Inland Revenue
Te Tari Taake

EMPLOYMENT COURT AWARDS FOR LOST WAGES OR OTHER REMUNERATION – EMPLOYERS' LIABILITY TO MAKE TAX DEDUCTIONS

PUBLIC RULING BR Pub 06/06

Note (not part of ruling): This ruling replaces Public Ruling BR Pub 01/06 published in TIB Vol 13, No 6 (June 2001). The preceding rulings were Public Rulings BR Pub 97/7 and 97/7A published in TIB Vol 9, No 6 (June 1997). This new ruling is essentially the same as the previous ruling. However, the new ruling has been updated and applies the Income Tax Act 2004, which came into force on 1 April 2005, rather than the Income Tax Act 1994 provisions. The changes between the provisions of the 1994 and 2004 Acts affecting this ruling do not affect the conclusions previously reached.

The ruling applies for an indefinite period.

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2004 unless otherwise stated.

This Ruling applies in respect of sections CE 1, BD 3, EI 8, NC 2, NC 16 , OB 1 (definitions of "employee", "extra pay", and "shareholder-employee"), and OB 2 (definition of "source deduction payment").

The Arrangement to which this Ruling applies

The Arrangement is an order by the Employment Court or the Employment Relations Authority requiring an employer to make a payment for lost wages or other remuneration to an employee under the Employment Relations Act 2000.

The Court or Authority will make such an award when an employee has lost wages or other remuneration as a result of an action by the employer which has been the subject of a personal grievance by the employee against the employer (e.g. unjustifiable dismissal or other unjustifiable action by the employer). An award for lost wages or other remuneration will usually be made under sections 123(1)(b) or 128 of the Employment Relations Act, but may be made under another provision.

This Ruling does not apply to an award of compensation for humiliation, loss of dignity, or injury to feelings made under section 123(1)(c)(i) of the Employment Relations Act.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

A. Employment income

The payment of an award for lost wages or other remuneration under the Employment Relations Act 2000 is "employment income" of the employee under section CE 1.

B. Employer's liability to make tax deductions from the award

The payment of an award for lost wages or other remuneration, under the Employment Relations Act 2000 is an extra emolument pay and is a "source deduction payment" under section OB 2 (1). The employer must make tax deductions from the payment under section NC 2 and account for those deductions to Inland Revenue in the normal way.

If an employer fails to make the required tax deductions from a payment, the employee is liable, under section NC 16, to pay an amount equal to those tax deductions to the Commissioner (and is also required to furnish to the Commissioner an employer monthly schedule showing details of the payment).

C. When the payment is derived by the employee

Under section BD 3(4), an employee derives a payment of an award for lost wages or other remuneration under the Employment Relations Act 2000 when the employee receives the payment, or when the payment is credited to an account or otherwise dealt with on the employee's behalf.

A person who is a shareholder-employee for the purposes of section EI 8 (as defined in sections OB 1 and OB 2 (2)) derives a payment of an award for lost wages or other remuneration under the Employment Relations Act 2000, in the income year that the expenditure on that award is deductible to the employer. If the expenditure on the award is not deductible to the employer, the shareholder-employee derives the award in the year of receipt.

The period for which this Ruling applies

This Ruling will apply to payments received on and following 1 October 2005 for an indefinite period.

This Ruling is signed by me on the 30th day of June 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR Pub 06/06

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 06/06 ("the Ruling").

The subject matter covered in the Ruling was previously dealt with in Public Rulings BR Pub 01/06 published in TIB Vol 13, No 6 (June 2001) which replaced Public Rulings BR Pub 97/7 and 97/7A published in TIB Vol 9, No 6 (June 1997). This Ruling applies for an indefinite period.

The commentary refers to the Income Tax Act 2004, particularly section CE 1 and the concept of "employment income".

Background

The Employment Relations Act 2000 provides for a number of remedies when an employee has a personal grievance against a current or former employer. This includes compensation for wages lost by the employee as a result of actions by the employer which are the subject of a personal grievance. Such compensation will usually be awarded under sections 123(1)(b) or 128 of the Act but may be made under another provision.

For example, in *Cleland v CIR* (2001) 20 NZTC 17,086, Hammond J was concerned with the assessability of part of an award made by the Employment Court in 1992. The Employment Court awarded compensation for lost wages up to the date of hearing under the equivalent of section 128 of the Employment Relations Act. An award for lost wages from that date on was made under the equivalent of section 123(1)(c)(ii) which provides for compensation for the loss of a benefit. The law in this area seems to be evolving and while awards for lost wages or other remuneration are now generally made under section 123(1)(b), the Ruling will apply under whatever provision such an award is made.

