer to the person's interest in issued share capital, a right to a share in the surplus assets on a wind up, and may include rights to other distributions. An interest in a company's capital is an interest in the performance of the company that is of an equity nature (rather than a debt or contractual right to receive payments).
22. The definition of a "share" for income tax purposes also specifically includes many instruments that are not shares under the CA 1993 such as profit related debentures, stapled debt securities, units in a unit trust, and interests in a group investment fund. These are all types of instruments that exhibit general features of equity.

23. This interpretation statement proceeds on the basis that the arrangement under consideration is with a purpose or effect of issuing or transferring "shares" in a "company", as those terms are defined for income tax purposes.
24. For completeness, para (g) in the definition of "share" contains a specific definition relevant to "exempt ESS" and limited to s CW 26C. This specific (narrower) definition of a share is relevant only for determining whether there is an exempt ESS for the specific purposes of s CW 26C. This is because an exempt ESS must be widely offered to almost all employees and provide the same rights to all employees. Exempt ESS are discussed briefly at [33] and [34] and are not the focus of this interpretation statement.

Who is an "employee" for income tax purposes?

25. For the purposes of the Act, an "employee" is defined to include a person who receives or is entitled to receive a "PAYE income payment". This includes a payment of "salary or wages", "extra pay" or a "schedular payment". A "schedular payment" is a payment of a class set out in sch 4 of the Act, that in turn lists payments made to a wide variety of workers including, for example, certain directors.
26. Accordingly, the term "employee" for income tax purposes (and therefore the ESS rules) includes persons that are employees under common law (ie under a contract of service) and, if they receive schedular payments, also persons that may be independent contractors under common law (ie under a contract for service). For more information on what constitutes an "employee" for tax purposes see **IG 16/01**: **Determining employment status for tax purposes (employee or independent contractor?**).
27. A common example of a person that might be an independent contractor at common law but an employee for tax purposes because they receive schedular payments, and therefore are subject to the ESS rules, is a company director. For more discussion of when fees paid to directors are schedular payments, see **IS 17/06**: **Application of schedular payment rules to directors' fees** and **IS 19/01**: **Income tax – application of schedular payment rules to non-resident directors' fees**.

When is an arrangement "connected to" the person's employment or service?

28. To constitute an ESS, the arrangement with a purpose or effect of issuing or transferring shares to an ESS beneficiary must be connected to the employee's employment or service. The Commissioner considers that this means the employment or service must be a substantial reason for the arrangement. This is discussed in further detail in the context of fringe benefit tax and whether a benefit is provided in connection with a person's employment in the commentary to **BR Pub 09/02**: **Federal Insurance Contributions (FICA) – Fringe Benefit Tax (FBT) Liability** at pages 10 and 11.
29. Where the arrangement is provided for in the person's employment contract, or pursuant to an employment policy or established practice of the employer, the Commissioner considers it is likely that the employment relationship will be the substantial reason for the provision of shares. This is because the right to receive the shares is part of the terms under which the employee agreed to provide their services to the employer.
30. Where there are reasons apart from, or not sufficiently connected to, the employment relationship that explain why the arrangement was entered into, the arrangement may not be in connection with the person's employment. The courts have on occasion considered the employment relationship was no more than part of the background facts or a mere historical connection. In these situations, the employment connection may not be sufficient enough to result in employment income (see for example the case law discussed in the commentary to **BR Pub 06/05**: **Assessability of payments under the Employment Relations Act for humiliation, loss of dignity, and injury to feelings** at pages 10 to 12).
31. Example | Tauira 2 and Example | Tauira 3 show when a transfer of shares to an employee might not be in connection with employment.

Arrangements excluded from being an employee share scheme: s CE 7(b)

32. Three exclusions are set out in s CE 7(b) for arrangements that would otherwise be an ESS. These are discussed from [33]. Example | Tauira 4 to Example | Tauira 8 show how some of the exclusions set out in s CE 7(b) may, or may not, apply.

First exclusion – exempt employee share schemes

33. The first exclusion is set out in s CE 7(b)(i) and is for an "exempt ESS". An exempt ESS is a scheme that meets the criteria set out in s CW 26C. Broadly, the criteria are intended to ensure that the scheme is genuinely offered to the vast majority of employees on equal terms and all employees can afford to participate in the scheme (ie not just the more highly paid employees). There is a limit on the amount of benefit that can be provided.

34. Unlike a benefit from an ESS, a benefit derived from an exempt ESS is not employment income under ss CE 1(1)(d) and CE 2. Rather, it is exempt income of the employee under s CW 26B. For more information, refer to **Employee share schemes** *Tax Information Bulletin* Vol 30, No 5 (June 2018): 71.

Second exclusion – market value paid on share scheme taxing date

35. The second exclusion is set out in s CE 7(b)(ii). It applies if market value consideration is paid by the ESS beneficiary for the transfer of shares in the company on the SSTD. In such a situation, the employee has not received any net value in respect of their employment that could be considered as received in substitution of salary.

36. Section CE 7CB defines the term "market value" for an ESS:

> CE 7CB Meaning of market value
>
> **Market value**, for an employee share scheme—
>
> (a) has the same meaning as in section YA 1 (Definitions), definition of **market value**, paragraphs (a) and (b); and
>
> (b) includes, for a share or option quoted on the official list of a recognised exchange, at the time, an amount equal to the 5-day volume weighted average price or any other method that is accepted by the Commissioner or is comparable to the 5-day volume weighted average price, for such shares or options.

37. Paragraphs (a) and (b) in the definition of "market value" in s YA 1 state:

> **market value**,—
>
> (a) for a share or option quoted on the official list of a recognised exchange, at the time, means an amount equal to the middle market quotation at the time for a share or option having the same terms as the share or option to be valued, unless the quotation is not a fair reflection of the market value, having regard at the time to the matters referred to in paragraph (e) of the definition of **recognised exchange**:
>
> (b) for a share or option not quoted on the official list of a recognised exchange at the time, means the amount that a willing purchaser would pay to acquire the share or option in an arm's length acquisition at the time and that is determined using a method that—
>
> (i) conforms with commercially acceptable practice; and
>
> (ii) may, in appropriate cases, have regard to the present value at the time of the company's anticipated income or cash flows and the realisable value at the time of the company's assets; and
>
> (iii) results in a valuation that is fair and reasonable:

38. The definitions deal with shares that are quoted on a recognised exchange and those that are not. For the former, the market value will usually be the quoted value on the exchange at the relevant time but s CE 7CB(b) extends the range of values that are acceptable. For the latter group of shares, the market value will be the value that a willing purchaser would pay at arm's length for the shares with certain qualifications as to the method that is used to determine the amount.

39. **CS 24/01 Determining the "market value" of shares that an employee receives under an employee share scheme** provides guidance on what methods are acceptable to us for determining the value of shares received under an ESS. It deals with listed and unlisted shares.

40. This second exclusion applies if market value consideration is paid for the transfer of the shares on the SSTD. The SSTD is considered in more detail from [47] and is broadly when shares are held by the ESS beneficiary or for their benefit and there are no conditions or protections under the ESS that defer the date under s CE 7B(1)(a).

Third exclusion – market value paid on acquisition and shares at risk

41. The third exclusion is set out in s CE 7(b)(iii) and may apply when market value consideration is paid other than on the SSTD.

42. The third exclusion applies if:
    - the ESS beneficiary pays market value consideration to acquire the shares;
    - the ESS beneficiary puts the shares at risk and the arrangement provides no protection against a fall in the value of the shares; and
    - none of the consideration for acquiring the shares is provided to the ESS beneficiary under an agreement that it used for acquiring the shares.

43. The ESS beneficiary will put shares at risk with no protection against a fall in value if they may be required to transfer the shares for market value and bear any resulting economic loss.
44. For example, the terms of the arrangement may require the ESS beneficiary to sell the shares back to the employer if the employee resigns within a specified period. If the selling price is for an amount equal to the lower of market value and the cost of the shares, then the ESS beneficiary will be putting the shares at risk and will not be protected against a fall in the value of the shares (meaning the exclusion may apply). This exception applies because if the shares decline in value and the ESS beneficiary is required to sell them back to the employer, the employee will bear that economic loss as they will only receive market value.
45. A contrasting scenario is where the ESS beneficiary is required to sell the shares back to the employer for an amount equal to the cost of the shares if the employee resigns within a specified period. In this case, the ESS beneficiary will be putting the shares at risk but will also be protected against a fall in value of the shares (meaning the exclusion will not apply). This is because the cost price of the shares will be returned to the ESS beneficiary and they will not bear any economic loss, even if the market value of the shares has declined.
46. For this third exclusion to apply, the ESS beneficiary cannot be provided with any of the consideration for acquiring the shares under an agreement that the ESS beneficiary uses it to acquire the shares. For example, the exclusion will not apply if the employer makes a loan (regardless of whether the terms are commercial or not) or pays a bonus to the employee with a requirement that those funds are used to purchase the shares.

The benefit and the share scheme taxing date

47. Section CE 1(1)(d) provides that an amount a person derives in connection with their employment or service is income if it is a benefit received under an ESS. The amount of the benefit is calculated on the SSTD using the formula in s CE 2(1). This section states:

> **CE 2 Benefits under employee share schemes**
>
> *Benefit*
>
> (1) A person who is an employee share scheme beneficiary described in section CE 7(a)(i) or (ii) receives a benefit for the purposes of section CE 1(1)(d) in relation to shares or related rights under the employee share scheme equal to the positive amount calculated on the share scheme taxing date using the formula—
>
> share value − consideration paid + consideration received − previous income.

48. Section CE 2(2) defines the items in the formula. Broadly, the amount of the employee's benefit under s CE 2(1) is the market value of the shares or related rights that an ESS beneficiary owns on the SSTD (or the amount of consideration paid or payable to an ESS beneficiary in relation to a transfer or cancellation of the shares or related rights) less any consideration provided by an ESS beneficiary.
49. Section CE 7B defines the SSTD as follows:

> **CE 7B Meaning of share scheme taxing date**
>
> *Meaning*
>
> **(1)** **Share scheme taxing date** means, in relation to shares or related rights under and employee share scheme, the earlier of the following dates:
>
> (a) the first date when the shares are held by or for the benefit of an employee share scheme beneficiary (**beneficial ownership**) and after which, under the provisions of the scheme,—
>
> (i) there is no material risk that beneficial ownership may change or that a right or requirement in relation to the transfer or cancellation of the shares may operate; and
>
> (ii) there is no benefit accruing to the employee share scheme beneficiary in relation to a fall in value of the shares; and
>
> (iii) there is no material risk that there will be a change in the terms of the shares affecting the value of the shares:
>
> (b) the date when the shares or related rights of an employee share scheme beneficiary are cancelled or are transferred to a person who is not associated with a beneficiary described in section CE 7(a)(i) or (ii).

> *Exclusions*
>
> (2) For the purposes of applying subsection (1), the following requirements and rights are ignored:
>
> (a) a right or requirement in relation to transfer by the employee share scheme beneficiary for market value consideration at the time of the transfer:
>
> (b) a right or requirement that is not contemplated by the employee share scheme's provisions:
>
> (c) a right or requirement that, at the time it came into existence, had no material risk of operating or no material commercial significance:
>
> (d) a right or requirement in relation to the transfer of shares, if the right or requirement is 1 that also applies to shares not under the employee share scheme.

50. The SSTD will arise under s CE 7B(1) on the earlier of the following dates:
    - Under s CE 7B(1)(a), the first date when the shares are held by or for the benefit of an ESS beneficiary (referred to as "beneficial ownership") and, after which, there are no conditions or protections under the ESS that defer the date under subparas (i) to (iii).
    - Under s CE 7B(1)(b), the date when the shares or related rights of an ESS beneficiary are cancelled or are transferred to a person who is not associated.
51. Example | Tauira 9 shows when the SSTD might be triggered by each of s CE 7B(1)(a) and (b).
52. In determining whether any of the factors in s CE 7B(1)(a) apply to defer the SSTD, s CE 7B(2) provides that certain rights and requirements are ignored:
    - Example 14 in *Tax Information Bulletin* Vol 30, No 5 (June 2018): 59 shows s CE 7(b)(2)(a) could apply, for example, where the employee is required to sell their shares back to the employer for market value consideration if they leave the company after they have vested.
    - Example 15 in *Tax Information Bulletin* Vol 30, No 5 (June 2018): 59 shows s CE 7B(2)(c) could apply where an employee has a right to sell shares back to the company for a nominal amount because such a right is unlikely to be utilised.
53. The remainder of this interpretation statement considers when the SSTD arises under s CE 7B(1)(a); in other words, when the SSTD is triggered by share ownership rather than cancellation or disposal of the benefit. In general, there are two matters to consider:
    - Are the shares "held by or for the benefit of" an ESS beneficiary so there is the "beneficial ownership" referred to in s CE 7B(1)(a)?
    - Does the arrangement provide any conditions or protections referred to in s CE 7B(1)(a)(i) to (iii) that result in the SSTD being deferred to a later time?

Are the shares held by or for the benefit of an ESS beneficiary?

54. It is first necessary to establish "the first date when the shares are held by or for the benefit of an ESS beneficiary". These words are abbreviated to "beneficial ownership" in s CE 7B(1)(a). This can be satisfied by either:
    - the ESS beneficiary holding the shares; **or**
    - another person holding the shares for the benefit of the ESS beneficiary.
55. Example | Tauira 9 to Example | Tauira 11 show how the s CE 7B(1)(a) requirement that shares are held by or for the benefit of an ESS beneficiary impacts the SSTD.

When shares are "held" by a person

56. The Act does not define the phrase "held by". The most relevant definition of "hold" as a verb in the *Oxford English Dictionary* is:

    > **6.a.** To have or keep as one's own absolutely or temporarily; to own, have as property; to be the owner, possessor, or tenant of; to be in possession or enjoyment of.

57. Based on these definitions, shares are "held" by a person when the person becomes the owner of the shares.
58. What constitutes a "share" for income tax purposes is set out in [13] to [24] above. While it is a broad definition, often a share will be issued under the relevant jurisdiction's companies' legislation (such as the CA 1993 in New Zealand).

59. The CA 1993 contains provisions relevant to determining when a person holds a share in a company registered in New Zealand. For example, s 89 provides:

> 89 Share register as evidence of legal title
>
> (1) Subject to section 91, the entry of the name of a person in the share register as holder of a share is prima facie evidence that legal title to the share vests in that person.
>
> …

60. The words "held" and "hold" are commonly used to mean legal ownership of shares according to the company's register of members. A leading case in this area is the High Court of Australia's decision in *Dalgety Downs Pastoral Company Pty Ltd v FCT* (1952) 86 CLR 335. The court in *Dalgety* looked at s 80(5) of the Australian legislation that governed the carrying forward of company losses. The section required that shares carrying at least 25% of the voting power in the company be "beneficially held" by the same persons during the relevant period. The issue was whether continuity of shareholding had been maintained when a shareholder transferred his shares as security for a loan. The court concluded the shares were held by the person whose name appeared in the company's share register. The court stated at 341–342:

> …. Dixon J so held in *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353, basing his conclusion upon the view that **in the terminology of company law shares are said to be "held" by the person who is registered as a shareholder** in respect thereof, and that s 80(5), being concerned with voting power, should be treated as using that terminology. We share this view. Indeed **it is not too much to say that the verb "hold" and its variants, when used in relation to shares in companies, normally refers to the legal ownership of the shares according to the register of members.** The Companies Acts of the United Kingdom and of several States of the Commonwealth have uniformly used the word in this sense, and common usage has followed their example. [Emphasis added]

61. New Zealand cases such as *Case D27* (1980) 4 NZTC60,621, *Case N26* (1991) 13 NZTC 3,219 at 3,228, and *BHL v CIR* (2011) 25 NZTC 20-088 have cited *Dalgety* and adopted the same interpretation.

62. If the "share" for income tax purposes is not a share issued under the relevant jurisdiction's companies' legislation (for example, if it is some other interest in the performance of the company that is of an equity nature), it will need to be determined who holds or is the legal owner of that interest.

63. In summary, in the context of an ESS and the SSTD, shares are "held by" a person when the person has legal ownership of those shares.

64. For completeness, s YB 21 contains an exception to this rule. It states:

> **YB 21 Transparency of nominees**
>
> *Treatment of nominee*
>
> (1) In this Act, unless the context otherwise requires, if a person holds something or does something as a nominee for another person, the other person holds or does that thing and the nominee is ignored.
>
> *Who is a nominee?*
>
> (2) A person holds or does something as a nominee for another person if the person acts on the other person's behalf. However, a trustee is a nominee only if the trustee is a bare trustee.
>
> …

65. Section YB 21 has general application and operates as an exception to various provisions of the Act. Where s YB 21 applies, the result is that if someone acts as a nominee for another person, that other person is deemed to hold or do something and the nominee is ignored.

66. Accordingly, s YB 21 can deem that a legal owner acts, and so holds their shares as nominee, on behalf of someone else. If so, that other person will be deemed to "hold" the shares in terms of s CE 7B(1)(a). Section YB 21(2) refers to a person (the "nominee") who "acts on the other person's behalf", including where the nominee is a "bare trustee" for the other person.

67. What it means for a person to be nominee for another in respect of shares is considered in detail from [86] in **IS 12/01: Income tax – timing of share transfers for the purposes of the continuity provisions**. Perhaps of relevance, IS 12/01 summarises when a vendor of shares may "hold" shares as "nominee" for the purchaser, including when the share transfer agreement has been settled. In those circumstances the vendor is the bare trustee for the purchaser of shares under an agreement that has been settled but the purchaser is not the registered holder of the shares. In such a case the purchaser may go on to be registered, or may never be registered.

68. It is unlikely s YB 21 will have a significant impact on outcomes in the context of s CE 7B(1)(a) because of the requirement that "shares are held by **or** for the benefit of" an ESS beneficiary. In other words, the definition of SSTD already extends to a person legally holding shares for someone else.

When shares are held "for the benefit of" an ESS beneficiary

69. When shares are "held by" a person is discussed at [56] to [68]. For the purposes of s CE 7B(1)(a), the shares must be held either by the ESS beneficiary **or** by someone else for the benefit of an ESS beneficiary. Where shares are held by a person for the benefit of the ESS beneficiary, the ESS beneficiary will not be the legal owner of the shares or named on the company's share register.

