TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE> WHAKAWĀ

Income tax, controlled foreign company, double tax agreement, shortfall penalties

Decision date | Te Rā o te Whakatau: 18 November 2021

Issue date | Te Rā Tuku: 1 June 2022

TDS 22/07

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Subjects | Ngā kaupapa

Income tax: income under ordinary concepts; employment income; attributed controlled foreign company income

Double tax agreement: tax residency; dependent personal services

TAA: shortfall penalties

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
CFC	Controlled foreign company
Commissioner or CIR	Commissioner of Inland Revenue
DTA	The Double Taxation Relief (United States of America) Order 1983
ITA	Income Tax Act 2007
LLC	Limited liability company
TAA	Tax Administration Act 1994
TCO	Tax Counsel Office
TRA	Taxation Review Authority
US	United States of America

Taxation laws | Ngā ture tāke

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

Facts | Ngā meka

1. The Taxpayer is a citizen of the United States of America (**US**) and therefore a tax resident of the US.

2. The Taxpayer was employed as CEO of a New Zealand company (**Company A**) under an employment agreement. The Taxpayer provided the CEO services through a company formed in the US (**the US LLC**) and a New Zealand company (**Company B**). The Taxpayer was the sole director and shareholder of both Company B and the US LLC.

3. Two service agreements were signed - one between Company A and Company B, and another between Company A and the US LLC. The terms of both management service agreements were that the Taxpayer was provided to Company A to act as its CEO in exchange for an annual remuneration.

4. During an investigation into the Taxpayer's tax affairs, Customer & Compliance Services, Inland Revenue (**CCS**) reviewed the bank accounts maintained by Company B. CCS noted many withdrawals from an account that they considered to be cash payments received by the Taxpayer or amounts used to pay the Taxpayer's private expenses. (These withdrawals from Company B will be referred to as **the disputed payments** in this TDS). These withdrawals included expenditure on accommodation, food and beverages, international airfares and cash withdrawals.

5. CCS also noted similar withdrawals from the US LLC's bank account which they considered to be cash payments received by the Taxpayer or used to pay for the Taxpayer's private expenses. CCS further identified a series of deposits into the US LLC's bank account which they considered to be remuneration received by the US LLC under the service agreement between the US LLC and Company A.

6. As a result of the investigation, CCS formed the following views, and issued a default assessment for the disputed income year accordingly:

   - The disputed payments were assessable income of the Taxpayer under s CA 1 (income under ordinary concepts) or alternatively under s CE 1 (employment income).
   - The US LLC was a controlled foreign company (**CFC**) for New Zealand income tax purposes and, therefore, the Taxpayer had attributed CFC income from the company.
   - The Taxpayer was a New Zealand tax resident under of the Double Taxation Relief (United States of America) Order 1983 (**DTA**) for the disputed income year

and article 15 of the DTA gave New Zealand the sole right to tax the disputed payments.

- The Taxpayer was liable to a gross carelessness shortfall penalty in relation to both the disputed payments and the attributed CFC income.

7. In their dispute documents, the Taxpayer contended that CCS's tax assessment and shortfall penalty assessment should be reduced to nil because they argued that:

   - The Taxpayer was a US tax resident and therefore was not required to file an income tax return in New Zealand. They argued that they had met their tax obligations by filing a personal income tax return in the US, which included the US LLC's business income.
   - CCS incorrectly treated deductible business expenditure of Company B as private expenditure of the Taxpayer and that any disallowed amounts should have been assessed as income of Company B. CCS failed to take a fair, balanced and common-sense approach and, therefore, their assessment was invalid.
   - The US LLC was not a CFC for New Zealand income tax purposes as the DTA took precedence.
   - The Taxpayer was not liable to pay a shortfall penalty because they returned all their income in the US as required.

Issues | Ngā take

8. The issues and sub-issues considered in this dispute were:

   - Procedural issues:
     - Whether the Taxpayer discharged their onus of proof by showing that CCS's assessment was arbitrary and invalid.
     - Whether there was a breach of the Taxpayer's human rights when CCS took the Taxpayer's marital status into account to determine their residency under the DTA.
   - Assessable income:
     - Whether the disputed payments were income of the Taxpayer under s CA 2(1) as income under ordinary concepts.
     - Whether the disputed payments were employment income of the Taxpayer under s CE 1(1).