This Ruling confirms the Commissioner's existing practice in respect of the assessability and deduction of tax from awards for lost wages or other remuneration made under the Employment Relations Act 2000.

Legislation

Relevant provisions of the Employment Relations Act 2000

Section 103(1) of the Employment Relations Act 2000 ("the ERA") defines "personal grievance" as:

> For the purposes of this Act, "personal grievance" means any grievance that an employee may have against the employee's employer or former employer because of a claim—
>
> (a) that the employee has been unjustifiably dismissed; or

(b) that the employee's employment, or 1 or more conditions of the employee's employment (including any condition that survives termination of the employment), is or are or was (during employment that has since been terminated) affected to the employee's disadvantage by some unjustifiable action by the employer; or

(c) that the employee has been discriminated against in the employee's employment; or

(d) that the employee has been sexually harassed in the employee's employment; or

(e) that the employee has been racially harassed in the employee's employment; or

(f) that the employee has been subject to duress in the employee's employment in relation to membership or non-membership of a union or employees organisation.

Section 103(3) provides:

In subsection (1)(b), unjustifiable action by the employer does not include an action deriving solely from the interpretation, application, or operation, or disputed interpretation, application, or operation, of any provision of any employment agreement.

Section 123(1)(b) of the ERA states:

Where the Authority or the Court determines that an employee has a personal grievance, it may, in settling the grievance, provide for any 1 or more of the following remedies:

…

(b) the reimbursement to the employee of a sum equal to the whole or any part of the wages or other money lost by the employee as a result of the grievance ...

Section 128 of the ERA states:

(1) This section applies where the Authority or Court determines, in respect of any employee, -

(a) that the employee has a personal grievance; and

(b) that the employee has lost remuneration as a result of the personal grievance.

(2) If this section applies then, subject to subsection (3) and section 124, the Authority must, whether or not it provides for any of the other remedies provided for in section 123, order the employer to pay to the employee the lesser of a sum equal to that lost remuneration or to 3 months' ordinary time remuneration.

(3) Despite subsection (2), the Authority may, in its discretion, order an employer to pay to an employee by way of compensation for remuneration lost by that employee as a result of the personal grievance, a sum greater than that to which an order under that subsection may relate.

Section 124 of the ERA states:

Where the Authority or the Court determines that an employee has a personal grievance, the Authority or Court must, in deciding both the nature and the extent of the remedies to be provided in respect of that personal grievance,—

(a) consider the extent to which the actions of the employee contributed towards the situation that gave rise to the personal grievance; and

(b) if those actions so require, reduce the remedies that would otherwise have been awarded accordingly.

Relevant provisions of the Income Tax Act 2004

Section CA 1(1) provides:

CA 1 Amounts that are income

Amounts specifically identified

(1) An amount is income of a person if it is their income under a provision in this part.

Section CE 1 provides

CE 1 Amounts derived in connection with employment

The following amounts derived by a person in connection with their employment or service are income of the person:

(a) salary or wages or an allowance, bonus, extra pay, or gratuity:

(b) expenditure on account of an employee that is expenditure on account of the person:

(c) the market value of board that the person receives in connection with their employment or service:

(d) a benefit received under a share purchase agreement:

(e) directors' fees:

(f) compensation for loss of employment or service:

(g) any other benefit in money.

Section BD 3(4) provides:

Income credited into account

Despite subsection (3), income that has not previously been derived by a person is treated as being derived when it is credited in their account or, in some other way, dealt with in their interest or on their behalf.

Section EI 8 provides:

EI 8 Matching rule for employment income of shareholder employee

Matching if company allowed deduction

(1) If a company is allowed a deduction for expenditure on employment income that is paid or is payable to a shareholder employee under section CE 1 (Amounts derived in connection with employment), the income is allocated in the way set out in subsections (2) and (3).

Allocation to deduction year unless unexpired

(2) The income is allocated to the income year to which the deduction allowed to the company is allocated, except for an amount equal to any unexpired portion for the income year of the company's expenditure under section EA 4 (Deferred payment of employment income).

Allocation otherwise when ceases being unexpired

(3) The remaining income is allocated to the income year or years in which the corresponding amount of the company's expenditure on the income is no longer treated as an unexpired portion.

Section NC 2(1) provides:

NC 2 Tax Deductions to be made by employers or PAYE intermediaries

(1) For the purpose of enabling the collection of income tax from employees by instalments, where an employee receives a source deduction payment from an employer, the employer, PAYE intermediary, or other person by whom the payment is made must, at the time of making the payment, make a tax deduction from the payment in accordance with the PAYE rules: provided that no tax deduction need be made from any source deduction payment made to any employee in respect of the employee's employment as a private domestic worker: provided also that if a tax deduction is not made by the employer or the PAYE intermediary in any such case section NC 16 applies to the employee.