70. "For the benefit of" has been said to mean "in trust for". In *Gillespie v City of Glasgow Bank* (1879) 4 App Cas 632 (HL) at 642 Lord Hatherley said:

> I cannot perceive a difference between the words "for behoof of" and "**in trust for**". I hold the expression "for behoof of" to mean exactly the same as if the words used had been "on behalf of" or "**for the benefit of**", or any of those other words, of which many might be suggested, which indicate that although to the bank you are the absolute owner of the shares, yet as regards a third person, with whom you have entered into an arrangement you are not that owner.' [Emphasis added]

71. This passage from *Gillespie v City of Glasgow Bank* was cited with approval in *Case D27* (1980) 4 NZTC 60,621.

72. To hold shares for the benefit of someone means you are not beneficially the owner of the shares. The person for whose benefit you hold the shares is the beneficial owner. In *Gillespie v City of Glasgow Bank* Lord Hatherley said at 641 and 642:

> … Whether you say you hold "for behoof of" some one, or you hold "on behalf of" someone, or you hold "in trust for" some one, there is no particular magic in the choice of words; all those words indicate that you are not beneficially the owner. You in effect tell the creditors of the concern, As between you and me, I am the holder of the stock, but as between me and a third person with whom you have nothing to do, I am the holder of it for that person's benefit.

73. Accordingly, shares will generally be held for the benefit of another person where that other person has the right to the economic benefits, or fruits, of the shares. This is referred to as "beneficial ownership". Whether shares are held for the benefit of an ESS beneficiary will depend on the terms of the ESS.

74. In some instances, a trust may be established to facilitate the ESS and hold shares for the benefit of ESS beneficiaries during a period of restrictions on the shares under the ESS. In such a case, if the employee has the required beneficial ownership the question will be whether any of the deferral provisions apply. Example | Tauira 9 illustrates this.

75. This can be contrasted with the situation of a group establishing a trust (ESS trust) to acquire and hold shares for the general purposes of the group share plans depending on the market and funding available at any given time. In such a case, the employer can sometimes choose how to satisfy its obligations to provide shares – perhaps by issuing shares, purchasing shares on market or via its ESS trust. If the shares in the ESS trust can be applied at the employer's discretion it is unlikely the shares will be held for the benefit of an ESS beneficiary. Example | Tauira 11 illustrates this.

76. A similar situation can arise when a company holds shares in itself (commonly referred to as treasury stock). Some companies may prefer to hold treasury stock to meet obligations under an ESS rather than having to sporadically issue new shares or establish a trust to maintain a pool of shares. In such a case, the question is whether the company holds any of its treasury stock for the benefit of an ESS beneficiary. Similar to the situation of a trustee described above, if the company merely holds a pool of shares to use as and when needed and is not subject to any terms or restrictions regarding its use and transfer of those shares, it is unlikely the company is holding shares for the benefit of an ESS beneficiary.

Determining when shares are transferred

77. We understand that often the process to transfer shares to an ESS beneficiary begins when an option is exercised or share rights vest under the scheme – for example shares are issued by the company, transferred from a trust or purchased on market. However, the actual transfer is often not able to be completed on the same date due to processes required to issue and transfer shares. Commentators have suggested it can be difficult to determine the exact date when those shares are held by the ESS beneficiary, or by someone for the benefit of the ESS beneficiary. We understand this is particularly an issue for global schemes where software calculates the benefit on the exercise date or vesting date (as applicable), and where payroll teams in New Zealand may not have access to any information other than the exercise date or vesting date.

78. The Commissioner will accept that the best evidence of when the shares are held by or for the benefit of the ESS beneficiary could be the vesting date or exercise date under the ESS (as applicable) for the purposes of determining the SSTD under s CE 7B(1)(a) where the following requirements are met:
    - the shares are expected to be held by or for the benefit of the ESS beneficiary within 10 working days after the exercise date or vesting date under the ESS; and
    - the employer is unable to determine the exact date by taking reasonable steps.
79. The above is shown in Example | Tauira 12. The Commissioner expects this practice would be applied consistently by the employer for the ESS.

Do any conditions or protections defer the taxing date?

80. If an ESS beneficiary holds the shares or has "beneficial ownership" for the purposes of s CE 7B(1)(a) (as described from [54] to [79]), it is necessary to consider whether any provisions that may defer the SSTD set out in s CE 7B(1)(a) apply. This section discusses these deferral provisions. Example | Tauira 6 to Example | Tauira 9 illustrate how some of the deferral provisions set out in s CE 7B(1)(a) may, or may not, apply.

Material risk of change in beneficial ownership or a transfer of shares

81. The first provision that could defer the SSTD is set out in s CE 7B(1)(a)(i). It applies where there is a material risk that beneficial ownership may change or a right or requirement in relation to the transfer or cancellation of the shares may operate.
82. The Act contains no definition of "material risk". However, two examples are set out in s CE 7B to illustrate what is a material risk that beneficial ownership may change:

> **Example 1 – Simple vesting period**
>
> Acme Limited transfers shares worth $10,000 to a trustee on trust for an employee, Alice, of Acme Limited. Under the terms of the trust, Alice forfeits, for no consideration, any contingent interest or beneficial ownership in the shares if she leaves the employ of Acme Limited within 3 years of the transfer of the shares to the trustee. Alice stays for 3 years, and, under the terms of the trust, the shares are transferred absolutely to her on her 3rd anniversary of employment. It is a material risk, for the 3 years after the transfer to the trustee, that the terms of the trust will operate to forfeit any contingent interest or beneficial ownership in the shares. Consequently, the share scheme taxing date for Alice's shares is her 3rd anniversary of employment.

> **Example 2 – Vesting subject to misconduct**
>
> Acme Limited transfers shares worth $10,000 to a trustee on trust for an employee, Bob, of Acme Limited. Under the terms of the trust, Bob forfeits, for no consideration, any contingent interest or beneficial ownership in the shares if he leaves the employ of Acme Limited because he is dismissed for serious misconduct within 3 years of the transfer of the shares to the trustee. It is not a material risk that the terms of the trust will operate to forfeit any contingent interest or beneficial ownership in the shares. The risk that Bob will be dismissed for serious misconduct within 3 years is not material. Consequently, the share scheme taxing date for Bob's shares is the date when the shares are transferred to the trustee.

83. The first example illustrates that a material risk of a change in beneficial ownership exists if an employee forfeits their benefit by simply choosing to leave employment for any reason. In contrast, the second example shows that a material risk of a change in beneficial ownership does not exist if an employee would only forfeit their benefit in the limited circumstance of being dismissed for serious misconduct.
84. Section CE 7B(1)(a) will only defer the SSTD where there is a material risk. If there is no material risk, the SSTD will arise when the shares are held by or for the benefit of the ESS beneficiary. Example | Tauira 13 shows what happens if the SSTD arises when there is not a material risk of a change in beneficial ownership, and forfeiture does in fact result.

Benefit accruing in relation to a fall in share value

85. The second provision that could defer the SSTD is set out in s CE 7B(1)(a)(ii). It applies where a benefit accrues to the ESS beneficiary in relation to a fall in value of the shares.

86. One situation where this provision might apply is if the ESS beneficiary is able to sell the shares back to the employer for the acquisition price to the ESS beneficiary. Another such situation is where the ESS beneficiary acquires the shares with a loan that is limited in recourse. These protections might provide the ESS beneficiary with complete (or some) downside risk protection. In either case, the ESS beneficiary may not suffer the full economic loss in circumstances where the shares decline in value. Where such terms are present in the ESS, s CE 7B(1)(b) will defer the SSTD until the ESS beneficiary is no longer protected from a fall in the value of the shares – for example, when the loan is either repaid or ceases to be limited recourse.

Material risk of a change in the share terms

87. The third provision that could defer the SSTD is set out in s CE 7B(1)(a)(iii). It applies where a material risk exists there will be a change in the terms of the shares affecting their value.

88. For example, this provision might apply if the ESS provides for restricted shares to be reclassified as ordinary shares and have the same rights as ordinary shares when a specified event occurs. Where this material risk exists, s CE 7B(1)(c) will defer the SSTD until the specified event occurs.

Apportionment

89. As set out at [47] and [48], the amount of an employee's benefit is calculated under s CE 2(1). It is essentially the market value of the shares or related rights owned by an ESS beneficiary on the SSTD (or the amount of consideration paid to an ESS beneficiary for a transfer or cancellation of those shares or rights) less any consideration provided by an ESS beneficiary.

90. Where an employee is non-resident and derives foreign-sourced income during the period they earn a benefit, s CE 2(5) and (6) contains an income apportionment formula. Broadly, s CE 2(5) allocates a portion of the benefit as non-residents' foreign-sourced income (which is not taxable to the employee). For example, this apportionment might apply where an employee of a New Zealand company moves to Australia part way through earning the benefit and continues to work for the New Zealand company, but performs their employment duties from Australia such that their services give rise to a foreign-sourced amount of income.

91. Section CE 2(5) states:

> **Apportionment**
>
> (5) For the person's benefit under subsection (1), the portion of that benefit calculated using the formula is treated as non-residents' foreign-sourced income—
>
> benefit before reduction × offshore period ÷ earning period.

92. The items in the formula are defined in s CE 2(6):

> **Definition of items in formula**
>
> (6) In the formula in subsection (5),—
>
> (a) **benefit before reduction** is the amount of the benefit under subsection (1):
>
> (b) **offshore period** is the number of days in the item **earning period** on which—
>
> (i) the person is not resident in New Zealand; and
>
> (ii) any services the person performs for the relevant employer give rise to an amount of income that is a foreign-sourced amount:
>
> **(c)** **earning period** is the period ending with the vesting of shares or relevant rights in the employee share scheme beneficiary and starting with the earlier of—
>
> (i) the first date used to measure the person's right in relation to the vesting of shares or relevant rights:
>
> (ii) the first date that the person has a right in relation to the vesting of shares or relevant rights.

93. The amount that can be treated as non-residents' foreign-sourced income is determined by first establishing the entire period over which the benefit accrues (the "earning period") and then determining the proportion of that period during which the person is non-resident and not deriving New Zealand source income from their employment (the "offshore period"). The earning period ends when the shares or rights vest.

94. As set out in **IS 19/01**: **Income tax – application of schedular payment rules to non-resident directors' fees**, the Commissioner considers that directors' fees a New Zealand company pays to a non-resident individual will, in most cases, have a New Zealand source regardless of whether the directorship services are performed in New Zealand or from overseas. Accordingly, it may be a non-resident director of a New Zealand company will rarely be able to apportion any of the benefit to non-residents' foreign-sourced income.

95. The earning period is intended to reflect the period over which the employee is earning the shares or related rights. This is not necessarily the same as the SSTD when the employee takes beneficial ownership of the shares, which may occur at a later stage. The purpose of apportioning the benefit over the earning period, rather than to the SSTD, is to ensure the employment income resulting from the ESS benefit is taxable in New Zealand to the extent it was earned while the employee was a New Zealand resident and/or deriving employment income sourced in New Zealand. Example | Tauira 14 illustrates how the apportionment may operate when an employee moves to New Zealand during the earning period.

96. The Act does not define what it means for the shares or relevant rights to "vest". The term "vest" is more commonly used in a trust law context. However, in the definition of "earning period" in s CE 2(6), the term "vest" is used to measure the period over which the employee is earning the ESS benefit. In other words, rather than necessarily being used in the context of

97. a trust relationship, it is used to determine when the employee has done what is necessary to have earned those shares or related rights. Accordingly, the Commissioner considers the term "vests" in this context means the employee has done what is necessary to have a present fixed right of future enjoyment of the shares or related rights.

98. In the context of an ESS, a common requirement is that an employee must work for the company for a specified period. Until the employee has worked for that period, they will not have a fixed right of future enjoyment of those shares or related rights as those shares or rights may not come to fruition. The provisions of the ESS may allow employees to retain their benefit if they leave earlier in certain circumstances, such as due to retirement, serious illness or death. Such leavers are often referred to as "good leavers" in ESS documentation, and the scope of what is a "good leaver" is determined by the ESS documentation. Where an employee retains their benefit under the terms of an ESS if they leave as a good leaver, the Commissioner considers that the employee will have a present fixed right of future enjoyment of the shares or related rights when they become a good leaver, as they have done what is necessary to earn the shares or related rights that will come to fruition. This is the case whether it is explicitly referred to as accelerating the benefit or not. Accordingly, in such circumstances, the shares or related rights will have vested for the purposes of determining the end of the earning period in s CE 2(5) and (6).

99. As noted at [95], the end of the earning period under s CE 2(6) may not always coincide with the SSTD under s CE 7B. For example, where an employee receives an option to acquire shares that is exercisable following a specified period of employment, the earning period will end at the conclusion of the specified period of employment. This occurs when the ESS beneficiary has done what is necessary to earn the right to acquire shares, ie the option is exercisable. However, the SSTD will not arise until the option is exercised and the shares are held by or for the benefit of the ESS beneficiary, or the option is cancelled or transferred to a non-associate if that occurs earlier. Example | Tauira 15 and Example | Tauira 16 illustrate when the earning period under s CE 2(6) could end and when the SSTD under s CE 7B could arise in some circumstances involving a good leaver.

Examples | Tauira

100. While each case will need to be considered on its on facts, these examples show how the rules discussed in this interpretation statement may apply.

Example | Tauira 1: Founder putting shares at risk to attract capital investment

Company was established by Carl, Jordyn and Lacey in 2015. All three were unrelated and non-associated individuals at the time. They had ideas for a software product that would make life easier. Carl was the biggest driver of the project, had the most expertise in the area, and was made CEO.

On incorporation, the initial shareholdings were as follows:

- Carl – 50%
- Jordyn – 25%
- Lacey – 25%

Market value was paid for the shares and they are not subject to any conditions or restrictions.

By 2022, the product was mostly ready but significant investment was required to market the product and set up appropriate distribution channels. A third party investor was found that was interested in the product and willing to inject funds into Company in subscription for shares. The investor considered that Carl's involvement in Company was crucial to success of the product, at least in its early stages of distribution. Accordingly, as part of the deal, Carl was required to agree to forfeit half his shares to the investor for nil consideration should he leave Company within 5 years of the capital being injected.

The arrangement that Carl may forfeit half his shareholding is not part of any arrangement with a purpose or effect of transferring shares to an employee for the purposes of s CE 7(a) and therefore the arrangement would not constitute an ESS. The fact that Carl ends up putting his shares originally acquired in 2015 at risk in 2022 does not bring those shares into the ESS rules.

Example | Tauira 2: Review of initial share allocations on incorporation of company

Company was established by Chris, Joanna and Grant in 2010. All three were unrelated and non-associated individuals at the time.

On incorporation:

- Chris contributed some incomplete designs and know-how for an initial shareholding of 46.5%
- Joanna contributed some marketing contracts she had arranged to target and research potentially interested markets for an initial shareholding of 48.5%
- Grant contributed some start-up cash for an initial shareholding of 5%

Chris is the CEO and a shareholder employee of Company. Chris has received an appropriate amount of remuneration in exchange for his services to Company since incorporation.

An independent review has been undertaken to consider whether the original share allocations were fair to Chris when Company was first incorporated. This review does not take into account Chris's activities as CEO (for which he has been appropriately remunerated). The review has concluded that the designs and know-how contributed by Chris, while incomplete, were at least as valuable as the marketing contracts provided by Joanna. Following the review, Joanna decides to transfer 1% of her shareholding to Chris for nil consideration so they have equal shares in Company.

It is unlikely that a transfer of 1% of the shares in Company from Joanna to Chris for nil consideration would be a transfer of shares "in connection with employment" for the purposes of s CE 7(a) and therefore the arrangement would not constitute an ESS.

Example | Tauira 3: Succession following retirement

Company was established by Susan, Jeremy and Joseph in 2012. Jeremy is Susan's only child. Joseph is unrelated to Susan and Jeremy.

On incorporation, the initial shareholdings were as follows:

- Susan – 34%
- Jeremy – 33%
- Joseph – 33%

Susan, Jeremy and Joseph are the CEO, CFO and COO respectively. Each has received an appropriate amount of remuneration in exchange for their services to Company since incorporation.

Susan is retiring and wants to pass her shares to Jeremy for nil consideration as she does not need the income from the shares in her retirement. Jeremy will become the new CEO and will receive an appropriate amount of remuneration for these services going forward. Company is to outsource the CFO role to a virtual CFO provider.

It is unlikely that a transfer of Susan's shares to Jeremy for nil consideration would be a transfer of shares "in connection with employment" for the purposes of s CE 7(a) and therefore the arrangement would not constitute an ESS.

Example | Tauira 4: Shares acquired on incorporation of a company

Casey, Joelle and Mary get together and incorporate a company with a view to developing some technology-related intellectual property (IP). They are each issued 20 shares on incorporation of the company and employed by the company. When the shares are issued they are worth virtually nothing and a nominal subscription price of $1 per share is paid by each shareholder-employee. The shareholders' agreement states that to ensure they commit to developing the IP over 3 years, if they leave within 3 years they forfeit their shares.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in a company to a person in connection with their employment and is therefore an ESS under s CE 7(a).

However, an exclusion to the definition of ESS in s CE 7(b) will apply.

Section CE 7(b)(iii) will be satisfied as market value was paid for the shares, not using money provided to the shareholder-employees for that purpose, and the shareholder-employees have then chosen to put the shares at risk. This means the scheme is not an ESS and the ESS rules do not apply to the scheme.

Variation of facts regarding incorporation

In some circumstances shares in a company on incorporation will not be worth virtually nothing and may have a market value.

Instead, say Casey, Joelle and Mary have been working on developing their IP for some time and have reached a point where it is looking like it could be profitable with the right investment to put it into production and market it.

At this point, Casey, Joelle and Mary think it might be time to formalise matters and incorporate a company. They each contribute their respective IP and related assets to the company in subscription for shares. The shareholders' agreement states that to ensure each commit to further developing the business over the next 3 years, if they leave within 3 years they forfeit their shares to the remaining founders.

In this case, the shares in the company will have a value and not be worth virtually nothing due to the assets contributed to the business. However, s CE 7(b)(iii) will still be satisfied as each of the founders paid market value for the shares by contributing the IP and related assets.

Further variation of the facts

Say Casey, Joelle and Mary also employ Grant for his technical expertise to get the IP ready for production. Given the business is cash poor, they offer Grant shares on incorporation for a nominal consideration of $1 so he can benefit from any uplift in the value of the company. The shareholders' agreement states that if Grant leaves within 3 years, the company will repurchase his shares for the nominal consideration of $1.