    - Whether the taxpayer had attributed CFC income from the US LLC under ss CQ 1 and CQ 2.
- New Zealand's taxing rights under the DTA:
    - Whether the Taxpayer was a tax resident of New Zealand or the US under article 4 of the DTA.
    - Whether New Zealand had the right to tax the disputed payments under article 15 of the DTA.
- Shortfall penalties:
    - Whether the Taxpayer was liable for a gross carelessness shortfall penalty under s 141C of the Tax Administration Act 1994 (**TAA**).
    - Alternatively, whether the Taxpayer was liable for a shortfall penalty for not taking reasonable care under s 141A of the TAA.
    - Whether the Taxpayer was eligible for a reduction in any shortfall penalty payable under s 141FB of the TAA.

Decisions | Ngā whakatau

9. The Tax Counsel Office (**TCO**) decided that:
    - Procedural issues:
        - The Taxpayer did not discharge their onus of proof as CCS's assessment was not arbitrary or invalid.
        - The breach of human rights claim was a procedural matter that should be addressed by the Taxation Review Authority (**TRA**) or a court. However, it was noted that the Taxpayer's marital status was relevant to determining the tax residency of the Taxpayer.
    - Assessable income:
        - The disputed payments were income under ordinary concepts under s CA 1(2).
        - The disputed payments were employment income under s CE 1(1).
        - The Taxpayer did not have attributed CFC income from the US LLC under ss CQ 1 and CQ 2. However, the Taxpayer may have attributed income under ss GB 27-29.
    - New Zealand's taxing rights under the DTA:

- The Taxpayer was treated as a New Zealand resident for the purposes of the DTA.
- The effect of article 15(1) of the DTA was that New Zealand had an exclusive right to tax the income that the Taxpayer derived from Company B.

- Shortfall penalties:
  - The Taxpayer was liable for a gross carelessness shortfall penalty under s 141C of the TAA.
  - Alternatively, if it was subsequently found by the TRA or a court that the requirements of the gross carelessness shortfall penalty were not satisfied, the Taxpayer was liable for a shortfall penalty for not taking reasonable care under s 141A of the TAA.
  - The Taxpayer was not eligible for a reduction in the shortfall penalty under s 141FB of the TAA because the shortfall penalties imposed in a previous dispute came within the definition of "disqualifying penalty".

Reasons for decisions | Ngā take mō ngā whakatau

Issue 1 | Take tuatahi: Procedural issues

Onus and standard of proof

10. The onus of proof in civil proceedings[1] 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]

11. 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 likely than not".[5] Whether the Taxpayer has discharged the onus of proof is considered in the other issues.

[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the TRA 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).

[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] *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

12. An assessment made by the Commissioner cannot be arbitrary. She must make the best judgment she can on the information in her possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[6]

13. The Taxpayer argued that CCS acted in an arbitrary and unfair way when they characterised the disputed payments, and because of this CCS's assessment was invalid. The Taxpayer contended that CCS assessed withdrawals that were clearly business expenses and effectively treated everything in Company B's account as private expenditure, thereby ignoring the business that was being carried on.

14. It was unclear whether the Taxpayer was arguing that CCS's characterisation of the withdrawals from the US LLC was also arbitrary and unfair. TCO, therefore, took a conservative approach and considered CCS's treatment of the withdrawals from both Company B and the US LLC.

15. TCO considered the information that CCS took into account and the methodology they adopted when they made the assessment and determined the assessment was not arbitrary or demonstrably unfair, for these reasons:

    - The methodology CCS adopted involved an honest exercise of judgment and the consideration of relevant facts and information, including the Taxpayer's relationship with the companies (ie, the Taxpayer performed services on their behalf) and where the Taxpayer was residing at the time the expenditure was incurred, or withdrawal was made.
    - CCS reviewed bank statements for both companies and made a judgment as to whether each of the withdrawals from the accounts were private expenditure or deductible business expenditure. CCS categorised each withdrawal into wholly private, wholly deductible or partly deductible.
    - A review of these categories did not suggest CCS treated obvious business expenditure as private or otherwise gave no consideration to how each withdrawal should be treated.
    - CCS gave the Taxpayer the opportunity to review the treatment of the withdrawals and to provide evidence if they disagreed, but the Taxpayer did not provide such evidence.

[6] *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

- CCS assessed on the basis of the information they had, and they were not required to seek further information from other sources.[7]

16. Consequently, it was also considered that the Taxpayer did not discharge the onus of proof that CCS's assessment was invalid.

The Taxpayer's human rights

17. The Taxpayer argued that their marital status was irrelevant to the dispute and argued that it was offensive, and in breach of their human rights under New Zealand law and the International Convention on Human Rights, that CCS considered it was relevant.