Section NC 16 provides

NC 16 Employee to pay deductions to commissioner

Where for any reason a tax deduction or a combined tax and earner premium deduction or combined tax and earner levy deduction is not made or is not made in full at the time of the making of any source deduction payment or payments, the employee must—

(a) Not later than the 20th day of the month that next follows the month in which payment of the source deduction payment was made, furnish to the Commissioner an employer monthly schedule containing those particulars that apply to the employee; and

(b) Unless the employee is exempted from liability to pay the same or is not liable to pay the same, pay to the Commissioner an amount equal to the total of the tax deductions or combined tax and earner premium deductions or combined tax and earner levy deductions that should have been made and were not made, and that amount shall be due and payable to the Commissioner on the 20th of the month following the month in which payment of the source deduction payment or payments was made.

Section NC 19 provides:

NC 19 Amount of tax deductions deemed to be received by employee

Where any amount has been deducted from a source deduction payment by way of tax deduction, or combined tax and earner premium deduction, or combined tax and earner levy deduction under the PAYE rules and, where applicable, section 115 of the Accident Rehabilitation and Compensation Insurance Act 1992 or section 285 of the Accident Insurance Act 1998 or section 221 of the Injury Prevention, Rehabilitation, and Compensation Act 2001, the amount so deducted—

(a) is deemed to have been received by the employee at the time of the source deduction payment:

(b) for the purposes of this Act, is deemed to have been derived by the employee at the same time and in the same way as the residue of the source deduction payment.

Section OB 1 defines:

"**employee**"—

…

(f) for an employer, means an employee of the employer

"employee share loan" is defined in section CX 29 (Meaning of employee share loan)

"employment income" –

means an amount that is income under section CE 1 (Amounts derived in connection with employment)

"**extra pay**"—

(a) means a payment that—

(i) is made to a person in connection with their employment; and
(ii) is not one regularly included in the salary or wages payable to the person for a pay period; and
(iii) is not overtime pay; and
(iv) is made in a lump sum; and
(v) is made in 1 lump sum or in 2 or more instalments; and
(vi) is made for a period of time or otherwise than for a period of time; and

(b) includes a payment of the kind described in paragraph (a) made—

(i) as a bonus, gratuity, or share of profits; or
(ii) as a redundancy payment; or
(iii) when the person retires from employment; or
(iv) by a retrospective increase in salary or wages, but the payment is included only to the extent to which the payment accrues from the start of the increase until the start of the first pay period in which the increase is included in salary or wages, and to the extent to which, when a week ends with a Saturday, the total of the increase for the week, and of the salary or wages for the week excluding the increase, and of any other salary or wages that the person earns for the week, is more than $4; and

(c) includes income that a person derives under section CE 9 (Restrictive covenants) or CE 10 (Exit inducements) if the income was derived in connection with an employment relationship between the person and the person who paid the income; and

(d) does not include a payment of exempt income

"**shareholder-employee**",—

(a) in sections EA 4 (Deferred payment of employment income) and EI 8 (Matching rule for employment income of shareholder-employee), means a

person who receives or is entitled to receive salary, wages, or other income to which section OB 2(2) (Meaning of source deduction payment: shareholder-employees of close companies) applies:

(b) in the FBT rules and in section 177A of the Tax Administration Act 1994, means a person who is, in relation to a close company,—

(i) a shareholder in and an employee of the company; and
(ii) a person to whom section OB 2(2) (Meaning of source deduction payment: shareholder-employees of close companies) applies

Section OB 2 provides:

OB 2 Meaning of source deduction payment: shareholder-employees of close companies

(1) In this Act, except as provided in subsection (2), **source deduction payment** means a payment by way of salary or wages, an extra pay, or a withholding payment, but does not include an amount attributed in accordance with section GC 14D.

(2) If a taxpayer is a shareholder in and an employee of a close company and in the taxpayer's tax year (or in the taxpayer's corresponding accounting year)—

(a) the taxpayer does not derive as an employee of the company—

(i) salary or wages of a regular amount for regular pay periods of 1 month or less regularly throughout that tax year (or corresponding accounting year); or
(ii) salary or wages, by way of regular payments throughout that tax year (or corresponding accounting year) of a regular amount for regular pay periods, that are in total at least two-thirds of the annual gross income which the taxpayer derives in that tax year (or corresponding accounting year) as an employee of the company; or

(b) any amount is paid or credited to the taxpayer, or applied on the taxpayer's account, in anticipation or in respect of any income that may subsequently be allocated to the taxpayer as an employee of the company,—

for the purposes of this Act, except the FBT rules,—

(c) all assessable income that the taxpayer derives as an employee of the company in every subsequent tax year (or corresponding accounting year) is deemed to be assessable income derived otherwise than from source deduction payments; and

(d) if the taxpayer so chooses, all assessable income that the taxpayer derives from the company in that tax year (or corresponding accounting year) as an employee of the company is deemed to be assessable income derived otherwise than from source deduction payments.