The arrangement has a purpose or effect of transferring shares in a company to a person in connection with their employment and is therefore an ESS under s CE 7(a). An exclusion to the definition of ESS in s CE 7(b) will not apply for Grant's shareholding. This is because the shares on incorporation do have a market value and Grant has only paid a nominal consideration. Accordingly, the ESS rules will apply to Grant's shares that he received on incorporation.

Example | Tauira 5: Employees of target company reinvesting in acquirer

Acquirer Co is looking to purchase all the shares in Target Co. The employees of Target Co hold 20% of its shares.

As part of the acquisition and to continue incentivising employees to act in the best interests of Target Co, Acquirer Co provides the employees the option to reinvest a portion of their sale proceeds into shares in Acquirer Co (at market value). This provides employees the opportunity to benefit from any uplift in value following the takeover. However, if they choose to do this, they are locked in for a 3-year period and if they leave during that time they will forfeit their shares for the lower amount of cost or market value. The employee can choose whether to reinvest or not; the employee is not required to use their sale proceeds to reinvest in Acquirer Co.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Acquirer Co to a person in connection with their employment and is therefore an ESS under s CE 7(a).

However, an exclusion to the definition of ESS in s CE 7(b) will apply.

Section CE 7(b)(iii) will be satisfied as:

- market value was paid by the employee for the shares in Acquirer Co;
- the employee is required to put the shares in Acquirer Co at risk;
- the arrangement provides the employee with no protection against a fall in value of the shares in Acquirer Co; and
- the employee was not provided consideration for acquiring the shares in Acquirer Co under an agreement that it is used to acquire the shares. This is because the employee has a choice whether to reinvest and use their sale proceeds to purchase shares in Acquirer Co.

This means the scheme is not an ESS and the ESS rules do not apply to the scheme.

Example | Tauira 6: Shares acquired with limited recourse loan

Employer Co provides an employee with an interest-free loan of $10,000 to acquire shares in Employer Co for market value. The loan is limited recourse in that the amount repayable is limited to the value of the shares at the time of repayment.

If the employee leaves Employer Co before they have repaid the loan, they must either repay the loan or return the shares in repayment of the loan.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Employer Co to its employee in connection with their employment and is therefore an ESS under s CE 7(a).

None of the exclusions to the definition of ESS in s CE 7(b) applies.

Section CE 7(b)(ii) does not apply. While the employee pays market value consideration, they do not do so on the SSTD. The SSTD arises when the loan is repaid (as set out under the next heading of this example).

Section CE 7(b)(iii) does not apply for two reasons. First, the arrangement provides protection for a fall in the value of shares while the limited recourse loan is outstanding. If the shares fall in value below what the employee paid for them, the employee does not bear the economic burden of that fall in value because the repayment obligation is limited to the value of the shares. Second, Employer Co provided the employee the consideration for acquiring the shares through a loan.

When does the SSTD arise under s CE 7B?

The SSTD will not arise at the time the employee acquires the shares. This is because while the employee holds the shares, the limited recourse loan means that a benefit is accruing to the employee in relation to a fall in the value of the shares. If the shares fall in value below what the employee paid for them, the employee does not bear the economic burden of that fall in value as the loan repayment obligation is limited to the value of the shares. As a result, the SSTD will be deferred under s CE 7B(1)(a)(ii) until the limited recourse loan is repaid.

Example | Tauira 7: Shares acquired with full recourse loan and potential transfer at market value

Employer Co provides an employee with a full recourse loan of $10,000 to acquire shares in Employer Co for market value. If the employee leaves Employer Co and is a "bad leaver", they must transfer the shares to Employer Co for the lower of cost and market value. If the employee leaves Employer Co and is a "good leaver", they must transfer the shares to Employer Co for market value.

A "good leaver" has a very broad meaning under the terms of the scheme: they are anyone who is not a "bad leaver". A "bad leaver" has a very narrow meaning under the terms of the scheme: they are a person who is dismissed for serious misconduct.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Employer Co to its employee in connection with their employment and is therefore an ESS under s CE 7(a).

However, an exclusion to the definition of ESS in s CE 7(b) will apply.

Section CE 7(b)(ii) will be satisfied as the employee pays market value consideration for the transfer of the shares on the SSTD, as the SSTD arises when the employee acquires the shares (as set out under the next heading of this example). This means the scheme is not an ESS and the ESS rules do not apply to the scheme. Accordingly, the employee will not have employment income from an ESS under ss CE 1(1)(d) and CE 2.

For completeness, s CE 7(b)(iii) would not apply to exclude the scheme from being an ESS because Employer Co provided the employee with the consideration for acquiring the shares through a loan.

When does the SSTD arise under s CE 7B?

The SSTD will arise at the time the employee acquires the shares under s CE 7B(1)(a).

While a requirement in relation to the transfer of the shares may operate in that the employee must transfer the shares to Employer Co when they leave Employer Co, this will not defer the SSTD under s CE 7B(1)(a)(i) for the following reasons.

First, there is no material risk that the employee will be a "bad leaver". As set out in example 2 in s CE 7B, the risk that the employee will be dismissed for serious misconduct is not material. Accordingly, the requirement to transfer the shares for the lower of cost or market value if the employee is dismissed for serious misconduct does not satisfy the criteria of s CE 7B(1)(a)(i).

Second, while a "good leaver" has a very broad meaning in the scheme and therefore the requirement to transfer the shares on being a good leaver is a material risk for the purposes of s CE 7B(1)(a)(i), this requirement can be ignored under s CE 7(b)(2)(a). This is because the requirement is for a transfer by the employee for market value consideration at the time of the transfer.

In addition, the deferral provision in s CE 7B(1)(a)(ii) will not apply. This is because no benefit accrues to the employee in relation to a fall in value of the shares. As the loan is full recourse, repayment is not limited to the value of the shares if they decline in value. Further, if the shares are required to be transferred under the scheme, this is for market value (or cost if lower for a bad leaver), meaning that if the value of the shares declines, the employee will bear the cost of that decline in value. They are required to pay the full acquisition cost price under the full recourse loan, but will only receive market value if a sale occurs under the terms of the scheme.

Example | Tauira 8: Shares acquired with full recourse loan and potential transfer at lower of cost and market value

Employer Co provides a full recourse loan to an employee so they can acquire $10,000 worth of shares in Employer Co (which is the current market value established by an independent valuation). If the employee leaves Employer Co for any reason during the following 3 years, Employer Co will repurchase the shares at the lower of cost ($10,000) or market value and the employee must repay the outstanding loan.

After 3 years, Employer Co has the right to buy the shares back for full market value if the employee leaves the company. Employer Co does not want the employee to hold its shares if they are not part of the company, but after 3 years Employer Co is prepared for the employee to receive the upside in the shares.

Before then, the employee bears the risk of loss but has no chance of gain. If the shares fall to $5,000 and the employee leaves Employer Co within 3 years, Employer Co will buy the shares back for $5,000 and the employee will lose $5,000 of their $10,000 investment. If the employee leaves Employer Co within 3 years and the shares are worth $20,000, then Employer Co will buy them back for $10,000 and the employee will be denied the upside.

Is the arrangement an ESS under s CE 7?

The arrangement has a purpose or effect of transferring shares in Employer Co to an employee in connection with their employment and is therefore an ESS under s CE 7(a).

None of the exclusions to the definition of ESS in s CE 7(b) applies.

Section CE 7(b)(ii) does not apply. While the employee pays market value consideration, they do not do so on the SSTD. The SSTD does not arise until the 3-year period ends (as set out under the next heading of this example).

Further, s CE 7(b)(iii) does not apply as Employer Co provides the employee with the consideration for acquiring the shares through a loan.

When does the SSTD arise under s CE 7B?

The SSTD will not arise at the time the employee acquires the shares. This is because, while the employee holds the shares, a material risk exists that they will be required to transfer the shares to Employer Co if they leave this employment. This means the SSTD is deferred under s CE 7B(1)(a)(i).

This requirement is not ignored under s CE 7B(2)(a) for the first 3 years because, if the employee leaves employment during that period, the transfer will be for the lower of cost and market value. This means that the transfer will not necessarily be for market value.

However, while Employer Co has the right to buy the shares back from the employee if they leave Employer Co after 3 years, this repurchase is for market value. This means that, while there is a material risk that a right in relation to the transfer of the shares may operate from the end of the 3-year period, as this right is for a transfer by the employee for market value at the time, it can be ignored under s CE 7B(2)(a) for the purposes of applying the deferral provision in s CE 7B(1)(a).

Accordingly, the first date on which the employee holds the shares and none of the deferral provisions applies is at the end of the 3-year period. The employee can enjoy any gain in the value of shares from this date given that they have now met the scheme's criteria. Before this date, the employee has exposure to any fall in value of the shares but cannot receive any upside.

Example | Tauira 9: Employee leaves employment early or continues employment

Employer Co grants 100 shares to each of its senior employees Sarah, John and Arnie, to incentivise their performance. Under the terms of the arrangement, an employee forfeits the shares for nil consideration if they leave the employ of Employer Co within 5 years, unless they are a "good leaver". For the purposes of the plan, a good leaver is defined narrowly as someone who leaves due to retirement, disability or death.

A trustee holds the shares for the 5-year period to ensure forfeiture can be implemented and the shares returned to Employer Co if necessary. Dividends are paid to the employee over this period as they arise (unless they have forfeited their interest). At the end of the 5 years, if the employee has not forfeited their entitlement they will be transferred the shares for no further cost.

After 1 year, Sarah resigns to take up a better offer in Australia. After 3 years, Arnie retires (as a good leaver under the terms of the ESS). John stays with Employer Co for many years.

When does the SSTD arise under s CE 7B?

The SSTD will not arise at the time the employee is granted the shares. This is because, while the shares are held by the trustee for the benefit of the employee, a material risk exists that they will forfeit their beneficial interest if they leave this employment within 5 years (other than as a good leaver). This means the SSTD is deferred under s CE 7B(1)(a)(i).

When Sarah resigns she forfeits her beneficial interest for nil consideration. Accordingly, the SSTD will arise when she leaves Employer Co under s CE 7B(1)(b). As Sarah received no consideration for the forfeiture of her rights, and paid no consideration for the grant of the rights, Sarah will not have any benefit under the formula in s CE 2.

When Arnie retires he does not forfeit his benefit, as he is a good leaver under the terms of the ESS, and he will be transferred the shares at the end of the 5-year period. At the time of Arnie's retirement there is no longer a material risk that he will forfeit the shares. As the shares are held by the trustee for Arnie's benefit, the SSTD will therefore arise on Arnie's retirement under s CE 7B(1)(a). Arnie's benefit under s CE 2 will be the market value of the shares at the time of Arnie's retirement. As Arnie did not pay anything for the shares there is no deduction from this value.

When John reaches his 5 years of employment he will be transferred the shares. At this point there is no longer a material risk that he will forfeit the shares. Accordingly, the SSTD will arise at that point under s CE 7B(1)(a). John's benefit under s CE 2 will be the market value of the shares when John reaches his 5 years of employment. As John did not pay anything for the shares there is no deduction from this value.

Example | Tauira 10: Delay in issue of new shares following exercise of option

Employer Co grants an option to an employee on 1 June 2021 to purchase 1,000 shares for $500. If still employed after 1 year, the employee can exercise the option at any time starting on 1 June 2022 and ending on 30 May 2023.

The employee exercises the option on 1 September 2022 and pays Employer Co $500. Employer Co issues 1,000 new shares to the employee on 15 September 2022.

When does the SSTD arise under s CE 7B?

On 1 June 2022 the employee has completed a year of employment and therefore has the right to exercise the option.

The employee exercises the option on 1 September 2022 to acquire the shares. However, the SSTD does not arise at this point as the shares are not in existence and therefore are not held by the employee or by a person for the benefit of the employee. Accordingly, the employee does not meet the introductory wording of s CE 7B(1)(a).

When the new shares are issued to the employee on 15 September 2022 the SSTD will arise under s CE 7B(1)(a). As the employer is aware of the date the shares are issued the position discussed above in [78] does not apply.

Example | Tauira 11: Delay in issue or delivery of shares and use of a trust

Under an ESS, an employee of Employer Co is entitled to receive 1,000 shares if they remain with Employer Co for 3 years. Employer Co can satisfy this obligation by issuing shares, purchasing shares on market or via a trust established for the purposes of facilitating its ESS. The employee satisfies this requirement on 10 August 2022.

When does the SSTD arise under s CE 7B if Employer Co issues new shares?

Employer Co decides to issue 1,000 new shares to the employee under the terms of the ESS. It takes a few days for the appropriate resolutions to be documented and the shares are issued to the employee on 15 August 2022.

The SSTD will arise on 15 August 2022 under s CE 7B(1)(a). This is because that is the first date when the shares are held by or for the benefit of the employee. Before 15 August 2022, the shares did not exist and therefore could not be held by any person. As the employer is aware of the date the shares are issued the position discussed above in [78] does not apply.

When does the SSTD arise under s CE 7B if shares are held in an ESS trust?

Instead, say there are sufficient shares in Employer Co's ESS trust to satisfy the employee's entitlement. Accordingly, on 10 August 2022 Employer Co directs the trustee, who in turn directs the share registry provider, to transfer 1,000 shares out of its pool of shares to the employee. The shares are put in the employee's name as soon as possible by the share registry provider.

Until 10 August 2022 the shares have not been beneficially held for the employee. Until the 10 August 2022 direction, the trustee has held the general pool of shares for the purposes of the ESS and is required to act on Employer Co's instructions regarding whether to buy, sell or transfer any of its shares. Any dividends paid on the general pool of shares are used for the purposes of the trust.

The shares will be held by or for the benefit of the employee on 10 August 2022 (and not before). On and from 10 August 2022 (and not before) Employer Co and the trustee cannot act in respect of those shares inconsistently with transferring them to the employee. When the employee satisfies 3 years of employment on 10 August 2022, there is also nothing to defer the SSTD under s CE 7B(1)(a). Accordingly, the SSTD will arise on 10 August 2022.

When does the SSTD arise if Employer Co needs time to calculate the employee's entitlement?

Say instead the employee is entitled to receive up to 1,000 shares if they remain with Employer Co for 3 years, subject to the company meeting certain financial conditions. The same trust arrangements apply as set out above.

Employer Co takes 3 weeks after 10 August 2022 to determine whether the financial conditions have been met and whether the employee is entitled to the full entitlement of 1,000 shares. It is determined the employee is entitled to 800 shares. On 31 August 2024 Employer Co directs the trustee, who in turn directs the share registry provider, to transfer 800 shares out of its pool of shares to the employee. The shares are put in the employee's name as soon as possible by the share registry provider.

The shares will be held by or for the benefit of the employee on 31 August 2022 (and not before). On and from that date (and not before) Employer Co and the trustee cannot act in respect of those shares inconsistently with them transferring to the employee. Accordingly, the SSTD will arise on 31 August 2022.

Example | Tauira 12: Incomplete information from foreign parent company

Under an ESS, an employee of NZ Employer Co is entitled to receive 1,000 shares in US Parent Co if they remain employed by the group for 3 years. The share plan states that US Parent Co can satisfy this obligation by issuing shares, purchasing shares on market or via a trust established for the purposes of facilitating its ESS. The employee becomes entitled to the shares on 10 August 2022 having been employed by the group for 3 years.

When does the SSTD arise?

NZ Employer Co's payroll team asks US Parent Co when the shares will be transferred to the employee so that it can determine when shares are held by or for the benefit of the employee and when the SSTD arises.

US Parent Co advises NZ Employer Co's payroll team the shares will be transferred to the employee within 1 week of the employee becoming entitled. Despite asking for clarification, NZ Employer Co receives no further details.

As the shares are expected to be transferred to the employee within 10 working days of the employee satisfying the share plan requirements, and Employer Co is unable to determine the exact date having taken reasonable steps to determine the exact date, the Commissioner will accept the best evidence of when the shares are held by or for the benefit of the employee as being the date the employee satisfies the share plan requirements. Accordingly, the employer treats 10 August 2022 as the SSTD as discussed above in [78].

Alternative facts – limitations of payroll software

Alternatively, the group's global payroll software reports benefits as arising on the date an employee becomes entitled. NZ Employer Co's payroll team asks US Parent Co when the shares will be transferred to the employee so that it can confirm whether 10 August 2022 is the correct SSTD.

US Parent Co does not reply in a timely fashion. However, NZ Employer Co knows from previous experience that shares are always transferred to employees within 1 week of the employee becoming entitled.

As the shares are expected to be transferred to the employee within 10 working days of the employee satisfying the share plan requirements, and Employer Co is unable to determine the exact date by taking reasonable steps, the Commissioner will accept the best evidence of when the shares are held by or for the benefit of the employee in this case is the date the employee satisfies the share plan requirements. Accordingly, the employer treats 10 August 2022 as the SSTD as discussed above in [78].

Example | Tauira 13: Acquisition subject to misconduct

Employer Co offers its senior employees the chance to buy into the company at a 50% discount. Employee takes up this offer and acquires 100 shares worth $10,000 for a price of $5,000.

Under the terms of the arrangement, employee forfeits the shares for an amount equal to the lower of cost and market value if they leave the employ of Employer Co because they are dismissed for serious misconduct within 3 years of the acquisition.

When does the SSTD arise under s CE 7B?

The SSTD will arise at the time the employee acquires the shares under s CE 7B(1)(a). As set out in example 2 in s CE 7B, the risk that the employee will be dismissed for serious misconduct is not material. Accordingly, while employee may be required to transfer the shares if they are dismissed for serious misconduct within 3 years, this is not a material risk and therefore the SSTD is not deferred under s CE 7B(1)(a)(i).

Accordingly, employee's benefit will be $5,000 (the market value of the shares on the SSTD of $10,000 less the cost to the employee of $5,000) in the year they acquire the shares.

What if employee is dismissed for serious misconduct?

Say employee is dismissed for serious misconduct 2 years after acquiring the shares. The market value of the shares at the time is $12,000. Accordingly, employee forfeits the shares for their cost of $5,000.

This does not alter the conclusions that the SSTD has passed and a benefit of $5,000 arose in the year of acquisition. That outcome is not reversed under the ESS rules.

The tax implications of the forfeiture of the shares will need to be evaluated based on the circumstances of the employee and the forfeiture at the time, outside of the ESS rules. For example, the following may need to be considered – whether the shares are:

- Held on revenue account. If so, further income may arise in respect of the forfeiture. The employee should then be entitled to a deduction for the cost of the revenue account property, including the amount of the employee's benefit arising from receiving the shares (see s CE 2(4)).
- Repurchased by the company. If so, the dividend and treasury stock rules may need to be considered.
- In a foreign company. If so, the international tax rules may need to be considered.