18. TCO considered that when it adjudicates a dispute, TCO must determine a taxpayer's tax liability according to law. Correctness is the sole criterion for determining tax liability.[8] Any claimed grounds of error, illegality or invalidity can be addressed by the TRA or a court if the dispute proceeds to challenge stage.[9]

19. Accordingly, the adjudication was only concerned with the Taxpayer's liability for tax.

20. However, TCO observed that the Taxpayer's marital status was relevant to assess whether the Taxpayer had a stronger personal and economic relation with New Zealand than the US. This is addressed in Issue 3.

Issue 2 | Take tuarua: Assessable income

21. The issue was whether the Taxpayer derived assessable income under the ITA during the disputed income year.

22. CCS argued that Company B paid private expenses on the Taxpayer's behalf and this amount was either income under ordinary concepts that was assessable under s CA 1(2), or it was employment income that was assessable under s CE 1. Further, CCS argued that the US LLC was a CFC and its net income for the disputed income year was attributed CFC income of the Taxpayer under s CQ 2.

23. The Taxpayer argued that CCS incorrectly treated deductible business expenditure of Company B as private expenditure of the Taxpayer and that the US LLC was not a CFC for New Zealand income tax purposes.

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[7] *CIR v New Zealand Wool Board* at 15,489.

[8] *CIR v Michael Hill Finance* (NZ) Ltd [2016] NZCA 276, (2016) 27 NZTC 22-056 at [29] and [43].

[9] *Tannadyce Investments Ltd v CIR* [2011] NZSC 158, (2011) 25 NZTC 20-103 at [55].

Income under ordinary concepts

24. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.

25. The key principles on what income under ordinary concepts means are:

- Income is something that "comes in".[10]
- Even if a taxpayer does not directly receive the money, it would be considered the taxpayer's income if it had been dealt with in the taxpayer's interest or on their behalf.[11]
- Whether or not a particular receipt is income depends on its quality in the hands of the recipient.[12]
- Regularity or recurrence indicates that payments may become part of the receipts that the recipient may depend on for living expenses.[13] However, regularity alone is not determinative – a single payment may also be income.[14]
- Consideration must be given to the relationship between payer and payee.[15]
- The purpose of any payments made must be considered.[16]

26. TCO first addressed CCS's characterisation of the disputed payments.

27. The withdrawals that were characterised as private expenditure by CCS included expenditure for accommodation, food and beverages, international airfares, foreign currency fees and overseas withdrawal fees, general expenses and cash withdrawals.

28. In treating these withdrawals as private expenditure, CCS relied on the nature of the expenditure, the fact that the Taxpayer was the only person who had control over Company B's bank account, and the fact that the Taxpayer did not maintain a separate bank account in their own name.

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[10] *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,335.

[11] Section BD 3(4); *Dunn v CIR* (1974) 1 NZTC 61,245 (NZSC) at 61,248-61,249.

[12] *Reid v CIR* (1995) 7 NZTC 5,176 (CA) at 5,183.

[13] *Reid v CIR*.

[14] *FCT v Hyteco Hiring Pty Ltd* 92 ATC 4694 at 4,700.

[15] *Reid v CIR*.

[16] *Reid v CIR*.

29. TCO concluded that the Taxpayer did not satisfy the onus of proof that CCS's characterisation of these withdrawals as private expenditure was wrong, or by how much it was wrong, for these reasons:

- The Taxpayer was a New Zealand tax resident under the DTA (discussed further in Issue 3). Consequently, TCO did not accept the Taxpayer's argument that they were in New Zealand for business purposes only and that the expenditure incurred in New Zealand was business related. The Taxpayer did not provide any evidence to suggest the expenditure was business expenses.
- There was no evidence to suggest that Company B had any service agreements that the Taxpayer was working on while outside of New Zealand or evidence of any overseas clients. The Taxpayer did not substantiate their argument that the travel expenditure and expenditure incurred outside of New Zealand were business related.
- The Taxpayer did not provide any evidence which would show the other general expenses and cash withdrawals had a nexus with Company B's income earning activities. The Taxpayer did not prove that CCS mistakenly treated business expenditure as private expenditure.