Section YA 3(3) provides:

Intention of new law

(3) Except when subsection (5) applies, the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994.

Section YA 3(5) provides:

Limits to subsections (3) and (4)

(5) Subsections (3) and (4) do not apply in the case of—

(a) a new law specified in schedule 22A (Identified policy changes); or

(b) a new law that is amended after the commencement of this Act, with effect from the date on which the amendment comes into force.

Application of the Legislation

An award for lost wages or other remuneration is made to compensate the employee for wages or other remuneration he or she may have lost as a result of an action by the employer which has been the subject of a personal grievance by the employee against the employer. The wages or other remuneration that would have been received if it were not for the personal grievance are "employment income". Employment income is defined as an amount that is income under section CE 1 and section CE 1 provides that certain amounts derived by a person in connection with the employment are included in the person's income. Those amounts include:

(a) salary or wages or an allowance, bonus, extra pay, or gratuity:

The term "extra pay" covers an award for lost wages or other remuneration. The payment of the award for lost wages or other remuneration must be made "in connection with the employment or service of the person" , even though the payment is made to resolve a personal grievance rather than for services actually performed.

Relationship with Income Tax Act 1994

The Income Tax Act 2004 introduces the concept of an amount received by a person "in connection with their employment or service" being income of a person. Previously, the 1994 Act referred to an amount being monetary remuneration, and thus gross income, if it was an amount derived by a person "in respect of or in relation to" their employment or service.

The wording of the 2004 Act provision is different to that in the 1994 Act. However, while the 2004 Act has replaced the 1994 Act, section YA 3(3) of the 2004 Act nevertheless provides that provisions of the 2004 Act are the provisions of the 1994 Act in rewritten form. The provisions of the 2004 Act are intended to have the same effect as the corresponding provision of the 1994 Act. The exception is, pursuant to section YA 3(5), where an "identified policy change", as specified in schedule 22A, exists.

In this instance no identified policy change has been specified in schedule 22A. Therefore, the presumption is that the adoption of the term "in connection with" was not intended to give rise to an interpretation that differs from that which would apply if the term "in respect of or in relation to", as used in the definition of "monetary remuneration" under the 1994 Act, still applied. It is therefore relevant to consider the meaning of the phrase "in respect of or in relation to" in the interpretation of the phrase "in connection with" in this situation.

The meaning of "in connection with"

The phrase "in connection with" is not defined in the Act. However, it has been considered in other contexts.

In *Strachan v Marriott* [1995] 3 NZLR 272, Hardie Boys J stated, at page 279:

> "In connection with" may signify no more than a relationship between one thing and another. The expression does not necessarily require that it be a causal relationship: Our Town FM Pty Ltd v Australian Broadcasting Tribunal (1987) 16 FCR 465, 479 per Wilcox J. But, as Davies J warned in Hatfield v Health Insurance Commission (1987) 15 FCR 487, at p 491:
>
> "Expressions such as 'relating to', 'in connection with' and 'in respect of' are commonly found in legislation but invariably raise problems of statutory interpretation. They are terms which fluctuate in operation from statute to statute.... The terms may have a very wide operation but they do not usually carry the widest possible ambit, for they are subject to the context in which they are used, to the words with which they are associated, and to the object or purpose of the statutory provision in which they appear."

In *Case E84* (1982) 5 NZTC 59,441 *Bathgate* DJ noted at page 59,445:

> It is a matter of degree whether, on the interpretation of a particular statute, there is a sufficient relationship between subject and object to come within the words "in connection with" or not. It is clear that no hard and fast rule can be or should be applied to the interpretation of the words "in connection with". Each case depends on its own facts and the particular statute under consideration.

In *Hatrick (A) & Co v R* [1923] AC 213, the Privy Council considered the meaning of "in connection with" in the context of section 10 of the Government Railway Act 1908, which empowered the Minister of Railways to fix charges to be paid for goods stored in any shed or store "in connection with a railway". Their Lordships stated, at page 225:

> In the view of their Lordships these words cannot apply to something done on a space or in a building merely contiguous to or abutting upon a railway, even though it be the property of a railway; if the thing done forms no part of or has no connection with the property business or a railway, as a carrier of passengers and goods by rail, or in other words that the expression "in connection with a railway" means connect with, subserving and being ancillary to, the business of a railway as such carriers … These words … must be direct to something different from propinquity or contiguity, and in their Lordships' view, having regard to all the provisions of the statute, mean in s 10 in connection with the business and operations of a railway as a carrier of goods by rail.