Example | Tauira 14: Employee moves to New Zealand during earning period

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee purchases 1,000 shares in Employer Co under an ESS by paying an acquisition price of $20,000, which is equal to 50% of their market value at the time. If the employee leaves Employer Co before the end of the 3 years, they forfeit their interest and the shares are transferred back to Employer Co for an amount equal to their cost.

Under the terms of the ESS, a trustee holds the shares for a period of 3 years to ensure forfeiture can be implemented and the shares returned to Employer Co if necessary. Dividends are paid to the employee over this period as they arise unless they have forfeited their interest. At the end of the 3 years, if the employee is still with Employer Co, they will be transferred the shares for no further cost.

The employee works for 2 years in Germany and then moves to New Zealand to work for Employer Co. After 1 year in New Zealand, the trustee transfers the shares to the employee. The market value of the shares is $80,000 at the time of transfer.

When is the SSTD under s CE 7B?

The SSTD under s CE 7B(1)(a) is at the end of the 3-year period when the employee is entitled to be transferred the shares. This is when the shares are held by or for the benefit of the employee and, after this point, none of the matters set out in subparas (i) to (iii) could apply to defer the date. Prior to this time, there is a material risk the shares will be transferred back to Employer Co if the employee leaves Employer Co. This means the SSTD will not arise under s CE 7B(1)(a)(i) until the 3 years of employment is satisfied.

The amount of the employee's benefit income calculated under s CE 2(1) is therefore $60,000 (being the market value on the SSTD of $80,000 less the cost to the employee of $20,000).

How is the employee's benefit apportioned under s CE 2(5)?

The amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5) is $40,000.

For the purposes of the calculation, the "earning period" under s CE 2(6)(c) is 3 years (being 1,095 days). The "offshore period" under s CE 2(6)(b) is the 2 years (being 730 days) the employee is not resident in New Zealand and is performing services in Germany such that their services give rise to a foreign-sourced amount of income. Once the person moves to New Zealand and performs services in New Zealand, the offshore period will end.

This means 2/3rds (being 730/1,095 days) of the benefit amount is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

Example | Tauira 15: Good leaver retaining benefit and being issued new shares in accordance with ordinary vesting schedule

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee is granted restricted stock units that provide them a contractual right to receive shares under the scheme after 3 years of employment. If they are a "bad leaver" (defined in the ESS as being where they leave the company before the end of the 3 years other than as a good leaver), they forfeit any rights under the scheme. If they are a "good leaver" (defined in the ESS as being where they leave due to retirement, disability or death), they retain their units and will receive the shares at the end of the 3-year period.

The employee works for 2 years in Germany and then retires to New Zealand. As a "good leaver", they keep their entitlement and are issued new shares at the end of 3 years.

When is the SSTD under s CE 7B(1)(a)?

The SSTD under s CE 7B(1)(a) is when the new shares are issued to the employee at the end of 3 years. That is when the employee holds the shares and when, under the provisions of the scheme, none of the matters set out in subparas (i) to (iii) could apply to defer the date. In other words, this is when the market value of the shares must be determined for the purposes of calculating the employee's benefit income under s CE 2(1).

If the shares were already in existence and held for the benefit of the employee when they retire as a good leaver, the SSTD could arise earlier (as illustrated in Example | Tauira 16).

How is the employee's benefit apportioned under s CE 2(5)?

However, for the purposes of determining the amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5), the earning period defined in s CE 2(6)(c) is 2 years (being 730 days) as the employee's retirement is when their right to future possession of the shares "vests". This is because, upon retiring and being a good leaver under the terms of the ESS, the employee has a present fixed right of future enjoyment of the shares.

The offshore period (when the employee is non-resident and performing services offshore) under s CE 2(6)(b) is also 2 years (being 730 days). This means the entire benefit is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

Example | Tauira 16: Good leaver retaining benefit and being transferred shares from an ESS trust in accordance with ordinary vesting schedule

Employer Co, a New Zealand resident company, has an employee who is not a tax resident in New Zealand and performs their employment duties in Germany such that their services give rise to a foreign-sourced amount of income. The employee purchases 1,000 shares in Employer Co by paying an acquisition price equal to 50% of market value at the time. If the employee leaves Employer Co before the end of the 3 years other than as a "good leaver" the shares are transferred back to Employer Co for an amount equal to their cost. A "good leaver" is defined in the ESS as being where they leave due to retirement, disability or death.

Under the terms of the ESS, a trustee holds the shares for a period of 3 years to ensure forfeiture can be implemented and the shares returned to Employer Co if necessary. Dividends are paid to the employee over this period as they arise (unless they have forfeited their interest). At the end of the 3 years, if the employee is still with Employer Co, or has left as a "good leaver" they will be transferred the shares for no further cost.

The employee works for 2 years in Germany and then retires to New Zealand. As they are a "good leaver" they keep their entitlement, and the trustee transfers the 1,000 shares to the employee at the end of 3 years.

When is the SSTD under s CE 7B(1)(a)?

The SSTD under s CE 7B(1)(a) is when the employee retires as a good leaver in this case. This is because the trustee holds the shares for the employee's benefit and, after this point, none of the matters set out in subparas (i) to (iii) could apply to defer the date. In other words, this is when the market value of the shares must be determined for the purposes of calculating the employee's benefit income under s CE 2(1).

How is the employee's benefit apportioned under s CE 2(5)?

The amount of the benefit that is non-residents' foreign-sourced income for the employee under s CE 2(5) is the same as in Example | Tauira 15. Briefly, the earning period defined in s CE 2(6)(c) is 2 years (being 730 days) because the employee's retirement is when their right to future possession of shares "vests". The offshore period (when the employee is non-resident and performing services offshore) under s CE 2(6)(b) is also 2 years (being 730 days). This means the entire benefit is treated as non-residents' foreign-sourced income and is not assessable to the employee in New Zealand.

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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 25/02: Financing arrangement to fund the refurbishment of a capital asset

Decision date | Rā o te Whakatau: 8 April 2024

Issue date | Rā Tuku: 13 February 2025

Subjects | Kaupapa

The proposed financing arrangement is to fund the refurbishment of a capital asset. The Applicants were two companies that were unable to source finance from traditional bank lending or by way of supplier financing.

Taxation laws | Ture take

All legislative references are to the Income Tax Act 2007 (ITA) and the Goods and Services Tax Act 1985 (GSTA).

Summary of facts | Whakarāpopoto o Meka

1. The Arrangement was a proposed financing arrangement to fund the refurbishment of a capital asset (Asset). The Applicants were two companies – ABC Ltd and DEF Ltd (ABC and DEF). The Applicants were unable to source finance from traditional bank lending or by way of supplier financing.
2. The relationship between the Applicants and the background to the Arrangement was as follows:
    - ABC had a licence for use of the Asset. ABC had a contractual obligation to hand the Asset back to the licensor in good condition at the end of the licence.
    - ABC operated and maintained the Asset and sub-licensed the use of the Asset to various licensees.
    - ABC was effectively wholly owned by DEF.
    - Shares in DEF were required to be held for a licensee to hold a licence from ABC. That is, the shareholders of DEF and ultimate shareholders of ABC were also the licensees.
3. Under the Arrangement, to obtain the required financing for the refurbishment it was proposed that:
    - The shareholders of DEF would make a series of interest-free loans over time to ABC to meet part of the cost of refurbishing the Asset. The remaining balance would be met from existing cash balances and future net operating cashflows of ABC, including periodic increases in existing licence fees.
    - Capital works licence fees payable would be charged to cover the refurbishment costs on a straight-line basis over the tax life of the new assets.
    - The loan repayments would match the capital works licence fees payable by the licensees.
4. The obligation of the licensees to pay the capital works licence fees to ABC would be set off against ABC's obligation to repay a portion of the principal amount of the interest-free loans to the licensees/shareholders. The set-off arrangement would be done via monthly invoices, which would show:
    - the licence fees due (comprising portions to cover both operating expenses and the capital works),
    - the set-off of the amount due against the loan principal owed, and
    - the remaining cash balance payable.

Issues | Take

5. The Tax Counsel Office (TCO) considered the following issues:

Income tax

- Whether the interest-free loans by shareholders in DEF to ABC involved downward value transfers and gave rise to a deemed dividend to ABC under s CD 6(1).
- Whether for each income year ABC derived taxable income under s CB 1 in respect of the licences that includes the capital works licence fees receivable from licensees that was set off in that income year against the loan principal of the loans to ABC.
- Whether a deemed dividend arose in relation to the making available of the licences to shareholders in DEF under s CD 6(1), with consequence that ABC had an obligation to withhold resident withholding tax (RWT) under the RWT rules.
- Whether ABC had depreciation loss deductions under s DA 1(1) for a portion of its cost of depreciable property acquired and installed under the refurbishment programme on a straight-line basis over the life of the property as per IRD depreciation tables.
- Whether s FA 2B (which treats certain debt securities stapled to shares as equity) applied.
- On repayment of loan principal by offset against licence fees, whether any income or deduction or RWT arose for ABC under the financial arrangements rules or RWT rules.
- Whether s BG 1 applied to negate or vary the above outcomes.

GST

- Whether ABC would be entitled to GST input tax credits under s 20(3) of the GSTA on capital expenditures without any adjustment under ss 21 to 21H of the GSTA.
- Under s 8(1) and 9(3) of the GSTA, whether ABC would be subject to GST in each GST period on the capital works licence fees paid by offset against ABC loan principal in that period.
- Whether there would be any substitution for ABC of open market value in place of the agreed licence fees under s 10(3) of the GSTA because the licences from ABC to the licensees were not “associated supplies” within the meaning in paragraph (a) or paragraph (b) of s 2(1) of the GSTA.
- Whether ss 5(14B), 14(1B)(b) and 10(3) of the GSTA applied.
- Whether s 76 of the GSTA applied to negate or vary the GST conclusions reached.

Decisions | Whakatau

6. TCO concluded that:

Income tax

- The interest-free loans by shareholders in DEF to ABC did not give rise to a deemed dividend to ABC under s CD 4.
- The provision of the licences by ABC to the shareholders in DEF did not give rise to a deemed dividend to the shareholders under s CD 4. ABC was not required to withhold or pay an amount of tax under s RA 6 in relation to the provision of the licences to the shareholders in DEF.
- The licence fees receivable (that includes the capital works licence fees) from licensees was business income for ABC under s CB 1 and was allocated as income to the income year in which ABC derived the amount under s BD 3(2).
- To the extent ABC owned depreciable property (as defined in s EE 6 and EE 7) that was used or available for use to derive assessable income, ABC could elect to use the straight-line method of depreciation under s EE 12 subject to the calculation rules under ss EE 9 to EE 11 to quantify its depreciation loss deductions under s DA 1(1) for each income year.
- Section FA 2B did not apply to the interest-free loans made by the shareholders of DEF to ABC.
- The repayment of the interest-free loan principal by ABC to the shareholders in DEF by offset against licence fees payable by the shareholders did not give rise to income or deductions under ss CC 3 or DB 7 for ABC.

- ABC was not required to withhold or pay an amount of tax under s RA 6 in relation to the interest-free loan repayments to the shareholders of DEF.
- Section BG 1 did not apply to negate or vary the income tax outcomes under the above conclusions.

GST

- ABC would be entitled to GST input tax credits under s 20(3) for GST on capital expenditures under ABC's work programme without any adjustment under ss 2121H.
- Under ss 8(1) and 9(3), ABC would be subject to GST in each GST period on the capital works licence fees paid by offset against ABC loan principal in that period.
- There would be no substitution for ABC of open market value in place of the agreed licence fees under s 10(3) because the licences from ABC to the licensees were not "associated supplies" within the meaning in paragraph (a) or paragraph (b) of s 2(1).
- Sections 5(14B), 14(1B)(b) and 10(3) did not apply to or for the licence rights.
- Section 76 did not apply to negate or vary the above conclusions.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Whether any deemed dividends arise

7. The issues were:
    - Whether the interest-free loans by shareholders in DEF to ABC involved downward value transfers and did not give rise to a deemed dividend to ABC under s CD 6(1).
    - Whether a deemed dividend arose in relation to the making available of the licences to shareholders in DEF under s CD 6(1), with consequence that ABC had an obligation to withhold RWT under the RWT rules.
8. Section CD 1 provides that a dividend derived by a person is income of the person. Section CD 3 provides that ss CD 4 to CD 20 define what is a dividend. For present purposes, ss CD 4 to CD 6 are relevant in determining whether a deemed dividend arises under the Arrangement:
    - Section CD 4(1) provides that a transfer of company value from a company to a person is a dividend if the cause of the transfer is a shareholding in the company.
    - Under s CD 5(1) a transfer of company value from a company to a person would occur when:
        - the company provides money or money's worth to the person; and
        - if the person provides money or money's worth to the company in exchange, the market value of what the company provides is more than the market value of what the person provides.
    - Under s CD 6, a transfer of company value would be 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.
9. TCO considered whether there was a "transfer of company value" as defined in s CD 5 from a company to a person, and if so, whether the transfer was caused by a shareholding relationship under s CD 6.
10. One indication that a transfer was caused by a shareholding was if the terms of the arrangement that resulted in the transfer were different from the terms on which the company would enter into a similar arrangement if no shareholding were involved.[1]

Interest-free loans to be provided by the shareholders in DEF to ABC

11. The provision of the interest-free loans would give rise to a transfer of value as the market value of what was provided by the shareholders (the interest-free loan) was more than the market value provided by ABC for the loans. Therefore, there was a transfer of value from the shareholders to ABC. However, for a dividend to arise under s CD 4, there needed to be a "transfer of company value" from a company to a person that was caused by a shareholding in the company.

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

12. In respect of the interest-free loans provided by the non-corporate shareholders of DEF, there could be no deemed dividend arising as there was no "transfer of company value" from a company to a person (ie, the transfer of value was not being provided by a company).
13. In respect of the interest-free loans provided by the corporate shareholders of DEF, there was a transfer of company value (the benefit of the interest-free loan) by a company (a corporate shareholder) to a person (ABC).
14. However, TCO considered it could not be said that the transfer is caused by a shareholding relationship. This was because TCO was satisfied that ABC (the recipient of value) did not hold shares in any corporate shareholder of DEF, and was not associated with any shareholders of DEF under ss YB 1YB 14, so the general test in s CD 6(1)(a) was not satisfied. Accordingly, no deemed dividend arose on the interestfree loans provided by shareholders in DEF to ABC under s CD 4 as s CD 6(1)(a) was not satisfied.

Licences by ABC to the shareholders in DEF

15. The licence fees to be charged to the DEF shareholders (who are also the licensees) would be at market value (which is a condition to the ruling). Accordingly, TCO considered that the provision of the licences would not give rise to a transfer of company value from ABC to the shareholders under s CD 5 because the shareholders/licensees would be paying market value for the licences; ie, there was no difference in money's worth provided by the shareholders and ABC, so there was no resulting transfer of value.
16. Accordingly, TCO considered it would not be necessary to consider whether a transfer was "caused by a shareholding" under s CD 6, as there was no transfer of company "value" from the provision of licences. Therefore, there was no deemed dividend arising under s CD 4 on the provision of licences.
17. As TCO considered that there was no deemed dividend arising under s CD 4, TCO also concluded that ABC was not required to withhold or pay an amount of tax under s RA 6 as there was no payment of resident passive income (as defined in s RE 2) in relation to the provision of the licences to the shareholders in DEF.

Conclusion

18. TCO concluded that:
    - The interest-free loans by shareholders in DEF to ABC would not give rise to a deemed dividend to ABC under s CD 4.
    - The provision of the licences by ABC to the shareholders in DEF would not give rise to a deemed dividend to the shareholders under s CD 4. ABC was not required to withhold or pay an amount of tax under s RA 6 in relation to the provision of the licences to the shareholders in DEF.

Issue 2 | Take tuarua: Income tax implications of licence fees and timing of derivation

Business income under s CB 1

19. The issue was whether the licence fees received by ABC, which included the capital works licence fees, would be business income under s CB 1.
20. Under s CB 1(1), an amount derived from a business was income of a person. This did not apply to an amount that was of a capital nature.
21. TCO considered the essential question in determining whether the licence fees were business income was whether the licence fees were derived from the current operations of ABC's business, and not merely connected to the fact that the business existed.[2]
22. The licence fees charged by ABC were designed to broadly cover ABC's operating expenditure incurred in operation of the Asset. TCO noted that the licence agreement allowed for additional licence fees to be charged to meet the cost of refurbishment work. This supported that the licence fees (including the capital works licence fees) would be an amount received by ABC in the ordinary course of its business operations for the provision of the licences to use the Asset.
23. TCO considered that the licence fees receivable (that includes the capital works licence fees) from licensees was business income for ABC under s CB 1.

2 *CIR v City Motor Service Ltd; CIR v Napier Motors Ltd* [1969] NZLR 1010, at 1,017 and 1,019.

Timing of derivation

24. Section BD 3(1) provides that income must be allocated to an income year. The general rule in s BD 3(2) provides that income is allocated to the income year in which it is derived unless an alternative provision in Parts C or E to I provides a basis for allocation. Therefore, it was necessary for TCO to establish that no provision in any of Parts C or E to I provided for allocation of the licence fee income on another basis.
25. TCO noted that Parts C and F to I of the Act did not apply to the allocation of the licence fee income. Accordingly, TCO focussed on Part E. TCO considered the provisions of Part E that might apply to allocate the licence fee income were:
    - *Subpart EW – financial arrangements rules*

      TCO considered that the licence agreement was prima facie a "financial arrangement" under s EW 3(2) as under the agreement a person (ABC) receives money (licence fees monthly in advance) in consideration for that person (ABC) providing money (licence to use, occupy and enjoy the Asset) to any person (the licensees) at a future time (from the date of commencement of the licence until termination).

      Further, TCO considered that the licence agreements were a "short-term agreement for sale and purchase" as defined in s YA 1, and thus were an "excepted financial arrangement" under s EW 5(22). This was because the licence agreement was a conditional agreement to acquire services. The use of the Asset was provided continuously over the term of the licence agreement, ABC rendered periodic (monthly) invoices in advance to the licensees for the services, with the service taking place over the course of the month (ie, performed before the 93rd day after each invoice was rendered).