30. Having concluded that the Taxpayer did not prove CCS's treatment of the disputed payments was wrong, TCO went on to conclude the disputed payments were the Taxpayer's income under ordinary concepts, and were assessable under s CA 1(2) because:

- The disputed payments were something which comes in. The payments that were paid to third parties or directly to the Taxpayer (in the case of cash withdrawals) were received by the Taxpayer as the Taxpayer was the only person who controlled Company B's bank account and was, therefore, the person who effected the payments. In any case, s BD 3(4) would treat the payments made to third parties as income of the Taxpayer as it was dealt with in the Taxpayer's interest or on their behalf.
- Company B was incorporated for the purpose of using it as a vehicle to perform the Taxpayer's personal services. The Taxpayer's exertions were the means by which Company B generated its income. It was considered that the disputed payments had the quality of a return received by the Taxpayer for their exertions.
- Evidence showed that the payments were recurrent. Further, as the payments were applied to meet the Taxpayer's private expenses, they were a part of the receipts upon which the Taxpayer depended on for their living expenses.

- The Taxpayer was Company B's sole shareholder and director, and the Taxpayer performed services which generated Company B's income.
- The purpose of the payments was to pay the Taxpayer's private expenses.

Employment income

31. CCS argued that if the disputed payments were not income under ordinary concepts, they were employment income under s CE 1.

32. Section CE 1(1) states that amounts derived by a taxpayer in connection with their employment or service are income of that taxpayer. Employment income includes:

    - Salary, wages, or allowances relating to the employment of a person.[17]
    - Expenditure on account of an employee, which is where an employer pays for expenditure that an employee has incurred or would incur.[18]
    - "Any other benefit in money", which is intended to have broad application to include all monetary benefit derived in connection with a person's employment, no matter how they are characterised.[19]

33. TCO noted that the Taxpayer did provide services to Company B, and it had been previously concluded that the Taxpayer had not proven CCS's characterisation of the disputed payments was wrong. TCO considered the best explanation for the disputed payments was that they were the Taxpayer's return for work they performed for Company B.

34. TCO concluded that the disputed payments came within s CE 1(1) as being salary or wages, or alternatively, they were "any other benefit in money" derived by the Taxpayer in connection with their employment or service.

35. The Taxpayer further argued that had they received employment income, they would have been entitled to a tax credit for the tax already deducted and paid to the Commissioner by Company B. However, the Taxpayer had not provided any evidence that any such amounts were deducted and paid to the Commissioner. Therefore, the Taxpayer had not proven that they were entitled to tax credits for the disputed income year.

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[17] "Salary or wages" is defined in s RD 5.

[18] "Expenditure on account of an employee" is defined in s CE 5.

[19] *Public Information Bulletin* No 136 – Part 3 (February 1986); Harris et al, *Income Tax in New Zealand* (Brookers, Wellington, 2004) at [5.2].

Attributed CFC income

36. CCS argued that the US LLC was a CFC and, therefore, the Taxpayer had attributed CFC income under the ITA. The Taxpayer argued that the US LLC was not a CFC for New Zealand income tax purposes.

37. Section CQ 1 provides that a person's income includes any attributed CFC income of the person. A person has attributed CFC income if the criteria in s CQ 2 are met.

38. The criteria relevant to the dispute are set out in s CQ 2(1)(a)-(f). TCO decided that all but one of the criteria had been met. This meant the Taxpayer did not have any attributable CFC income under ss CQ 1 and CQ 2. For each of the requirements, TCO concluded:

- The US LLC was a foreign company which was a CFC during one of its accounting periods for these reasons (s CQ 2(1)(a)):
    - The US LLC was a foreign company because:
        - The particular US State legislation that governs the US LLC (the State LLC legislation) provides that a limited liability company is an entity distinct from its members. It also provides that a limited liability company has the capacity to sue and be sued in its own name and the power to do all things necessary or convenient to carry on its activities. Therefore, it was considered that the US LLC met the definition of "company" in s YA 1, being a body corporate or other entity that is distinct from its members.
        - It was not a resident in New Zealand under s YD 2 as it was not incorporated in New Zealand, and it followed that it was not liable to tax in New Zealand and not treated as a New Zealand resident under the DTA.
    - The US LLC was a CFC under s EX 1(1)(b) because:
        - The Taxpayer, being a New Zealand resident, had at least a 40% control interest[20] in the US LLC. Relevantly, a person has a direct control interest in a foreign company if they held any shares in the company (s EX 5(1)(a)) or if they had a right to receive any income of the company (s EX 5(1)(c)). A share includes any interest in the capital of a company.[21] The provisions of the State LLC legislation

[20] Control interests are defined in ss EX 2 and EX 7, which relate to direct and indirect control interests respectively. Indirect control interests were not relevant to the dispute.