In *Hammington v Ross* (1992) 2 NZ ConvC 191,150, the High Court considered whether a lawyer's omission to disclose his investment in the client's product to the

client was a "civil liability incurred in connection with the provision of professional services". *McGechan* J stated, at page 191,162:

> One next goes to the operative clause. It provides cover for claims arising from civil liability incurred "in connection with" provision of "professional services". The clause is a broad one. It extends to "civil liability", not mere classical "neglect, error or omission". It extends to claims incurred "in connection with" the provision of professional services, as contrasted with "in the" provision of professional services. It is not limited to strict integral components of those very services themselves. With that wider wording it was conceded, and rightly, that activity covered would include omission to provide, and "ancillary conduct not strictly professional work - eg, the business advice here". Clearly however there must be a nexus between such wider activity giving rise to liability and the professional services. The wider activity must be related, and not merely co-existent.

In *Pan Pacific Forest Industries (NZ) Ltd v Norwich General* (1997) 7 TCLR 560, the High Court considered whether an insurance policy applied where the product supplied was faulty. The relevant policy applied to "accidental loss of…property…resulting from accidents in connection with the business". *Paterson* J stated at page 569:

> The operative provisions of the policy apply if the accident was "in connection with the business". Giving those words their natural and ordinary meaning the accident did arise in connection with the business if it arose because the business supplied faulty materials and parts and gave faulty advice.

The phrase "in connection with", has also been considered in the context of section DJ 5 of the Income Tax Act 1994, a provision that allows a tax deduction for costs incurred "in connection with" the determination of a liability to tax. In that context, Bathgate DJ found in *Case* E84 that the term required a narrow interpretation. He said, at page 59,445:

> It may be that only an empirical and common sense approach to the interpretation of the words can be applied in each particular case to determine where, if at all, the line should be drawn to allow or not allow expenditure "in connection with" an assessment. However I believe that a narrow interpretation of the words "... any expenditure ... in connection with ... the assessment ..." is the correct interpretation: only expenditure closely and immediately connected to the assessment itself is intended to be allowed as a deduction, and expenditure more remote, as for instance in this case, the expenditure of O in making his trip to visit A, is not expenditure allowed as a deduction under the section.

This case suggests that, in the context of section DJ 5, the phrase "in connection with" requires a close linkage between the expenditure and the "determination" or "calculation" of a liability to tax.

The above cases suggest that for something to be "in connection with" something else, a necessary degree of nexus is required, and that the two things must be related to each other in some way. Overall, the Commissioner considers that they suggest that a broad interpretation should be given to the term.

The meaning of "in respect of or in relation to"

It is also necessary to consider the relevant words that were used in the Income Tax Act 1994. As noted, in that Act the relevant test was whether an amount was "in respect of or in relation to" employment, and thus "monetary remuneration".

A wide interpretation of the words "in respect of or in relation to the employment or service" was endorsed by the Court of Appeal in *Shell New Zealand Ltd v CIR* (1994) 16 NZTC 11,303, in response to Shell's argument that a payment was not made in respect of or in relation to employment because it was not made under a contract of employment. The Court stated that the words "in respect of or in relation to" are words of the widest import. The Court also found that the words "emolument (of whatever kind), or other benefit in money" were not to be read *ejusdem generis* with the preceding words, the genus being reward for services. Thus, for the purposes of the definition of "monetary remuneration", the words "emolument ... or other benefit in money" were not confined to rewards for services.

In *Shell* the Court found it important that the employees were only in a position to receive compensation payments (for changing the employees' place of employment) because of their employment relationship with the employer. So, although the employees received compensation for the costs of moving rather than payments for services, this was still monetary remuneration. Similarly, the lost wages or other remuneration awarded on the personal grievance claim arise directly out of and as a result of an employee's employment relationship with the employer. Again, although this is not a payment for services, it was within the definition of "monetary remuneration".

Other cases have also stressed the width of the words "in respect of or in relation to". In the Queens Bench case of *Paterson v Chadwick* [1974] 2 All ER 772, Boreham J considered the meaning of the phrase "in respect of" in relation to discovery, and adopted the comments of Mann CJ in the Australian case *Trustees, Executors & Agency Co Ltd v Reilly* [1941] VLR 110, where the learned Chief Justice said:

> The words "in respect of" are difficult of definition but they have the widest possible meaning of any expression intended to convey some connection or relation in between the two subject-matters to which the words refer.

Similarly, in *Nowegijick v The Queen* [1983] CTC 20 at page 25, the Supreme Court of Canada described the phrase "in respect of" as "probably the widest of any expression intended to convey some connection between two related subject-matters".