      Therefore, TCO considered the financial arrangements rules did not apply to alter the allocation of income or expenditure in respect of the licence fee agreement.
    - *Section EI 4B – which allows the spreading of land inducement payments on a lease or licence as income or expenditure*

      TCO noted that ABC must derive the licence fees as income under s CC 1B before s EI 4B can apply to spread the income. TCO considered that the licence fees were not consideration for the "grant, renewal, extension or transfer" of the licence. Rather, TCO considered the licence fees were an amount paid by reference to rights held and services provided over the term of the licence.

      Therefore, TCO considered that s CC 1B did not apply to the licence fee income and the timing provision in s EI 4B did not apply to alter the timing of income derivation on the licence fee income.
    - *Sections EJ 10 or EJ 10B – in relation to certain lease payments*

      TCO noted that ss EJ 10 and EJ10B contained timing rules that may apply in respect of a lease that was of a personal property lease asset.

      TCO considered the licence fee agreement did not satisfy the definition of a "lease" in s YA 1 as there was no transfer of any asset to the licensees, and the licensees did not have the right to possess the Asset under the agreement. Further, the agreement was for the use of land (real property) and other ancillary facilities, and so could not be a lease of "personal property" as defined in s YA 1.

      Therefore, TCO considered the timing rules in ss EJ 10 or EJ 10B had no application to alter the timing of the licence fee income.

Conclusion

26. As TCO considered that no specific timing provisions under Part E applied to the licence fee agreement, TCO concluded that the licence fees receivable (including the capital works licence fees) from licensees was business income for ABC under s CB 1 and was allocated as income to the income year in which ABC derived the amount under s BD 3(2).

Issue 3 | Take tuatoru: Deduction for depreciation losses

27. The issue was whether ABC had depreciation loss deductions under s DA 1(1) for the cost of depreciable property acquired and installed under the refurbishment programme.
28. Under s EE 1, a person has an amount of depreciation loss if:
    - the taxpayer owns property,
    - the property is depreciable property as defined,
    - the property is used, or is available for use, to derive assessable income (ie, the general permission in s DA 1 is satisfied), and
    - the amount of the depreciation loss is calculated in the appropriate manner by application of the correct method and rate of depreciation under ss EE 9 to EE 11.
29. TCO noted that:
    - ABC would own the depreciable property (as defined in s EE 6 and EE 7) to be acquired and installed under the refurbishment programme.
    - Under the refurbishment programme, the depreciable property was expected to become available for use, or be used in, ABC's business to derive assessable income progressively as the works and related installation progresses.
    - The amount of depreciation loss was to be calculated under ss EE 9 to EE 11. Section EE 9 provided that one of the methods of calculating an amount of depreciation loss was the straight-line method. Under s EE 12(2)(b) the straight-line method could be used for any item of depreciable property
30. Therefore, TCO concluded that, to the extent ABC owned depreciable property (as defined in s EE 6 and EE 7) that was used or available for use to derive assessable income, ABC could elect to use the straight-line method of depreciation under s EE 12 (subject to the calculation rules under ss EE 9 to EE 11) to quantify its depreciation loss deductions under s DA 1(1) for each income year.

Issue 4 | Take tuawhā: Whether there is a stapled debt security

31. The issue was whether s FA 2B applied to recharacterise the interest-free loans as equity.
32. The description of the Arrangement stated that the shares in DEF and the loan to ABC must always be held together such that the loans (and any new loans by new shareholders) would in substance be "stapled" to the shares in DEF.
33. In respect of s FA 2B:
    - TCO considered that the meaning of stapled as outlined in s FA 2B(5) would be satisfied in that the loans and the shares must be held together. Further, the exclusion in s FA 2B(6) did not apply because DEF was a widely-held company.
    - TCO considered the interest-free loans would not constitute a "debt security" as defined in s FA 2B(4). While the loans were "financial arrangements" that did provide funds for ABC, the loans did not give rise to any amount for which ABC would otherwise have a deduction. TCO noted this was consistent with its conclusion on the application of the financial arrangements rules to the interest-free loan (discussed in this summary).
    - Even if the section did apply to the interest-free loans, it would have no effect as there was no interest payable on the loans to be treated as a dividend and in respect of which a deduction could be denied: s FA 2B(2).
34. Accordingly, TCO concluded that s FA 2B did not apply to the interest-free loans.

Issue 5 | Take tuarima: Financial arrangements rules and RWT

35. The issue was whether the repayment of the interest-free loan principal by ABC to the shareholders in DEF by offset against licence fees payable by the shareholders gave rise to income or deductions (under ss CC 3 or DB 7) for ABC.
36. TCO considered the interest-free loan and licence fee agreement were part of the same wider arrangement, given the knowledge and connection of the parties with respect to each element of the agreements, and given the existence of some interdependence of cash flows under the agreements.[3] TCO considered this wider arrangement was a financial arrangement, comprising a financial arrangement under s EW 3(2) (the interest-free loan), and an excepted financial arrangement under s EW 5(22) (the licence fee agreement).

3 *CIR v Dewavrin Segard (NZ) Ltd* (1994) 16 NZTC 11,048 (CA).

37. Under s EW 6(3), amounts solely attributable to the excepted financial arrangement must be taken into account. Applying the financial arrangements rules, no income or expenditure arose for ABC in respect of the interest-free loan, or the licence fee agreement, as there was no net flow of consideration under either arrangement. The financial arrangements rules do not deem interest to arise on interest-free loans. The consideration for the services provided under the licence fee agreement as determined under s EW 32 is the same as its stated value under the Arrangement as the licence fees are charged at market value and there is no discount component in the contract for services to be spread.
38. Accordingly, TCO concluded that the repayment of the interest-free loan principal by ABC to the shareholders in DEF by offset against licence fees payable by the shareholders did not give rise to income or deductions under ss CC 3 or DB 7 for ABC.[4]
39. If there was no amount to spread under the financial arrangements rules, the amounts paid and received under the agreements might still be recognised as income derived or expenditure incurred under the relevant provisions of the Act (outside the financial arrangements rules). Therefore, this conclusion did not affect TCO's earlier conclusion that the licence fees receivable by ABC were business income for ABC under s CB 1 and was allocated as income to the income year in which ABC derived the amount under s BD 3(2).
40. TCO also considered whether there was income from "interest" as defined in s YA 1, which could have RWT implications. TCO concluded that there was no "interest" arising on the interest-free loans as while there was money lent, the only cashflows under the interest-free loans were the advancing of principal and the repayment of that principal, and TCO had concluded earlier that no income or deductions arose in respect of the interest-free loan and licence fee agreement under the financial arrangements rules. Therefore, TCO concluded that ABC was not required to withhold or pay an amount of tax under s RA 6 in relation to the interest-free loan repayments.

Issue 6 | Take tuaono: Whether s BG 1 applied

41. The issue was whether s BG 1 applied to negate or vary any of the other income tax rulings being sought.
42. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. Section GA 1 enables the Commissioner to make an adjustment to counteract a tax advantage obtained from or under a tax avoidance arrangement.
43. The Supreme Court in *Ben Nevis* considered it desirable to settle the approach to applying s BG 1.[5] This approach is referred to as the Parliamentary contemplation test, which is an intensely fact-based inquiry. *Ben Nevis* has been followed in subsequent judicial decisions.
44. TCO's approach in making this decision is consistent with Interpretation statement: IS 23/01 Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007 (3 February 2023) (IS 23/01). IS 23/01 will not be replicated in this TDS but in summary the steps are as follows:
    - Understanding the legal form of the arrangement. This involves identifying and understanding the steps and transactions that make up the arrangement, the commercial or private purposes of the arrangement and the arrangement's tax effects.
    - Determining whether the arrangement has a tax avoidance purpose or effect. This involves:
        - Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
        - Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts. Artificiality and contrivance are significant factors.
        - Considering the implications of the preceding steps and answering the ultimate question under the Parliamentary contemplation test: Does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?
    - If the arrangement has a tax avoidance purpose or effect that is not the sole purpose or effect of the arrangement, consider the merely incidental test. The merely incidental test considers many of the same matters that are considered under the Parliamentary contemplation test.

4 TCO included references to ss CC 3 and DB 7 which were the provisions under which financial arrangement income or deductions could arise.

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

45. Taking into account all of the relevant facts and circumstances (noting that as this is a summary it may not contain all the facts or assumptions relevant to the decision and, therefore, cannot be relied on) the Tax Counsel Office concluded as follows.

The Arrangement

46. The Arrangement was the proposed financing arrangement to fund the refurbishment of the Asset, including the following steps:
    - The shareholders of DEF would make a series of interest-free loans over time to ABC to meet part of the cost of refurbishment of the Asset.
    - Capital works licence fees would be charged to cover the refurbishment costs on a straight-line basis over the tax life of the new assets.
    - The loan repayments would match the capital works licence fees payable by the licensees to recover capital refurbishment costs under the licences. In substance, the shares in DEF and the loan to ABC were required to be held together.
47. TCO considered that the legislation was working as intended in respect of the following tax effects of the Arrangement:
    - Dividend income was only intended to arise when a transfer of company value was caused by a shareholding relationship. Parliament was concerned with the transfer of value received by shareholders (being a return on investment), rather than value being provided by shareholders to a company they held shares in (downward transfers of value).
    - The licence fees charged were based on an arm's length market rate (which was included as a condition of the ruling), and as such there was no transfer of value or dividend arising on the provision of the licence to the shareholders.
    - ABC still derived the same amount of taxable licence fee income over time (being the charges to the licensees for the cost of operating the Asset). The provision of the loans did not distort ABC's timing of derivation of the licence fees.
    - The depreciation deductions claimable reflected the spreading of actual costs incurred by ABC in acquiring depreciable property used or available for use in deriving its assessable income.
48. TCO considered that ABC may be receiving a benefit (in the form of the value of the interest-free loans) that did not give rise to taxable income in its hands. Accordingly, TCO analysed the tax effects that could potentially arise from a s BG 1 perspective in respect of the provision of the interest-free loans, which were:
    - No financial arrangement income or deduction arose under subpart EW, ss CC 3 or DB 7 in respect of the interest-free loans. The repayment of the interest-free loan principal by ABC to the shareholders in DEF by offset against licence fees payable by the shareholders did not give rise to income or deductions under ss CC 3 or DB 7 for ABC.
    - Section FA 2B did not apply to the interest-free loans issued by ABC to the shareholders of DEF.
    - ABC was not required to withhold or pay an amount of tax under s RA 6 in relation to the interest-free loan repayments to the shareholders of DEF.
    - No income arose for ABC under s CC 1B because the benefit of the interest-free loan was not consideration for the grant, renewal, extension or transfer of the licence.

Parliamentary contemplation

49. TCO considered that Parliament contemplated capital could be provided by way of interestfree loans. TCO also considered that the focus in the Act was on actual payments and net gains and losses. While various provisions were aimed at ensuring excessive interest deductions were not taken in New Zealand, there were no provisions seeking to create income where no amount was actually received over and above the money lent in this context.
50. TCO was satisfied the provision of capital by way of interest-free loans from its ultimate shareholders had a commercial purpose that objectively met ABC's genuine commercial need to raise funding for the refurbishment of the Asset because it had been unable to obtain third-party financing (which was a condition of the ruling). The shareholders of DEF and indirectly of ABC had a united purpose to carry out the capital works.
51. TCO considered the use of interest-free loans did not artificially change the amount or timing of derivation of ABC's licence fee income. Similarly, the shareholders did not receive any real economic gain for providing the interest-free funding as they were still being charged market rates for the licence fees (which was another condition of the ruling). As such, there was no indication that the absence of interest on the loans was artificially set to obtain a tax advantage.

52. TCO considered it was clear that it was not intended for s CC 1B to capture every payment received "in relation to" a land right. There needed to be a direct link between the payment and the grant, renewal, extension or transfer of the land right.
53. TCO considered the Arrangement made use of the relevant provisions in a manner that was consistent with Parliament's purpose for those provisions. Therefore, TCO concluded the Arrangement did not have a tax avoidance purpose or effect.

Conclusion

54. TCO concluded that there was no tax avoidance purpose or effect of this Arrangement. Accordingly, TCO concluded that in the context of the issues being ruled on, s BG 1 did not apply to negate or vary the black letter outcomes above. It was therefore not necessary for TCO to go on to consider the merely incidental test.

Issue 7 | Take tuawhitu: Input tax credits without adjustments

55. The issue was whether ABC would be entitled to GST input tax credits under s 20(3) of the GSTA for GST on capital expenditures under the refurbishment programme without any adjustment under ss 21 to 21H of the GSTA.

Entitlement to input tax credits

56. Under s 20(3)(a), ABC would be required to deduct from the output tax attributable to the taxable period one or more of the following:
    - Input tax in relation to the supply of goods and services (not being a supply of "secondhand goods" to which s 3A(1)(c) applies) made to ABC during the taxable period.
    - Input tax in relation to the supply of "secondhand goods" to which s 3A(1)(c) applies to the extent that a payment in respect of that supply was made during the taxable period.
    - Input tax invoiced or paid, whichever is the earlier, under s 12 during that taxable period on the importation of goods (not being fine metal) into New Zealand.
    - Any amount calculated in accordance with any of ss 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b).
57. As noted above:
    - ABC had a license for use of the Asset, and
    - ABC operated and maintained the Asset and sub-licensed the use of the Asset to various licensees.
58. TCO was satisfied that ABC's business was a taxable activity and ABC's supplies of rights to licensees were taxable supplies. ABC would be carrying on that taxable activity and making those taxable supplies of rights when the cost of the refurbishment programme was incurred. The licence fees would consist of the regular licence fees that licensees paid to cover the operating costs of the Asset along with an increase for the capital works licence fee.
59. TCO considered that the input tax arising out of the refurbishment programme would be incurred to acquire goods or services that had sufficient nexus to the taxable supplies produced by ABC.
60. Finally, TCO considered that ABC would not make exempt supplies to which an apportionment of the refurbishment costs under s 20(3C) could potentially be required.[6]

Adjustments under ss 21 to 21H

61. Section 21(1) requires a registered person to work out at the end of an adjustment period if an adjustment needs to be made for the period. The adjustment, if required, would be for any percentage difference in a supply of goods or services compared to the actual use of those goods for making taxable supplies.
62. Applying this to ABC, TCO considered that the goods or services acquired by the refurbishment programme were wholly connected to taxable supplies to be produced by ABC. The percentage intended use of the goods or services at acquisition therefore was 100%. If the nature of ABC's business did not change (ie, ABC did not start using the Asset to make non-taxable or exempt supplies), then the percentage actual use of the relevant goods or services would also be 100% (ie, those goods or services would still be wholly connected to taxable supplies produced by ABC). No percentage difference would arise and no adjustment would need to be made under ss 21–21H for the goods or services to be acquired by the refurbishment programme.

6 TCO considered that s 20(3D) would not apply to the Arrangement.

Conclusion

63. TCO concluded that ABC:
    - would be entitled to claim a full deduction for the input tax credits under s 20(3) arising out of the refurbishment programme at the time of supply of the relevant goods or services; and
    - would not have to make any adjustment under ss 21 to 21H for the input tax arising out of the refurbishment programme.

Issue 8 | Take tuawaru: Is GST imposed on licence fees paid by offset against loan principal?

64. The issue was whether ABC would be subject to GST on the licence fees paid by offset against loan principal under ss 8(1) and 9(3) of the GSTA.
65. TCO considered that the licence fees would be subject to GST under s 8(1).
66. A supply of goods and services is generally deemed to occur at the earlier of when an invoice is issued by the supplier or the recipient or a payment is received for the supply under s 9(1). However, s 9(1) is subject to s 9(2) and (3).
67. Relevantly, TCO considered s 9(3)(a) applied when services were supplied under any agreement that provided for periodic payments. Those services would be deemed to be successively supplied for successive parts of the period of the agreement, and each of the successive supplies is deemed to take place at the earlier of when a payment becomes due or is received.
68. For the purposes of s 9(3)(a), the licences record an agreement between ABC and the licensees under which ABC granted rights to use the Asset in exchange for consideration including the payment of the capital works licence fee. Those capital works licence fees would be periodical payments that would only become due for payment when ABC's repayments of the interest-free loans also became due.
69. Therefore, TCO considered the periodical capital works licence fees for ABC's services would be deemed to be successively supplied. Also, TCO considered each of those successive supplies would be deemed to take place at the earlier of when a payment became due or was received.
70. TCO concluded that, under s 8(1) and 9(3), ABC would be subject to GST on the capital works licence fees in each GST period in which those fees were paid on the due date by way of set off against ABC's repayments of the interest-free loans.[7]

Issue 9 | Take tuaiwa: Will open market value be substituted for the agreed licence fees amount?

71. The issue was whether s 10(3) would apply to treat the consideration for the supply of licence rights as being the "open market value" of that supply in substitution for the agreed licence fees. In essence, TCO was required to determine whether the supply of licence rights was an "associated supply" under s 10(3)(b).
72. TCO noted that the definition of "associated supply" applied to:
    - supplies that a supplier made to an associated recipient, and/or
    - certain supplies under an "equity security" or "participatory security".

