



TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE > WHAKAWĀ

Exempt income and R&D credits

Decision date | Te Rā o te Whakatau: 22 July 2021

Issue date | Te Rā Tuku: 2 December 2021

TDS 21/06

DISCLAIMER | Kupu Whakatūpato

This document is a summary of an original technical decision so it may not contain all the facts or assumptions relevant to that decision.

This document 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 general 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).

For more information refer to the [Technical decision summaries guidelines](#).

Subjects | Ngā kaupapa

ITA 2007: CW 42, exempt income; Subpart MX, R&D credits

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
ITA 2007	Income Tax Act 2007
TAA	Tax Administration Act 1994
R&D	Research and Development
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ngā ture take

All legislative references are to the Income Tax Act 2007 (**ITA 2007**) unless otherwise specified.

Facts | Ngā meka

1. Company Z (**Z**) is registered under the Companies Act 1993 with its two shareholders being Entity A (**A**) and Entity B (**B**), both being registered charities.
2. In the 2017 tax year Z treated its income as taxable, and as its deductible expenditure exceeded its assessable income it had a net tax loss.
3. As a consequence of the loss, Z claimed a research and development (**R&D**) loss tax credit.
4. Customer and Compliance Services, Inland Revenue (**CCS**) proposed to disallow the R&D loss tax credit on the basis that Z's income is exempt under s CW 42.

Issues | Ngā take

5. The main issues considered in this dispute were:
 - whether Z's income was exempt under s CW 42. To establish this, the following two sub-issues were relevant:
 - whether Z's business was being carried on by, for, or for the benefit of, A and B.
 - if so, whether a person with some control over Z's business was able to direct or divert an amount derived from the business to the benefit or advantage of a person other than A and B.
 - whether Z had a R&D loss tax credit under subpart MX.
6. There was also a preliminary issue on the onus and standard of proof.

Decisions | Ngā whakatauranga

7. The Tax Counsel Office (TCO) decided that:
 - Z's income was **not** exempt under s CW 42(1). Z's business was not being carried on by, for, or for the benefit of, A and B. As a result, the second sub-issue did not need to be considered.
 - Z had a R&D loss tax credit under subpart MX.

Reasons for decisions | Ngā take mō ngā whakatauranga

Preliminary Issue | Take tōmua: Onus and standard of proof

8. The onus of proof in civil proceedings¹ is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.² The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.³

¹ Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to a Taxation Review Authority or a court) are civil proceedings.

² Section 149A(2) of the TAA.

³ *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

9. The standard of proof in civil proceedings is the balance of probabilities.⁴ This standard is met if it is proved that a matter is more probable than not. Whether Z has discharged the onus of proof is considered in the other issues.

Issue 1 | Take tuatahi: Whether Z's income was exempt

10. The issue is whether the Taxpayer's income from the business was exempt from tax under s CW 42(1). At the relevant time, s CW 42(1) exempted income derived directly or indirectly from a business carried on by, or for, or for the benefit of a trust, society or institution of a kind referred to in s CW 41(1).⁵
11. The trust, society, or institution must:
 - carry out its charitable purposes in New Zealand, and
 - be a tax charity when the income is derived.
12. The trust, society, or institution must be a trust for charitable purposes, or a society or institution established and maintained exclusively for charitable purposes and not carried on for the profit of any individual (s CW 41(1)) and no person with some control over the business is able to direct or divert an amount derived from the business to the benefit or advantage of another person or entity.

Whether Z's business was being carried on by, for, or for the benefit of, A and B

13. TCO considered the following in analysing this issue:
 - Natural and intended meaning of the phrase "by, for, or for the benefit of".
 - Determining the purpose of an entity.
 - Relationship between a company and its shareholders.
 - Case law specific to s CW 42 and its predecessor sections.
14. It was not asserted by Z or CCS that Z's business was carried on by either A or B so the word "by" was not considered any further.

⁴ Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

⁵ Section CW 42 was amended with effect for the 2020-21 and later income years to require that the entity carrying on the business was registered as a charitable entity under the Charities Act 2005 when the income was derived. This dispute would not have arisen under the amended legislation as Z was not registered as a charity under the Charities Act 2005.