The earlier TRA decisions on the previous legislation also illustrate the wide meaning that may be attributed to the words "in respect of or in relation to the employment or service of the taxpayer". In *Case L92* (1989) 11 NZTC 1,530, Barber DJ considered the term "monetary remuneration" in relation to a payment of compensation for unjustified dismissal under the Industrial Relations Act 1973. The compensation was calculated on the basis of the personal hurt and procedural unfairness suffered by the objector. Barber DJ found that, even though the compensation was damages in nature, it was money received in respect of the objector's employment. He stated that the words "compensation for loss of office or employment", "emolument (of whatever kind), or other benefit in money" and "in respect of or in relation to the employment or service of the taxpayer" have a wide embrace and go beyond the narrower concept of "salary, wage, allowance, bonus gratuity, extra salary" which precede them. On the particular facts of this case he said that "monetary remuneration", interpreted widely, covered the payment in issue.

Barber DJ reached the same conclusion in relation to a similar compensation payment in *Case L78* (1989) 11 NZTC 1,451. This case examined the nature of an ex gratia payment made to an employee as a result of a personal grievance claim brought against the employer under section 117 of the Industrial Relations Act 1973 which covered reimbursement for lost wages. The ex gratia payment was made up of six weeks' holiday pay and pay for untaken sick leave. This holiday and sick leave was not owing to the taxpayer. The payment, which the taxpayer said he regarded as "extra wages", was held to fall within the definition of "monetary remuneration" in section 2 of that Act.

In *Case P19* (1992) 14 NZTC 4,127, Barber DJ examined whether a severance payment of $77,598 paid to an objector by his overseas employer was assessable income. The objector was a jockey who entered into a three-year oral contract to ride his employer's horses. The employer became dissatisfied with the objector's performance and unilaterally terminated the contract after about 4 months. After negotiation, the matter was settled on the basis that the employer made the severance payment. Barber DJ held that "the severance payment was made as compensation for the objector's loss of income due to the millionaire having terminated the contractual relationship". He inferred that "the payment was a top-up of the first year's minimum income" made to "assist the objector re-build his income earning process" and said that that type of payment "must be revenue in nature". He stated that:

> In terms of the definition of "monetary remuneration", the payment made to the objector must be "compensation for loss of office or employment, emolument (of whatever kind), or other benefit in money, in respect of or in relation to the employment or service of the taxpayer;"

Although not concerning a Court award, *Case P19* supports the proposition that payments made as compensation for loss of income fall within the definition of monetary remuneration.

In *Case S96* (1996) 17 NZTC 7,603 and *Case U38* (2000) 19 NZTC 9,361 the taxpayers in each case did not dispute that the portion of their compensation payment that was for lost wages was taxable, and this was accepted by the TRA. Doogue J in the High Court decision in *Sayer v CIR* (1999) 19 NZTC 15,249 also accepted the assessability of the part of a settlement agreement attributed to lost remuneration.

In *Case U39* (2000) 19 NZTC 9,369 an IRD officer was awarded compensation of $126,000 being $46,000 (loss of wages), $30,000 (humiliation), and $50,000 (loss of benefits) by the Employment Court in 1992. The Commissioner accepted that the humiliation payment was not assessable and assessed the balance of $96,000.

Barber DJ readily found that the compensation for lost wages was monetary remuneration, and so was the compensation for loss of benefits. He said (at paragraph 26, p 9,374):

> Awards made by the Employment Court pursuant to ss 227(c)(ii) above and 229 (for lost income) of the Labour Relations Act 1987 are generally deemed to be "monetary remuneration" and assessable income pursuant to s 65(2)(b) of the Income Tax Act 1976. Indeed, because awards under s 229 are a reimbursement of, or compensation for, "lost remuneration" for the worker, any such award (in this case $50,000 [sic] of the $96,000 in issue) must, obviously, be revenue in character and within the above s 2 (of the Act) definition of "monetary remuneration", and assessable.

(Section 128 of the Employment Relations Act 2000 is the equivalent of section 229 of the Labour Relations Act).

In his decision on appeal dated 30 April 2001, Hammond J upheld the TRA's decision: *Cleland v CIR* AP44/00 High Court, Hamilton. He found that the reimbursement of lost wages was "monetary remuneration", saying, at paragraph 41:

> I cannot see how the loss of wages due up to the date of hearing under s229 ($46,000) is not "monetary remuneration" under s2 of the Income Tax Act 1976.

He went on to find that the $50,000 awarded by the Employment Court under section 227(c)(ii) for loss of benefits, which included an element of future wages, was also assessable as "monetary remuneration".