Associated persons

73. The definition of "associated persons" in s 2 of the GSTA states that two companies would be associated persons if there is a group of persons who have voting interests, or if a market value circumstance exists for either company, market value interests, in each of those companies of 50% or more when added together or who have control of each of those companies by any other means whatsoever. Further, a company and a person other than a company would be associated if the person has voting interests, or if a market value circumstance exists for the company, market value interests, in the company of 25% or more.
74. Under the Arrangement:
    - no individual or trust shareholder of DEF had 25% or more ownership of DEF, and no corporate shareholder had 50% or more ownership in DEF; and
    - ABC did not hold shares in any corporate shareholder of DEF.
75. The licensees were not persons who are associated with DEF (or, by extension, with its wholly-owned subsidiary ABC) under the above tests.[8]

7 Having reached this conclusion, TCO did not need to also consider s 9(2).

8 Neither, on the facts of the Arrangement, did the tripartite test in s 2A(1)(i) appear to apply.

76. Accordingly, ABC would not be making supplies to associated persons when it supplied licence rights to licensees.

Equity securities or participatory securities

77. TCO noted that:
    - An "equity security" was an interest in or right to share in the capital of a body corporate.
    - A "participatory security" was a participation right in a "contributory scheme".
    - Broadly, a "contributory scheme" (as defined in s 3) included syndicates that had more than five investors or a professional manager. A "contributory scheme" did not include an "equity security" or a "debt security".
78. TCO ruled out the possibility that the supply of a right to receive licence rights might be under a "participatory security". This was because, if the shares in ABC were the source or origin of the licence rights, those shares were an "equity security" that was excluded from the s 3 definition of "participatory security" for the purpose of para (b) of the "associated supply" definition.
79. TCO was satisfied that:
    - Share ownership in ABC was merely a vehicle for procuring the licence rights for licensees.
    - The vehicle for acquiring the licence rights themselves was the licence supplied by ABC (not the shares in ABC) for which licensees separately paid the periodic licence fees.
    - The licence rights (to use, occupy and enjoy the Asset) were discrete and were not an incident of owning shares in ABC.
    - Those rights did not have a source or origin in the shares in ABC and, as such, were not rights attaching to those shares.
80. TCO considered that the licence rights were not rights supplied under a share in ABC. Also, although the mechanism for procuring licence rights was share ownership in ABC, this did not convert the supply to licensees of licence rights into a supply of rights under a GST-exempt "equity security" for the purposes of the s 2(1) "associated supply" definition.
81. Therefore, TCO considered that licensees' right to receive a supply of licence rights from ABC was not a right supplied "under" an equity or participatory security for the purposes of para (b) of the s 2(1) "associated supply" definition. TCO also concluded above that licensees were not persons associated with ABC for the purpose of para (a) of that definition. As such, ABC's supplies of licence rights would not be "associated supplies" as defined in s 2(1).

Conclusion

82. TCO concluded that s 10(3) would not apply to treat the consideration for the supply of the licence rights as being the "open market value" of those supplies.

Issue 10 | Take tekau: Whether s 76 applied

83. The issue was whether s 76 (tax avoidance) of the GSTA applied in the circumstances.
84. In 2000, s 76 was aligned with a predecessor of s BG 1 of the Income Tax Act 2007 (the income tax general anti-avoidance provision). The Supreme Court in *Ben Nevis* considered it desirable to settle the approach to applying s BG 1.[9] This approach is referred to as the Parliamentary contemplation test, which is an intensely fact-based inquiry. *Ben Nevis* has been followed in subsequent judicial decisions. TCO's approach in making this decision is consistent with IS 23/01 (see above at [44]).
85. The Supreme Court in *Glenharrow* considered the application of an earlier version of s 76.[10] The Court held that the same objective test applied to GST avoidance as it does to income tax avoidance under s BG 1. The Court relied on income tax avoidance cases to support its view. Significantly, the Supreme Court delivered its decision in *Glenharrow* on the same day as its income tax avoidance decision in *Ben Nevis*. Four of the five justices who made up the Supreme Court bench in *Ben Nevis* were also on the bench in *Glenharrow*.
86. 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.

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

10 *Glenharrow Holdings Ltd v CIR* [2008] NZSC 116, [2009] 2 NZLR 359.

87. ABC was a GST registered person. ABC, in commercial and economic reality, would incur capital costs under the refurbishment programme. Those costs would be incurred in carrying out capital works that ABC must undertake to comply with its contractual obligations under the head licence for the Asset. ABC would incur the relevant costs in acquiring goods and services that would be charged with tax under s 8(1). ABC's entitlement to claim input tax deductions for the tax charged on those costs in the taxable period in which it holds the taxable supply information for the supply would clearly be within Parliamentary contemplation.
88. To fund the immediate costs to be incurred under the refurbishment programme, ABC would have to look to its economic owners (the DEF shareholders) for finance. This was because ABC was unable to obtain funding from the banks, or from non-bank lenders or suppliers on terms that it considered affordable (which was a condition of the ruling). Ultimately, the cost of the refurbishment programme would be paid for by a monthly capital works licence fee that was payable by licensees (who were also the DEF shareholders). The monthly capital works licence fees collected would enable ABC to repay the loans.
89. TCO accepted that it was commercially explicable for:
    - a company to fund a capital project with finance obtained from its economic owners where external funding was unavailable or considered to be unaffordable,
    - a loan between associated persons to be interest-free in that context, and
    - a loan to be effectively tied to ownership of the borrower, or to ownership of a person associated with the borrower, so that the interests of the borrower's owners and its creditors did not diverge.
90. TCO considered whether the combined effect of the steps and transactions that made up the Arrangement might suggest that in commercial and economic reality the advances that ABC received from DEF shareholders under the loans would really be repayable. In TCO's view, Parliament would expect that ABC must be subject to a real obligation to repay the loan advances. TCO considered whether it was possible to view the advances as a pre-payment for the capital works licence fees in commercial and economic terms rather than an obligation to repay. The concern was that, if a pre-payment, there would be a significant temporal mismatch spanning 20 or more years. This would be to the extent of the payment treated as periodically supplied over the term of the Arrangement so that input tax credits were obtained in advance of output tax liability arising in later years.
91. The Arrangement, however, and all of its steps or transactions, were commercially explicable involving real economic consequences in terms of capital expenditures that had to be funded and paid for, and were reasonably common in commercial practice in similar contexts. Outgoing sub-licensees would also be repaid their outstanding loan balance using funding provided by incoming sub-licensees. In pursuing those commercial purposes, TCO considered that, on balance, the Arrangement objectively had not been deliberately structured in the way to create or take advantage of a temporal mismatch between outputs and inputs to obtain a tax advantage. In TCO's view, the Arrangement was not artificial or contrived in its commercial context.
92. Therefore, TCO considered that, on balance:
    - The steps and transactions that made up the Arrangement make use of the specific provisions that they engage consistent with Parliament's purposes for those provisions.
    - The Arrangement did not have a tax avoidance purpose or effect for the purpose of determining whether s 76 would apply to negate or vary conclusions reached on the application of the GST black letter law provisions being ruled on.
93. As TCO concluded that there was no tax avoidance purpose or effect of this Arrangement, it was not strictly necessary for it to go on to consider the merely incidental test. However, as TCO indicated above, its conclusion was on balance. TCO went on to consider the merely incidental test.

Merely incidental

94. There were three particular tax effects of the Arrangement that, in TCO's view, could potentially cause concern from a s 76 perspective. These tax effects were:
    - Treating the physical payment of loan principal by ABC shareholders as occurring under the loans and not (in commercial and economic reality) as consideration for the licence rights.
    - Recognising the supply of a financial service as occurring for the payment by ABC and collection by ABC's shareholders of loan repayments.
    - Recognising the payments that licensees make for the licence fees by way of setoff against the loan repayments as being the payment that triggers the time of supply of the licence rights under s 9(3)(a).
95. ABC would be obliged to incur expenditure under the refurbishment programme to satisfy its contractual obligations under the head licence. To fund that expenditure, ABC would receive upfront payments as loan advances from the ABC shareholders, who in their alternative capacity as licensees would be obliged to pay monthly capital works licence fees to ABC. The arrangements for the repayment of loan advances, payment of the capital works licence fees and the holding of the loans, viewed objectively, could suggest that the loan advances were in commercial and economic reality a payment for the capital works licence fees.
96. However, TCO concluded that the Arrangement along with its constituent steps and transactions satisfied a real commercial need as ABC was effectively unable to borrow externally due to commercial requirements imposed by external third-party lenders. In addition, it was not possible or practical to obtain Licence fee prepayments from Licensees. Debt financing from shareholders on the other hand was commercially explicable and was a less complicated and practical way to fund the refurbishment. Additionally, as ABC had to look to their economic owners for funding, it was commercially explicable for the Loans to be effectively tied to the shares. This achieved another commercially explicable outcome of ensuring that the decision-making among the shareholder group was aligned to the best interests of the Applicants and the body of shareholders as a whole.
97. Consequently, on balance, TCO considered that the Arrangement was appropriately structured around a series of loans under which ABC would assume a legal obligation to repay the advances made to it under those loans. Otherwise, the DEF shareholders/licensees (being the only viable source of finance) would be reluctant to provide the amount of funding required to progress the capital works and the Arrangement would not achieve its commercial purposes. On reaching this conclusion, it must also follow that there was a separate payment:
    - by ABC to repay the loans, which constituted the supply of a financial service; and
    - by licensees to satisfy their obligation to pay the capital works licence fees on the due date for payment, which to that extent triggered the time of supply of the licence fees.
98. Accordingly, for the reasons set out above and having regard to the commercial purposes of the Arrangement, TCO considered that if a temporal mismatch between outputs and inputs did arise under the Arrangement, and it did constitute a tax avoidance purpose or effect, it would be merely incidental to the commercial purposes of the Arrangement.

Conclusion

99. TCO further concluded that the Arrangement, if it did have a tax avoidance purpose or effect, that purpose or effect would be merely incidental to the commercial purposes of the Arrangement. Therefore, in the context of the issues being ruled on, the Arrangement was not a GST avoidance arrangement for the purposes of s 76 and it did not apply to negate or vary the GST conclusions reached.

TDS 25/03: GST – Output tax deductions, shortfall penalties

Decision date | Rā o te Whakatau: 11 October 2024

Issue date | Rā Tuku: 28 February 2025

Subjects | Kaupapa

Output tax deductions for indemnity payment under a deed, shortfall penalties

Taxation laws | Ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GSTA), except for Issue 2 in which references are to the Tax Administration Act 1994 (TAA).

Summary of facts | Whakarāpopoto o Meka

1. The Taxpayer was a company that owned property with both residential and commercial leases.
2. The Taxpayer was registered for GST from its date of incorporation on a payments basis.
3. The Taxpayer entered into both a lease and a separate deed with a tenant.
4. The deed required action to be taken by the Taxpayer in the form of alterations to the building, by a date specified in the deed (the date of default).
5. The deed contained a contractual obligation to indemnify the tenant for certain obligations incurred under the lease for a period of time. The obligation was triggered when the alterations to the building were not made by the date of default.
6. Failure to fulfil this obligation resulted in a payment to the tenant.
7. The Taxpayer made a payment the amount of which equalled the rent and outgoings of the tenant under the lease for a specified period and claimed a deduction from output tax for GST on this payment.

Issues | Take

8. The main issues considered in this dispute were:
   - Whether the Taxpayer was entitled to a deduction from output tax for GST on the payment under s 20(3)(b)(iv).
   - Whether the Taxpayer was liable for a shortfall penalty for not taking reasonable care, reduced by 50% for previous behaviour, under ss 141A and 141FB of the TTA.

Decisions | Whakatau

9. The Tax Counsel Office (TCO) decided:
   - The Taxpayer was not entitled to claim a deduction from output tax under s 20(3)(b)(iv) for GST on the payment made to the tenant under the deed.
   - The Taxpayer was not liable for a shortfall penalty for not taking reasonable care.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Was the Taxpayer entitled to a deduction from output tax under s 20(3)(b)(iv)?

10. Customer and Compliance Services (CCS) argued the Taxpayer was not entitled to a deduction from output tax for the GST on the payment because the deed did not alter the amount of rent and outgoings payable by the tenant under the lease.
11. CCS argued the payment compensated the tenant for the loss associated with the Taxpayer's failure to make the alterations to the building by the specified date and accordingly, there was no underlying supply of a good or service on which GST was charged.
12. The Taxpayer argued the payment was a refund of rent and outgoings paid by the tenant under the lease and in respect of which it had accounted for GST output tax to the Commissioner.
13. The Taxpayer argued it accounted for an incorrect amount of output tax on its supply of services to the tenant and was entitled to an adjustment for the excess output tax paid.
14. The Taxpayer described the issue as being whether the payment was consideration for an earlier supply of services made by it to the tenant for which it could claim an input tax deduction under s 25(1).
15. It was not disputed that there was taxable supply of the property by the Taxpayer to the tenant on which the Taxpayer had accounted for output tax. Further, neither CCS or the Taxpayer considered the payment was consideration for a supply of goods or services acquired by the Taxpayer from the tenant. The issue was whether the payment made by the Taxpayer to the tenant under the deed was an alteration of the previously agreed consideration for that supply or supplies under s 25(1)(b), and whether the deed altered the previously agreed consideration for the supply of services by the Taxpayer to the tenant under the lease such that a deduction from output tax for the GST on the payment could be claimed under s 20(3)(b)(iv).
16. TCO noted:
    - Section 20(3)(b)(iv) provides that a taxpayer who accounts for GST on a payments basis can deduct from its output tax an amount calculated in accordance with s 25(2)(b), to the extent that a payment has been made in respect of that amount.
    - The effect of s 25(2)(b) is that where a supplier has accounted for an incorrect amount of output tax because the previously agreed consideration for the supply has been altered, whether due to the offer of a discount or otherwise, the supplier must make an adjustment to correct the amount of tax (s 25(1)(b) and (e)).
    - Section 25(1)(b) refers to a situation where the previously agreed consideration for a supply of goods and services has been "altered".
17. TCO concluded the previously agreed consideration for a supply could not be altered without an element of reciprocity to link the payment to a supply.[1]
18. TCO concluded the parties did not, under the deed, agree to alter the previously agreed consideration for the supply of services by the Taxpayer to the tenant under the lease. In particular:
    - The use of the word "indemnify" in the deed was not determinative of the legal nature of the payment.[2]
    - What was important was the legal arrangements actually entered into, not the economic or other consequences of the arrangement and/or an arrangement that could have been entered into but was not.[3]
    - In accordance with the deed, the legal nature of the payment made by the Taxpayer was a payment for a breach of contract.

1 *Montgomerie v CIR* (2000) 19 NZTC 15,569.

2 *CIR v New Zealand Refining Co Ltd* (1997)18 NZTC 13,187.

3 *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 at p 13,192 citing *Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 at p 706 [also reported as *Marac Life Assurance Ltd v CIR; CIR v Marac Life Assurance Ltd* (1986) 8 NZTC 5,086 at pp 5,097, 5,098].

- The payment was for the Taxpayer's failure to meet the terms of the deed on or before the specified date, rather than an alteration of the previously agreed consideration for the Taxpayer's supply of services to the tenant under the lease.
- In economic terms, the effect of the payment was that the tenant was reimbursed for the rent and outgoings for a specified period to the end of the first term of the lease. However, it was not appropriate to conflate contractual or legal effect with economic outcomes or equivalents.[4]

19. TCO agreed with CCS that the Taxpayer was not entitled to claim a deduction from output tax under s 20(3)(b)(iv) for GST on the payment made to the tenant under the deed.

Issue 2 | Take tuarua: Did the shortfall penalty apply?

20. In this part of the summary, all legislative references are to the TAA unless stated otherwise.
21. Section 141A imposed a shortfall penalty of 20% of the tax shortfall if a taxpayer does not take reasonable care in taking a taxpayer's tax position.
22. The shortfall penalty for not taking reasonable care was considered in the Interpretation statement *Shortfall penalty for not taking reasonable care* published in *Tax Information Bulletin* Vol 17, No 9 (November 2005): 3. Despite later case law, TCO considered that the Interpretation statement correctly stated the law in relation to the penalty.
23. The Taxpayer was liable for a shortfall penalty under s 141A if the following requirements were satisfied:
    - The Taxpayer had taken a taxpayer's tax position as defined in s 3(1).
    - The Taxpayer's tax position led to a tax shortfall as defined in s 3(1).
    - The Taxpayer had not taken reasonable care in taking the taxpayer's tax position.
24. In *Case W4*, Judge Barber said that the test of "reasonable care" was whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood that an act or failure to act would cause a tax shortfall.[5] This was having regard to all of the circumstances.
25. The Taxpayer would have taken reasonable care in taking a tax position if any of the following tests were satisfied:
    - They relied on the action or advice of a tax advisor (and none of the exceptions listed in s 141A(2B)(b)-(e)), applied).
    - The tax position taken was an acceptable tax position.[6]
    - They did what a reasonable person in their circumstances would have done.[7]
26. TCO concluded that the Taxpayer was not liable for a shortfall penalty for not taking reasonable care.
27. TCO noted that notwithstanding the incorrectness of the tax position taken, the issue was significant and complex, and while a reasonable person might have foreseen the possibility of a shortfall, the Taxpayer sought advice in taking the tax position.
28. The Taxpayer consulted an accountant who was a member of an approved advisor group and therefore a "tax advisor" under s 141A(2B).
29. The accountant had business and tax credentials that had not been (explicitly or validly) disputed by CCS. The accountant also thought that the tax position taken in relation to the payment was the correct one.
30. The Taxpayer did what a reasonable person would have done in the circumstances by involving the accountant.
31. TCO considered the Taxpayer, in relying on the advice of the accountant, had taken reasonable care for the following reasons:
    - The accountant was external to the Taxpayer.
    - The evidence provided supported the conclusion that the accountant had adequate information and instructions relating to the tax position taken.
    - There was nothing indicating that the Taxpayer had reason to believe that the accountant's advice was incorrect or that it previously had a tax shortfall for GST in a period ending less than 4 years before the beginning of the period to which the tax position relates.

4 *Marac Life Assurance* supra.

5 *Case W4* (2003) 21 NZTC 11,034. See also *Hong v CIR* [2018] NZHC 2539, (2018) 28 NZTC 23-073 at [22].

6 See s 141A(3).

7 See *Case W4* at [61].

32. TCO agreed with the Taxpayer that it was not liable for a shortfall penalty for not taking reasonable care under s 141A.

Conclusion

33. TCO concluded that the Taxpayer was not entitled to claim a deduction from output tax under s 20(3)(b)(iv) for GST for the payment made to the tenant under the deed.
34. TCO concluded that the Taxpayer was not liable for a shortfall penalty for not taking reasonable care under s 141A.

TDS 25/04: Deductions and shortfall penalties

Decision date | Rā o te Whakatau: 3 September 2024

Issue date | Rā Tuku: 7 March 2025

Subjects | Kaupapa

Income tax and GST input tax deductions: Whether expenditure incurred by the Taxpayer on educational courses, motor vehicle costs, home office costs, power, insurance, rent, advertising, website, eftpos, and stock was deductible. Some of the expenses were incurred before the business commenced and/or before the GST registration date.

Whether the Taxpayer was liable for shortfall penalties for not taking reasonable care.

Taxation laws | Ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GSTA), the Income Tax Act 2007 (ITA 2007), and the Tax Administration Act 1994 (TAA).