15. The terms “for” and “for the benefit of” are not defined in the ITA 2007. Where the legislation does not define a term, it should be interpreted according to its natural and intended meaning.⁶
16. For guidance as to the natural and intended meaning of “for” and “for the benefit of”, TCO considered the dictionary definitions of the terms⁷ and case law. This indicated that in s CW 42 both “for” and “for the benefit of” suggest that the business deriving the income does so in order to give it to another person who is ultimately entitled to that income.⁸
17. Determining the purpose of an entity was considered by reference to relevant case law (as discussed below in [19] to [23]).
18. In considering the relationship between a company and its shareholders, reference was made to an Inland Revenue publication referred to by Z and the case law cited within.⁹ The proposition put forward in the bulletin is that the income of a business carried on by a company will not be treated as exempt merely because all the shares in the company are transferred to charitable entities. The Companies Act 1993 was also considered.

Summary of principles derived from case law

19. The case law is not entirely consistent, but some principles can be extracted.
20. A mere shareholding relationship is not sufficient to satisfy the phrase “for, or for the benefit of ” in s CW 42. Without more, a company cannot be said to be acting “for” its shareholders, that term being apt to the relationship of principal and agent, but hardly that of a company and its shareholders.¹⁰
21. The founding documents, such as a deed of trust or company constitution, can establish that the entity derives income from a business carried on for a trustee in trust for charitable purposes under s CW 42.¹¹
22. When a body’s founding documents are clear as to what its purpose is, then its purposes must be ascertained from those documents.¹²

⁶ *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175 (CA).

⁷ *Concise Oxford English Dictionary* (12th ed, 2011, Oxford University Press).

⁸ *Gillespie v City of Glasgow Bank* (1879) 4 App Cas 632 at 642.

⁹ *Technical Bulletin* No 15 September 1959: “Charitable Purposes – Company with all shares held by charities”.

¹⁰ *CIR v NTN Bearing-Saeco (New Zealand) Ltd* (1986) 8 NZTC 5,039.

¹¹ *Calder Construction Co Ltd v CIR* [1963] NZLR 921 (SC). See also *Bearing-Saeco*.

¹² *Institution of Professional Engineers v CIR* (1991) 13 NZTC 8,162 (HC). See also *Calder Construction*.

23. For s CW 42 to apply the only permitted application of the profits of the business must be for charitable purposes, although the profits do not need to be paid immediately for charitable purposes. Funds derived from the business can be used for business development or the creation of reserves instead of being immediately distributed to the charity but any resulting assets from the business must ultimately be required to be applied for charitable purposes.¹³

Application

24. TCO concluded that Z was not within s CW 42(1). This was because:
- Z's only shareholders were charities. Having tax charities as the only shareholders in a company is not (by itself) sufficient to establish that the company is carrying on a business for, or for the benefit of, a charitable entity.
 - Z's directors were required to act in the best interests of Z rather than considering the interests of the shareholders. This is required by s 131 of the Companies Act 1993 and by the provisions of Z's constitution.
 - Z's constitution did not require that all the profits and assets of Z's business could only be applied for the benefit of A and B. The constitution was silent on the matter.
 - The constitution is clear with no ambiguity and did not make any provision that required that all the profits and assets of Z's business could only be applied for the benefit of A and B.
25. This conclusion made it unnecessary to consider whether a person with some control over Z's business was able to direct or divert an amount derived from the business to the benefit or advantage of a person other than A and B (s CW 42(1)(c)).

Issue 2 | Take tuarua: Whether Z had a R&D loss tax credit under Subpart MX

26. Subpart MX provides for a R&D loss tax credit if certain criteria are met. It was accepted by both parties that Z satisfied all the criteria for a R&D loss tax credit except in relation to two particular requirements:
- That the company has a net loss for the year (s MX 1(c));
 - If the company is a member of a R&D group of entities, the group in aggregate has a net loss for the year (s MX 1(d)).

¹³ Refer *Calder Construction*.

27. CCS argued that Z derived exempt income and therefore did not have a net loss for the year and was part of a group of entities that derived exempt income and did not have a net loss for the year.
28. TCO concluded that Z's income was not exempt under s CW 42. Therefore, the loss that Z incurred was a net loss for tax purposes (s BC 4). Consequently, the requirements in s MX 1(1)(c) and (d) were met. Z, and the R&D group of which it was a member, had a net loss.
29. Therefore, since Z, and the R&D group of which it was a member, had a net loss for the year and it was agreed that all the other requirements for Subpart MX applied, Z had a R&D loss tax credit.