Other New Zealand cases (*Case U38* (2000) 19 NZTC 9,361 and *C of IR v Kerslake* (2001) 20 NZTC 17,158) have also considered the phrase "in respect of or in relation to". Both cases are consistent with the authorities cited above in this commentary.

As noted earlier in this commentary, the law in this area seems to have moved on from requiring a division of awards of lost wages between those up to the date of the hearing (under the reimbursement remedy), and those from that date on (under the loss of benefits remedy). Compensation for lost wages, including those that the employee would have been likely to receive over some future period but for the grievance, are generally awarded under section 123(1)(b) of the Employment Relations Act. See for example *Trotter v Telecom Corporation of NZ Ltd* [1993] 2 NZER 659.

These cases clearly indicate that an award for lost wages or other remuneration is considered assessable as gross income to the employee. The Commissioner considers that these payments are made "in connection with the employment or service" and therefore are included in employment income of the taxpayer.

When the employment relationship has ended

In some cases the employment relationship of the employer and employee will have ended by the time the employer pays the court award to the employee. The fact that the employment relationship may have ended by the time the employer pays the award does not change the fact that the award is made "in connection with the employment or service" of the former employee. In *Freeman & Ors. v FC of T* (1982) 82 ATC 4629 the Supreme Court of Victoria found that a payment is made "in relation to the employment" of a former employee when the entitlement to that payment arises out of the employment or from services performed by the employee before the termination of employment.

In *Freeman* the taxpayers were directors, shareholders, and employees of the appellant company which ceased to carry on business. The next day the business was sold to another company controlled by the taxpayers and carried on business as before. Six months later it was decided that the appellant company should pay to each of the taxpayers certain lump sum payments. The evidence suggested that the source

of the greater part of the payments consisted of fees (or "salaries") received by the appellant company after it ceased carrying on business. The Court found that the payments received by the appellants were assessable income under section 26(e) of the Income Tax Assessment Act 1936-1978. Section 26(e) provided that assessable income included the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses and premiums given to him or her in relation directly or indirectly to their employment or services rendered by him or her. Kaye J found that payments out of the income of the appellant company to employees by way of allowances for past services, which had been rendered by them, were within section 26(e). The decision on this aspect of the case was unchanged when the appeal was heard by the Federal Court.

Awards for lost wages or other remuneration arise out of the employee's previous service with the employer. A court award that compensates for lost wages or other remuneration is made as a result of the employee's service with the employer, and so is made in connection with the employment of the employee.

Employer's liability to make tax deductions from the award for lost wages or other remuneration

The Ruling states that the payment of an award for lost wages or other remuneration is a source deduction payment. Under section NC 2 (1), an employer must make the appropriate tax deduction from every source deduction payment made to an employee.

Award is a source deduction payment

The definition in section OB 2(1) of "source deduction payment" includes a payment by way of salary or wages, an extra pay, or a withholding payment.

Section OB 1 defines "extra pay" as a payment that:

…

(i)	is made to a person in connection with their employment; and
(ii)	is not one regularly included in the salary or wages payable to the person for a pay period; and
(iii)	is not overtime pay; and
(iv)	is made in a lump sum; and
(v)	is made in 1 lump sum or in 2 or more instalments; and
(vi)	is made for a period of time or otherwise than for a period of time; and

An award for lost wages or other remuneration is generally paid in a lump sum but according to section 123(2) of the Employment Relations Act 2000 it can also be paid in instalments if the financial position of the employer requires it. Such a payment would however not regularly be included in the salary or wages payable to the person. As discussed above, the payment of an award for lost wages or other remuneration is made to a person in respect of or in relation to the employment of that person. As the payment of an award for lost wages or other remuneration is generally made in a lump sum, or if made in instalments it is not regularly included in the salary or wages payable to the person, such a payment is considered as being made in connection with the employment of a person, and is not a payment of salary or wages but an extra pay.

As the payment of the award is an extra pay, it is included in the definition of "source deduction payment".

A former employee is an "employee"

Section NC 2 requires an employer to make tax deductions from source deduction payments to employees. Section OB 1 defines "employee" as a person who receives or is entitled to receive a source deduction payment.

As discussed above, the payment of an award for lost wages or other remuneration constitutes a source deduction payment. A payment can still be "monetary remuneration" and a source deduction payment when it is paid to a former employee. A former employee who is entitled to receive this source deduction payment is also an "employee" for the purposes of section NC 2 (even though he or she may no longer be in an employment relationship with the employer).