Summary of facts | Whakarāpopoto o Meka

1. The Taxpayer was an individual.
2. Customer and Compliance Services (CCS) agreed that the Taxpayer was in business and about the nature of the business. However, the parties did not agree about when the business commenced.
3. The dispute concerned deductions for expenses claimed in income tax returns for a number of income years, and input tax deductions claimed in GST returns for recent return periods. The disputed expenses were for educational courses, motor vehicle costs, home office costs, power, insurance, rent, advertising, website, eftpos and stock.
4. In particular, some of the expenses claimed by the Taxpayer related to:
    - Income tax and GST input tax deductions claimed for educational courses undertaken by the Taxpayer.
    - Income tax deductions for motor vehicle and home office expenses for which insufficient details had been provided.
    - GST input tax deductions claimed for expenses that were incurred prior to the effective date of the Taxpayer's GST registration.

Issues | Take

5. The main issues considered in this dispute were:
    - When did the Taxpayer's business commence?
    - Whether the Taxpayer was entitled to income tax deductions for educational expenses.
    - Whether the Taxpayer was entitled to income tax deductions for motor vehicle and home office expenses.
    - Whether the Taxpayer was entitled to the disputed input tax credits for goods and services.
    - Whether the Taxpayer was liable for shortfall penalties for not taking reasonable care.
6. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

7. The Tax Counsel Office decided on the balance of probabilities that:
    - The evidence provided by the Taxpayer did not go close to establishing that the Taxpayer commenced business prior to the date CCS argued was the business commencement date.
    - The educational expenditure for the course in the New Zealand Certificate in Business was a deductible expense. However, the Taxpayer had not demonstrated that they were entitled to income tax deductions for the remaining educational expenses.

- The Taxpayer had not proved that the motor vehicle and home office expenses claimed were deductible.
- The Taxpayer was entitled to input tax credits for the purchase of stock, even though the expense pre-dated the GST registration. However, the Taxpayer had not demonstrated they were entitled to input tax deductions claimed for expenditure related to power, insurance, rent, advertising, website and eftpos, and educational studies.
- The Taxpayer was liable for shortfall penalties for not taking reasonable care on all income tax and input tax deductions claimed other than for the New Zealand Certificate in Business and the stock.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

8. Except for proceedings relating to evasion or similar act or obstruction, the onus of proof is on the taxpayer to show that an assessment is wrong, why it is wrong, and by how much it is wrong.[1] However, if the taxpayer proves, on the balance of probabilities, that the amount of an assessment is excessive by a specific amount, the taxpayer's assessment must be reduced by the specific amount.[2]
9. The standard of proof required is the balance of probabilities.[3]
10. It is appropriate that the same onus and standard of proof be applied in the disputes process as in challenge proceedings. TCO considered whether the Taxpayer has discharged the onus of proof in the context of the issues raised by the parties in the dispute, based on the documentary evidence put before it.

Issue 1 | Take tuatahi: When did the Taxpayer's business commence?

11. CCS argued that the Taxpayer's business commenced at a certain time (CCS's commencement date). The Taxpayer argued that the business commenced approximately four years earlier (Taxpayer's commencement date).
12. TCO noted that the leading case on the meaning of "business" in the tax context was *Grieve*.[4] Further, TCO noted that actions that were merely preparatory to the commencement of a business did not constitute a business.[5] TCO considered the following relevant principles regarding the commencement of business could be drawn from case law:
    - For a business to exist it is fundamental that there has been more than mere preparation.[6]
    - A commitment to engage in business must have been made. But the activity must go beyond merely establishing the profit-making structure.[7]
    - Ordinary current business operations must have begun (ie, conduct that it is hoped will ultimately yield a profit if persisted in).[8]
    - Activities being carried on continuously that are an integral part of the income-earning process will indicate that a business has commenced.[9]
13. TCO considered that the evidence provided by the Taxpayer did not go close to establishing, on the balance of probabilities, that the Taxpayer commenced business prior to CCS's commencement date. TCO noted that the evidence provided by the Taxpayer was limited. That evidence did not establish operations and transactions of a sufficient scale, or sufficient commitment of time, money and effort to establish a business.
14. TCO concluded that the Taxpayer did not commence the business, or income earning activity, before CCS's commencement date.
15. Accordingly, the rest of TCO's analysis proceeded on the basis that the Taxpayer's business commenced on CCS's commencement date.

1 Section 149A(2) of the TAA. See also *Case V17* (2002) 20 NZTC 10,192, *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC), and *Vinelight Nominees Ltd v CIR (No 2)* (2005) 22 NZTC 19,519 (HC).

2 Section 138P(1B) of the TAA.

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

4 *Grieve v CIR* (1984) 6 NZTC 61,682 (CA).

5 *Birmingham & District Cattle By-Products Co Ltd v IRC* (1919) 12 TC 92.

6 *Calkin v CIR* (1984) 6 NZTC 61,781 (CA).

7 *Calkin v CIR* supra.

8 *Calkin v CIR* supra.

9 *Whitfords Beach Pty Ltd v FCT* 83 ATC 4277 (FCAFC).

Issue 2 | Take tuarua: Income tax deductions for educational expenses

16. The Taxpayer claimed expenses for educational studies incurred (for the most part) before CCS's commencement date. CCS argued that the educational expenses could not be claimed for three alternative reasons:
    - There was no nexus between the expenditure and the business or income-earning activity.
    - The expenditure was prior to the commencement of the business or income-earning activity.
    - The expenditure was of a private and/or capital nature.
17. TCO considered that there were two alternative grounds under which a deduction was permitted under s DA 1 of the ITA 2007 (sometimes referred to as the first and second limbs of s DA 1). A deduction was allowed for expenditure or loss incurred by a person:
    - in deriving their assessable income, or
    - in the course of carrying on a business for the purpose of deriving their assessable income.
18. TCO noted that the alternative grounds were not cumulative. Expenditure or loss would be deductible under s DA 1 if only one of the alternative grounds was met.
19. Among the many cases analysed, TCO specifically considered cases on the deductibility of educational expenditure, such as *Case N2* and *Case Q18*.[10] Those cases established that the expenditure on education would be deductible when it was for continuing relevant education, undertaken at the time when the income-earning process already existed, and where the expenditure was made with a view to increase a person's earnings. In such cases there was sufficient nexus, and the expenditure is not of a private or capital nature.
20. TCO considered that the educational expenditure for the course in the New Zealand Certificate in Business, Level 4, was a deductible expense. TCO noted that the reasoning in *Case N2* and *Case Q18* applied to this expenditure for this course. TCO considered that it met the nexus with the income earning process that had already begun after CCS's commencement date. Skills acquired during this course could be said to be reasonably necessary to run the business, and in the nature of continuing education. The expenditure on this course was not excluded by the private or capital limitation.
21. However, TCO considered that the courses to obtain other qualifications were not deductible, as the Taxpayer had not established, based on the information provided, that there was a sufficient nexus between the business or income-earning activity and that expenditure.
22. In addition, there was a relatively small amount claimed for which no evidence or explanation had been provided by the parties. TCO considered that this expense was not deductible as the Taxpayer had not provided the required evidence to support this.

Issue 3 | Take tuatoru: Income tax deductions for home office and motor vehicle expenses

23. The Taxpayer claimed deductions for motor vehicle expenses and home office expenses (rent and power). CCS argued that the Taxpayer had not provided sufficient information to support the deductions.
24. Section 22 of the TAA states that a taxpayer who carries on an activity or business for the purpose of deriving assessable income is required to keep sufficient records to enable the taxpayer's deductions to be readily ascertained. TCO noted that in the absence of business records it is very difficult for a taxpayer to prove that an income tax assessment made or proposed by the Commissioner is wrong.[11]

Motor vehicle expenses

25. TCO observed that under subpart DE of the ITA 2007, deductions were allowed for expenditure for the business use of a motor vehicle (s DE 2(1)). As part of this, subpart DE sets out the rules for determining the proportion of business use to total use, when a person uses a motor vehicle partly for business purposes and partly for other purposes (s DE 2(1)(a)).
26. The Taxpayer's emails to CCS referred to logbooks, however none have been provided. Therefore, TCO considered it was not possible to verify whether they comply with the logbook requirements in s DE 7, and whether the business proportion of the use of the motor vehicle could be ascertained in reliance on the logbooks.
27. Therefore, TCO considered that the Taxpayer had not provided sufficient records.

10 *Case N2* (1991) 13 NZTC 3,012, *Case Q18* (1993) 15 NZTC 5,100.

11 *Case 1/2012* (2012) 25 NZTC 1-013.

28. Further, in the absence of actual records, TCO considered that the deduction for the motor vehicle was limited to the lesser of the proportion of actual business use, and 25% of the total use of the vehicle (s DE 4). As the Taxpayer had not provided sufficient evidence about what the actual business use of the vehicle was, TCO considered the actual business use should be treated as zero. Therefore, no deduction was available to the Taxpayer for the motor vehicle.
29. In summary, TCO concluded that the Taxpayer had not proved, on the balance of probabilities, that the motor vehicle expenses claimed were deductible.

Home office expenses

30. The deductibility of home office expenses depended on the application of the general deductibility principles already stated in this summary. This was unless the taxpayer relied on s DB 18AA of the ITA 2007, which provided taxpayers with a simplified method for determining the total amount that could be deducted for the business use of premises that were partly used for business purposes and partly used for other purposes. This included home offices.
31. In correspondence to CCS, the Taxpayer referred to square meters for the home office when working out the expense amounts. Therefore, TCO understood that the Taxpayer was relying on s DB 18AA (although this was not expressly stated by the Taxpayer).
32. CCS requested the Taxpayer to provide the calculations for the home office expenses claimed, including a floor plan for the whole house. CCS stated that this would have enabled them to verify the area of the house that was actually used for the home office.
33. TCO noted that although the Taxpayer's entitlement to a deduction was not dependent on a particular type of record being maintained (for example, an invoice), there still must be sufficient records to verify the expenditure (s 22 of the TAA). In the absence of sufficient records, it was very difficult for the Taxpayer to prove on the balance of probabilities that CCS's proposed adjustments were wrong (*Case 1/2012*).
34. TCO considered that, based on the information provided by the Taxpayer, there were insufficient records available to verify the Taxpayer's claims for the deduction for the home office expenditure in the income tax returns.
35. Therefore, TCO concluded that the Taxpayer had not proved, on the balance of probabilities, that these expenses could be claimed.

Conclusion

36. TCO concluded that CCS was correct in not allowing the motor vehicle and home office expenses as claimed by the Taxpayer in the income tax returns.

Issue 4 | Take tuawhā: Entitlement to disputed input tax credits for goods and services

37. The Taxpayer claimed input tax deductions for pre-registration expenses (educational courses, power, insurance, rent, advertising, website, eftpos and stock). CCS argued that educational courses acquired prior to GST registration were not deductible under s 20(3C)(a) of the GSTA.
38. Similarly, CCS argued that the input tax deductions claimed for power, insurance, rent, advertising, website and eftpos were not deductible. This was because they were goods or services acquired in previous years that were not available to be used by the Taxpayer post-registration as they were already used up.
39. As a preliminary matter, TCO noted that under s 20, only a registered person could deduct input tax paid when acquiring goods and services against the output tax charged on supplies made by the person in the same period (s 20(3)). Persons who were not registered for GST could not claim input tax.
40. Under s 21B, a registered person may make an adjustment under s 21, if the person:
    - before becoming a registered person, acquires goods and services on which tax has been charged under s 8(1) (s21B(1)(a)), and
    - at the time of registration, or at a later time, uses the goods or services for making taxable supplies (s 21B(1)(b)), and
    - meets the tax invoice or adequate records requirements (s 21B(3)(a)), and
    - in identifying the "percentage actual use" of goods and services in the first adjustment period, uses a method that provides a fair and reasonable result (s 21B(3)(b)).

41. TCO considered that:
    - Input tax deductions for the pre-registration expenses for education could not be claimed because the Taxpayer had not used the educational services in making taxable supplies at the time of, or after, registration. Although the benefits from the education may have had positive effects on the business, the services themselves were not provided after the Taxpayer registered for GST, and they were used up by the Taxpayer prior to registration. This meant they could not be used to make taxable supplies at, or after, registration.
    - Input tax deductions for the pre-registration expenses on power, rent, advertising, eftpos, insurance and website were for services that were also all used up prior to the Taxpayer registering for GST. For that reason, the Taxpayer could not have used these services in making taxable supplies at the time of, or after, registration.
    - In relation to the input tax deductions for stock, CCS's basis for proposing to disallow the input tax deductions was because the individual supplies were under $5,000 and no adjustment was permitted under s 21(2)(b). However, TCO considered this was not a requirement for pre-registration expenses under s 21B of the GST Act. In TCO's view the correct focus under s 21B was to establish whether or not at the time of registration, or at a later time, the Taxpayer had used, or would use, any of the stock in making taxable supplies. Therefore, TCO considered the proposed adjustments should not be made because the basis of CCS's argument was incorrect.
42. Accordingly, TCO concluded that the Taxpayer was entitled to input tax credits for the purchase of stock, even though the expense pre-dated the GST registration. However, TCO concluded the Taxpayer had not demonstrated they were entitled to input tax deductions claimed for expenditure related to power, insurance, rent, advertising, website and eftpos, and educational studies.

Issue 5 | Take tuarima: Shortfall penalties

43. CCS considered that the Taxpayer was liable for a shortfall penalty for not taking reasonable care of 20% for each tax shortfall identified for the relevant GST and income tax returns (under s 141A of the TAA). CCS also considered that the penalties should be reduced by 50% under s 141FB of the TAA. The Taxpayer did not agree.
44. Section 141A imposes a shortfall penalty of 20% on a tax shortfall if a taxpayer does not take reasonable care in taking a tax position, if the following requirements are satisfied:
    - The Taxpayer has taken a taxpayer's tax position.
    - The Taxpayer's tax position has led to a tax shortfall.
    - The Taxpayer has not taken reasonable care in taking the taxpayer's tax position.
45. It was not disputed that the Taxpayer had taken a tax position in each of the relevant tax returns in relation to the various income tax deductions and GST input tax deductions that were the subject of the dispute.
46. TCO considered it was evident that the Taxpayer's tax positions resulted in too little tax being paid (a tax shortfall) because the Taxpayer incorrectly claimed deductions for expenses as explained under the substantive headings above in this summary.
47. TCO subsequently considered whether the Taxpayer had taken reasonable care in taking the tax positions.
48. Relevantly, in *Case W4*, Judge Barber said that the test of "reasonable care" is whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood that an act or failure to act would cause a tax shortfall.[12] This is having regard to all of the circumstances. Further, Judge Barber said that whether the taxpayer acted intentionally is not a consideration. He said that it is not a question of whether the taxpayer actually foresaw the probability that the act or failure would cause a tax shortfall, but whether a reasonable person in the taxpayer's circumstances would have foreseen the tax shortfall as a reasonable probability.

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

Income tax

49. TCO considered that the Taxpayer had not taken reasonable care in relation to educational expenses claimed in the income tax returns. There was a significant lack of evidence that the Taxpayer commenced the business before CCS's commencement date. And there was no evidence that the Taxpayer checked their assessment on this matter including through seeking advice. A reasonable person could not have concluded that the costs of these earlier educational courses were business expenditure in that context. There was no credible argument that had been evidenced that established a sufficient nexus between these expenses and the Taxpayer's business. There is therefore no reasonable basis for taking these tax positions, and a reasonable person would have foreseen the possibility of a tax shortfall arising by taking these positions. Consequently, the lack of reasonable care penalty applied.
50. TCO noted that the penalty did not apply to the deductible expense for the Certificate in Business, for which there was a sufficient nexus (as there is no tax shortfall).
51. In relation to the income tax deduction claims for the motor vehicle and the home office, TCO considered there was no evidence of adequate records being maintained to support the claims. A reasonable person would not have failed to maintain adequate records in this context. And, by failing to maintain such records, would have foreseen the possibility of a tax shortfall arising. Therefore, the lack of reasonable care penalty applied.

GST

52. Input tax deductions for the pre-registration expenses for education were denied because the Taxpayer had not used the educational services in making taxable supplies at the time of, or after, the registration. Although the benefits from the education may have had positive effects on the business, the services themselves were not provided after the Taxpayer registered for GST, and were used up by the Taxpayer prior to the registration. Therefore, they could not have been used to make taxable supplies at, or after, registration. TCO considered no reasonable person could have taken the Taxpayer's tax positions on those expenses, particularly without seeking advice on this matter. A reasonable person would therefore have foreseen that taking these tax positions would lead to tax shortfalls. Therefore, the lack of reasonable care penalty applied.
53. Input tax deductions for the pre-registration expenses on power, rent, advertising, eftpos, insurance and website were for services with a short lifespan and were also all used up prior to the Taxpayer registering for the GST. For that reason, the Taxpayer could not have used those services in making taxable supplies at the time of, or after, the registration. This would have been evident to a reasonable person considering this matter. And, it would have also been foreseeable that taking these tax positions would lead to a tax shortfall. Therefore, the lack of reasonable care penalty applied.
54. TCO agreed with CCS that the Taxpayer qualified for a reduction of the shortfall penalty by 50% under s 141FB.

TDS 25/05: GST - input tax, taxable activity, taxable supplies, registration

Decision date | Rā o te Whakatau: 24 September 2024

Issue date | Rā Tuku: 10 March 2025

Subjects | Kaupapa

GST input tax deductions, taxable activity, taxable supplies, GST registration

Taxation laws | Ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GSTA) unless otherwise specified.

Summary of facts | Whakarāpopoto o Meka

1. The Taxpayer was a GST-registered company with multiple shareholders. It owned land that it leased to one of its shareholders.
2. The Taxpayer sold the land and ceased making taxable supplies. The Taxpayer did not de-register for GST.
3. Some of the Taxpayer's shareholders raised concerns about the previous administration of the Taxpayer and apparent irregularities in its accounts. The Taxpayer incurred legal fees defending the shareholder claims.
4. Around five years later, the Taxpayer claimed input tax deductions relating to legal fees it had incurred in the previous two years while the Taxpayer was not making any taxable supplies.
5. Customer and Compliance Services, Inland Revenue (CCS) argued that, as the Taxpayer had not made any taxable supplies during the previous five years, it had no taxable activity and was not entitled to the input tax deductions it had claimed for legal fees. CCS argued the Taxpayer's GST registration should be cancelled.
6. The Taxpayer argued it had always had a taxable activity and the legal fees it claimed related to that taxable activity. The Taxpayer said the legal fees related to the dispute with its shareholders and that it could not complete its taxable activity or start a new one until the dispute was resolved.

Issues | Take

7. The main issue in dispute was whether the Taxpayer was entitled to the input tax deductions it claimed (s 20(3C)). The Tax Counsel Office (TCO) considered:
    - whether the Taxpayer was carrying on a taxable activity, and
    - whether the legal services to which the input tax related was used for making taxable supplies.
8. A further issue was whether the Taxpayer's GST registration should be cancelled.
9. There was also a preliminary issue concerning the onus and standard of proof.

Decisions | Whakatau

10. TCO concluded that the Taxpayer was not entitled to the input tax deductions it claimed. The Taxpayer was carrying on a taxable activity as there were actions still being done in connection with the termination of the activity. However, the Taxpayer had not shown the legal services were used for making taxable supplies.
11. TCO also concluded the Taxpayer's GST registration should not be cancelled.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

12. Except for proceedings relating to evasion or similar act or obstruction, the onus of proof is on the taxpayer to show that an assessment is wrong, why it is wrong, and by how much it is wrong.[1] However, if the taxpayer proves, on the balance of probabilities, that the amount of an assessment is excessive by a specific amount, the taxpayer's assessment must be reduced by the specific amount.[2]
13. The standard of proof required is the balance of probabilities.[3]
14. It is appropriate that the same onus and standard of proof be applied in the disputes process as in challenge proceedings. TCO considered whether the Taxpayer has discharged the onus of proof in the context of the issues raised by the parties in the dispute, based on the documentary evidence put before it.

Issue | Take: Whether the Taxpayer is entitled to the input tax deductions it claimed

15. To be entitled to an input tax deduction, a person must be carrying on a "taxable activity".[4] In addition, the goods or services to which the input tax relates must be used for, or intended to be used in, making taxable supplies.[5]

Taxable activity

16. A taxable activity is any activity carried on continuously or regularly by any person that involves or is intended to involve the supply of goods and services (s 6).
17. Anything done in connection with the ending of a taxable activity is treated as being carried out in the course of the taxable activity (s 6(2)).
18. The phrase "in connection with" requires a close and immediate connection.[6] It is a question of fact whether a close and immediate connection exists.[7]
19. Things done "in connection with" the ending of a taxable activity may include:
    - The disposal of assets used in the taxable activity.[8]
    - Things done over a reasonable period after the making of taxable supplies had ceased to tidy up the affairs of the taxable activity and wind it up,[9] including things done during the process of the receivership of a company.[10]
    - Defending and attempting to settle legal proceedings for misrepresentation and breach of fiduciary duties following the sale of a business.[11]
    - The pursuing of trade debts after the cessation of trading.[12]
20. The Taxpayer argued that defending the shareholders' claims was done "in connection with" the ending of its taxable activity. CCS argued that the defending of the claims was done "in connection with" the ending of the Taxpayer's structure, not the ending of its taxable activity.
21. TCO considered the Taxpayer was carrying on a taxable activity because, although not making, or intending to make, any taxable supplies, the Taxpayer's defending of the shareholders' claims was something done "in connection with" the ending of its taxable activity.

1 Section 149A(2) of the TAA. See also *Case V17* (2002) 20 NZTC 10,192, *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC), and *Vinelight Nominees Ltd v CIR (No 2)* (2005) 22 NZTC 19,519 (HC).
2 Section 138P(1B) of the TAA.
3 *Yew v CIR* (1984) 6 NZTC 61,710 (CA), *Case Y3* (2007) 23 NZTC 13,028, and *Case X16* (2005) 22 NZTC 12,216.
4 See the definition of "input tax" in ss 3A, 6, 20(3) and 51(1) and (3).
5 Section 20(3C).
6 *Case E84* (1982) 5 NZTC 59,446 and *Case Z9* (2009) 24 NZTC 14,100, which concerned similarly worded income tax provisions, and *Malololailai Interval Holidays New Zealand Ltd v CIR* (1997) 18 NZTC 13,137 (HC), which concerned s 11A(1)(1)(e).
7 *Malololailai Interval Holidays New Zealand Ltd v CIR*.
8 *Thompson v CIR* (2009) 24 NZTC 23,725 (HC).
9 *Case U29* (2000) 19 NZTC 9,273.
10 *Case Q43* (1993) 15 NZTC 5,208.
11 *Case T30* (1997) 18 NZTC 8,216.
12 *Case 4/2011* [2010] NZTRA 13, (2011) 25 NZTC 1-004.

22. TCO noted that until the shareholders' claims were resolved, the land sale proceeds could not be distributed or otherwise disbursed. Further, the balance of the land sale proceeds available to be distributed or disbursed could not be determined.
23. TCO further noted resolution of the shareholders' claims may have required adjustments to the Taxpayer's financial statements, meaning they could not be finalised until the claims were resolved. Accordingly, unless the Taxpayer defended the shareholders' claims it would have been unable to tidy up the affairs of its taxable activity.
24. TCO found that s 6(2) applied to treat the Taxpayer's defending of the shareholders' claims as being carried out in the course of its taxable activity. The effect of this was that the Taxpayer's taxable activity was treated as continuing while it defended the shareholders' claims.

The legal services to which the input tax relates must have been used for making taxable supplies

25. To be entitled to an input tax deduction it is not sufficient that a person is carrying on a taxable activity. The goods or services to which the input tax relates must be used for, or intended to be used in, making taxable supplies (use test) (s 20(3C)).
26. TCO noted that there was no relevant case law on the use test. TCO considered the sufficient nexus approach taken by the courts in relation to the former principal purpose test to be relevant. Before 1 April 2011, the requirement was that the goods or services must have been acquired for the "principal purpose of making taxable supplies" (principal purpose test).[13] In cases that considered the former principal purpose test the courts made it clear that there must be a sufficient connection or nexus between the acquisition of goods or services and the making of taxable supplies (sufficient nexus approach). The goods and services need not be directly linked to taxable supplies.[14] Whether a sufficient connection or nexus existed was a question of fact.[15].
27. Although support for the use test requiring the possibility of future supplies could arguably be seen in *Case Q43*, TCO considered that the better view was no such requirement existed. In the context of s 6(2), the use test may be met where there is a sufficient nexus between goods or services and taxable supplies made in the past.
28. The Taxpayer was not making, or intending to make, any taxable supplies when it acquired the legal services. Accordingly, for the legal services to be used in making taxable supplies they must have been sufficiently connected to the taxable supplies of land the Taxpayer made in the past.
29. The legal services were acquired in defending the shareholders' claims. TCO considered the nature of the shareholders' claims and whether they concerned matters sufficiently connected to the making of the Taxpayer's past taxable supplies. To the extent they did, then the legal services should also be sufficiently connected to the making of the Taxpayer's past taxable supplies.
30. TCO concluded that the Taxpayer had not shown that all the shareholders' claims were, or the extent to which they were, sufficiently connected to the making of the Taxpayer's past taxable supplies. Some of the claims related to loans and other transactions that were not taxable supplies or sufficiently connected with the making of taxable supplies. Insufficient information had been provided to show other claims were sufficiently connected to the making of the Taxpayer's past taxable supplies.
31. Although some of the claims were sufficiently connected with the making of the Taxpayer's past supplies, there was evidence the claims had been resolved before the legal services were provided.
32. In summary, the Taxpayer had not shown the shareholders' claims were sufficiently connected to the making of the Taxpayer's past taxable supplies. It follows that the legal services relating to the claims were not sufficiently connected to the making of the Taxpayer's past taxable supplies.
33. Accordingly, the use test was not met. The Taxpayer had not shown the legal services to which the input tax related were used for, or intended to be used in, making taxable supplies.

Cancellation of GST registration

34. Where the Commissioner is satisfied a registered person's taxable activity has ended, the Commissioner may cancel that person's GST registration. The cancellation takes effect from the last day of the taxable period in which the Commissioner was so satisfied or from any other date determined by the Commissioner. The date may be a retrospective date (s 52).

13 See the Taxation (GST and Remedial Matters) Act 2010 which substituted s 3A(1)(a) and introduced ss 20(3C).

14 *CIR v Trustees in the Mangaheia Trust and Trustees in the Te Mata Property*.

15 *Case 4/2011* [2010] NZTRA 13, (2011) 25 NZTC 1-004 and *Case W3* (2003) 21 NZTC 11,014.

35. As the evidence showed the Taxpayer was continuing to defend the shareholders' claims, TCO considered that CCS could not cancel the Taxpayer's GST registration from the date proposed.

Conclusion

36. The Taxpayer was not entitled to the input tax deductions it claimed. While the Taxpayer was carrying on a taxable activity, it had not shown the legal services to which the input tax related were used for making taxable supplies.
37. As the Taxpayer was carrying on a taxable activity while it defended the shareholders' claims, its GST registration should not be cancelled from the date proposed.

TDS 25/06: Receipt of funding

Decision date | Rā o te Whakatau: 27 November 2024

Issue date | Rā Tuku: 12 March 2025

Subjects | Kaupapa

Income tax: income, capital/revenue, capital contribution property

Taxation laws | Ture tāke

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

Summary of facts | Whakarāpopoto o Meka

1. The Applicant of this ruling is a trust. Its purpose is to manage funding and to hold assets that generate income for the benefit of its beneficiaries. The Applicant received funding from the Crown under a Funding Agreement (the Funding). The Funding Agreement stipulated that the Funding is applied as follows:
   - acquisition of a list of specified assets (Specified Assets);
   - transaction costs relating to the acquisition; and
   - working capital.
2. Upon receiving the Funding, the Applicant passed the funds to its wholly owned subsidiary (the Subsidiary). In accordance with the Funding Agreement, the funds were used to acquire the Specified Assets (including transaction costs) and as working capital for the Subsidiary.

Issues | Take

3. The main issue considered in this ruling was whether the Funding was income to the Applicant under ss CA 1(2), CB 1, CG 4 and CG 8.

Decisions | Whakatau

4. The Tax Counsel Office (TCO) concluded that the funding is not income to the Applicant under any of ss CA 1(2), CB 1, CG 4 or CG 8.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Income under subpart C

5. The issue is whether the receipt of the funding is income to the Applicant under subpart C. TCO reviewed the provisions in subpart C and concluded that ss CA 1(2), CB 1, CG 4 and CG 8 were most relevant to this ruling.

Section CA 1(2) – income under ordinary concepts

6. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.
7. To be "income under ordinary concepts", the amount must be something that comes in to a person.[1] However, receipts that are on capital account are not income according to ordinary concepts.[2]
8. Therefore, to determine whether the Funding is income under s CA 1(2), TCO considered whether the receipt is capital or revenue in nature.

1 See *Tennant v Smith* (1892) 3 TC 158 and *CIR v Grover* (1988) NZTC 5,012 (CA).

2 *Reid v CIR* (1985) 7 NZTC 5,176 (CA); *Case S86* (1996) 17 NZTC 7,538.

9. In the context of a receipt, particular regard is to be given to the character of the receipt in the hands of the recipient.[3]
10. Where a recipient carries on a business, the relevant factors for determining the character of receipts in the hands of the recipient include:[4]
    - the scope of the recipient's business;
    - the periodicity, recurrence or regularity of the receipts;
    - the consideration provided for the receipts; and
    - the purpose and reason for which the money is received.
11. TCO considered each of these factors.

Scope of the recipient's business

12. Case law indicates that profit made in the course of carrying on the recipient's business will often, in itself, be a fact of telling significance. A transaction that is unusual or extraordinary, when judged against the transactions that the recipient usually engages in, in the course of carrying on the business, may indicate that the amount received from the transaction is capital and not income.[5]
13. Further, the sale of a capital asset used in carrying on a business will not be an ordinary incident of that business.[6]
14. TCO considered the Funding is the means by which the Applicant was able to establish its income earning structure, through the Subsidiary. Without the Funding, the acquisition of the Specified Assets, and the ability to generate revenue through those assets, would not have been possible. In contrast, the Funding is not a payment received that is used in the Applicant's ordinary business operations or the course of carrying on its business. Despite the fact the Funding enables the Applicant to carry on its business, it was not a receipt in the ordinary course of those business activities.
15. TCO noted that while the Funding was allocated to three things – acquisition of assets, transaction costs and working capital – the same characterisation applies to all aspects of the Funding.
16. TCO considered the Funding was not within the scope of the Applicant's ongoing business activities and concluded that the Funding is of a capital nature.

Consideration provided for the receipt

17. If consideration is provided in respect of an amount received, that consideration will ordinarily supply the touchstone for determining whether the receipt is capital or revenue in nature.[7] For example, a receipt in exchange for the sale of a capital asset will ordinarily be capital in nature.[8]
18. TCO considered the fact that the Funding was not provided in exchange for any consideration, nor was the Applicant required to give anything to the Crown in return, strongly indicates that the receipt is capital in nature. The contractual arrangements in the Funding Agreement only set out requirements on how to use the money, not on any obligation the Applicant has to the Crown for the Funding.

Periodicity, recurrence or regularity of the receipts

19. The qualities of periodicity, regularity, or recurrence of a receipt may stamp it with a revenue character. But that in itself is not enough, and consideration must be given to the relationship between payer and payee and to the purpose of the payment, in order to determine the quality of the payment in the hands of the payee.[9]
20. The Applicant received a single payment from the Crown. There may be other advances made to the Applicant but there is no indication of when that might occur. TCO considered this suggests the receipt is capital in nature, although did not regard this as determinative on its own and the other capital/revenue factors are more relevant in this case.

3 See *GP International Pipecoaters Pty Ltd v FCT* 90 ATC 4,413 (HCA); *MIM Holdings Ltd v FCT* 97 ATC 4,420 (FFCA) and *CIR v City Motor Service Ltd* [1969] NZLR 1010.

4 *GP International Pipecoaters*

5 *FCT v Myers Emporium* 87 ATC 4363 (HCA)

6 *CIR v Rangatira Ltd* (1995) 17 NZTC 12,182; *Californian Copper Syndicate Ltd v Harris* (1904) 5 TC 159, at 165.

7 *MIM Holdings; The Federal Coke Company Ltd v FCT* 77 ATC 4,255 (FCA), at 4,273.

8 See for example, *Birkdale Service Station Ltd v CIR* [2001] 1 NZLR 293 (CA) and *GP International Pipecoaters.*

9 *Reid v CIR* [1985] 7 NZTC 5,176 (CA), at 5,183

The purpose and reason for which the money is received

21. The character of the receipt in the hands of the recipient is not to be confused with how the recipient subsequently applies the receipt.[10] And the presence or absence of a dedicated use to which a receipt must be put is not determinative of the character of the receipt.[11]

22. The Funding was distributed by the Applicant to the Subsidiary to complete the purchase of the Specified Assets. However, this was not considered determinative and TCO placed no weight on this factor.

Overall conclusion on s CA 1(2)

23. The character of the Funding was best understood by considering the first two factors. These factors strongly indicate that the Funding was received outside the scope of the Applicant's ongoing business activities and was not made in exchange for any consideration. This suggests that the Funding is a capital receipt.

24. TCO also considered the other factors as well as the accounting treatment applied to the Funding. These factors did not change the conclusion that the Funding is a capital receipt, being part of the Applicant's business structure rather than its ongoing business activities.

25. Given the above, TCO concluded the Funding is capital in nature and is, therefore, not income of the Applicant under s CA 1(2).

Section CB 1 – amounts derived from business

26. Section CB 1(1) provides that an amount derived from a business is income of a person. However, this does not apply to an amount that is of a capital nature (s CB 1(2)).

27. TCO concluded that the Funding is not from the Applicant's business activities. Rather, it is sourced from the Crown to acquire assets.

28. In any event, as TCO previously concluded that the Funding is a capital receipt, s CB 1(2) prevents it from being income under s CB 1(1).

Section CG 4 – receipts for expenditure or loss from insurance, indemnity or otherwise

29. Section CG 4 provides that when a person is allowed a deduction for expenditure or loss and derives an amount relating to the expenditure or loss, whether through insurance, indemnity or otherwise, the amount derived is income to the extent of the deduction.

30. The Funding in this ruling was used by the Applicant to fund the acquisition of the Specified Assets and added to its investment in its Subsidiary. Both have increased the Applicant's capital structure and therefore no deduction is allowable for that expenditure.

31. For s CG 4 to apply, funds are received in relation to an amount that has been deducted. Given the Applicant did not receive the Funding for an expenditure or loss that was deducted, TCO concluded that s GC 4 cannot apply because the first requirement under CG 4 is not met.

Section CG 8 – capital contributions

32. Capital contributions are income if s CG 8 applies. For s CG 8 to apply, an amount must be a capital contribution.

33. "Capital contribution", as defined in s YA 1, means an amount that:
    - is paid by the payer to the recipient under an agreement between them;
    - is paid by the payer other than in their capacity of settlor, partner, or shareholder of the recipient;
    - is not income of the recipient (ignoring ss CC 1B and CG 8);
    - is paid as a contribution for capital contribution property under the express terms and conditions of the agreement; and
    - is paid in relation to an interruption or impairment of business activities, if the agreement is a contract of insurance, indemnity, or compensation.

10 *GP International Pipecoaters* at 4,419

11 *CIR v Wattie* (1998) 18 NZTC 13,991; *GP International Pipecoaters*.

34. TCO considered each of these requirements:
    - The Funding was paid to the Applicant under an agreement between the parties – the Funding Agreement. Therefore, the first requirement is met.
    - The second requirement is met because the Funding was not paid by the Crown in its capacity of settlor, partner, or shareholder of the recipient.
    - The Funding is a capital receipt and not income of the Applicant. The third requirement is met.
    - The fourth requirement is that the amount is paid as a contribution for capital contribution property under the express terms and conditions of the agreement. "Capital contribution property" is defined in s YA 1. For the purposes of this ruling, the first meaning in the definition is applicable. That is, for a recipient of an amount, depreciable property owned or to be acquired by the recipient. TCO concluded that this requirement is not met because the Funding Agreement did not expressly require the acquisition of depreciable property, only the acquisition of the Specified Assets (which are not depreciable property). The Funding does not meet the definition of capital contribution property.
    - The Funding was not paid in relation to an interruption of business activities under a contract of insurance, indemnity or compensation and, therefore, the fifth requirement is not relevant.
35. Because the definition of "capital contribution" is cumulative, meaning that all requirements must be satisfied for the definition to apply, TCO concluded that the Funding is not a "capital contribution". Therefore, s CG 8 cannot apply to treat the Funding as income to the Applicant.

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Tax Counsel Office

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Legal Services manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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Technical Standards sits within Legal Services and contributes the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters. Technical Standards also contributes to the "Your opportunity to comment" section.

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