The appropriate tax deduction

Section NC 2 requires the employer to make the appropriate tax deduction from source deduction payments to employees. As the payment of an award for lost wages or other remuneration constitutes an "extra emolument", the employer must deduct tax at the extra emolument rate as provided for in section NC 2(5) and clause 8 of Schedule 19. (This currently provides a minimum rate of 21 cents in the dollar, or 33 cents or 39 cents in the dollar depending on the recipient's income level, or on whether the recipient makes an election for a particular rate under section NC 8(1A)).

The employer must also:

- deduct ACC earner premium and earners' account levy from the payment; and
- account for the deductions to Inland Revenue in the normal way and pay the remaining amount to the employee; and
- pay employer premium and residual claims levy in respect of the gross award for lost wages or other remuneration.

By deducting tax from the gross award and paying the net sum to the employee, the employer will satisfy the requirements under both the court award and the Income Tax Act. When an employer has deducted tax from a source deduction payment, section NC 19(a) deems the employer to have paid the amount deducted to the employee. Thus, the employer is deemed to have paid the total amount of the award to the employee for the purposes of satisfying the obligation imposed by the Court or Authority.

When the Court or Authority awards a net sum

In some cases a Court or Authority may make an award for lost wages or other remuneration net of tax, i.e. the sum that the employee would have received as remuneration after the deduction of tax. Because it is a "source deduction payment", in such cases the employer would normally "gross up" the award to take account of the PAYE, the ACC earner premium, and the earners' account levy. The employer is then required to pay the tax on the gross of the net award to Inland Revenue and pay

the net award to the employee. In this way the employer would fulfil his or her obligations to both the employee and the Commissioner.

If the employer breaches the Court's or the Authority's direction to pay the net sum to the employee, the onus will be on the employee to enforce the terms of the award by requiring the employer to pay the employee the full net amount of the award. The required tax deduction must be made from whatever amount is paid to the employee.

When an employer fails to make tax deductions

Under section 168 of the Tax Administration Act 1994, if the employer fails to make the correct tax deductions from the payment of the award, the unpaid tax deductions become a debt owed by the employer to the Commissioner. The debt is due and payable on the date that the tax deductions were due to be paid to the Commissioner.

Where an employer fails to make a deduction, the employee is liable, under section NC 16, to:

- furnish the Commissioner with an employer monthly schedule containing particulars of the source deduction payment (i.e. the award) by the 20th of the month following the payment of the award; and

- pay the Commissioner a sum equal to the tax deductions that the employer should have made on that source deduction payment (unless the employee is exempted from this requirement) by the 20th of the month following the payment of the award.

When the payment is derived by the shareholder-employee

Under section EB 1, a person is a shareholder-employee if he or she is a shareholder-employee in a close company and has met the criteria set out in section OB 2(2).

Example 1

An employee is dismissed from her job. She issues proceedings against her former employer alleging unjustifiable dismissal. She seeks reinstatement and damages for wages lost as a result of the unjustifiable dismissal.

The Employment Relations Authority orders the employer to reinstate the employee and awards her $27,000, a sum equivalent to the employee's wages from the time of dismissal to the time of reinstatement, to compensate for the wages lost as a result of the unjustified dismissal.

The Authority makes the award for lost wages on 20 March 2006. The employer pays this award to the employee on 10 April 2006.

1. The award for lost wages is derived by the employee in the 2006-07 income year, as this is the year of receipt.

2. The employer must deduct tax and ACC earner premium and earners' account levy from the court award, and pay the following amounts to the employee and Inland Revenue respectively (in the 2007 income year):

Award for lost wages	$27,000
Less tax at the extra emolument rate, in this case 21%	$5,670
Less ACC earner premium ($27,000 x 0.011)	$ 297
Total payable to Inland Revenue	$ 5,967
Total payable to the employee	$21,033

Example 2

The facts are the same as in Example 1, except that the Authority awards damages of $27,000 and states that this sum is net of tax. In order to ensure that it pays the employee a net sum of $27,000, the employer "grosses up" the payment by the extra emolument tax rate plus ACC earner premium and levy. The employer should make the following calculations and payments:

Award for net lost wages	$27,000.00
Divided by 0.779 (1 - 0.21 - 0.011) to give the gross wage	$34,659.82
Less tax at the extra emolument rate of 21%	$ 7,278.56
Less ACC earner premium ($34,659.82 x 0.011)	$ 381.26
Total payable to Inland Revenue	$ 7,659.82
Total payable to the employee	$27,000.00

In both examples:

- The employer must also pay the employer premium and residual claims levy on the gross award.

- Any other source deduction payments received by the employee from that employer in the 4 weeks prior to payment of the award must also be taken into account in calculating her annualised salary or wages and determining the appropriate tax deduction rate.

- If the employee is required to file an income tax return, she will include the amount of the award for lost wages in her return for the 2006-07 income year and claim the tax paid as a credit.