[21] Definition of "share" in s YA 1.

indicate that an LLC of that State does not have shareholders but has members. Prior to dissolution, a member of an LLC has a right to receive distributions from the LLC in equal shares with other members and upon winding up, the members have a right to receive any surplus remaining after creditors have been paid. Given that the Taxpayer is the only member of the US LLC, the Taxpayer had a right to receive 100% of any distributions of capital or income from the US LLC prior to its dissolution and on winding up. It was considered that the Taxpayer's interest in the US LLC included an interest in the capital of the US LLC and, therefore, met the definition of a "share". It followed that the Taxpayer had a 100% control interest in the US LLC under s EX 5(1)(a). The Taxpayer also had a 100% control interest under s EX 5(1)(c) for the same reasons.

        - There was no evidence to suggest that anyone other than the Taxpayer held a control interest in the US LLC. Therefore, the circumstances in s EX 1(1)(1)(b)(i)-(iii) did not apply.

    - The US LLC was a CFC during one of its accounting periods.[22]

- The requirement that the US LLC's accounting period ended during the income year was met (s CQ 2(1)(b)).
- The Taxpayer was not a portfolio entity (s CQ 2(1)(bb)). The Taxpayer was not a company or a fund and, therefore, could not be a portfolio investment entity.[23]
- The Taxpayer had an income interest in the US LLC for the accounting period (s CQ 2(1)(c)).[24] For the same reasons it was concluded that the Taxpayer had a 100% control interest in the US LLC under s EX 5(1), it was also concluded that the Taxpayer had 100% of the income interest in the US LLC under s EX 9(1).
- The requirement that the Taxpayer was a New Zealand resident but not a transitional resident during the accounting period was met (s CQ 2(1)(d)).
- The requirement that the Taxpayer's income interest was 10% or more and they were not a portfolio investment entity under s EX 14(1) was met (s CQ 2(1)(e)).
- The Taxpayer did not derive attributable CFC income for the accounting period under s EX 20C. Therefore, the requirement under s CQ 2(1)(f) was not met. For

[22] For a foreign company, the term "accounting period" means the foreign company's accounting year. Since there was no evidence of a balance date for the US LLC, it was considered that the company's accounting year was its tax year.

[23] See s HM 2.

[24] See ss EX 8 and EX 9.

the Taxpayer to have derived attributable CFC income from the US LLC, all the criteria for an attributable CFC amount in s EX 20B(9)(a)-(f) must have been met.[25] Section EX 20B(9)(f) requires that a person who holds an attributing interest in the CFC files a return in which the attributed amount from the CFC is included. However, given the Taxpayer did not file such a return, that requirement was not met.

39. Even though it was decided the Taxpayer did not have attributable CFC income under ss CQ 1 and CQ 2, TCO noted that the Taxpayer may have attributed income under ss GB 27-29. As the parties did not address this issue, the dispute was referred back to the parties to allow them the opportunity to do so.

Issue 3 | Take tuatoru: New Zealand's taxing rights under the DTA

40. To determine whether New Zealand had the right to tax the disputed payments, it was necessary to consider:

- whether the Taxpayer was a tax resident of New Zealand or the US under the tie-breaker test in article 4 of the DTA; and
- whether article 15 of the DTA applied to treat the Taxpayer's income from Company B as taxable only in New Zealand.

41. CCS argued that:

- the Taxpayer was a New Zealand resident under the tie-breaker test;
- article 15 of the DTA gave New Zealand the right to tax the disputed payments;
- alternatively, if the Taxpayer was treated as a US tax resident under the tie-breaker test, CCS argued that article 15 treated the Taxpayer's income as taxable in New Zealand.

42. The Taxpayer argued that they were a US resident under the tie-breaker test. They did not advance any arguments concerning article 15.

[25] Section EX 20C(3)(a) provides that "attributable CFC" is the CFC's "attributable CFC amount". An attributable CFC amount is calculated using a formula that includes a "gross" amount (s EX 20B(1)). Relevantly, the item "gross" in this formula includes income for personal services of a type referred to in s EX 20B(9) (s EX 20B(3)(h)).

Approach to the interpretation of double taxation treaties

43. The general approach to interpreting a double taxation treaty was considered.

44. Article 31(1) of the Vienna Convention on the Law of Treaties 1969 provides that a treaty shall be interpreted in accordance with the ordinary meaning of the terms of the treaty in their context and in light of its object and purpose.

45. The background of a treaty can legitimately be taken into account as part of the context relevant to the interpretation of its terms.[26] The courts of New Zealand and other countries refer to the OECD Model and OECD Model Commentary for background context. [27]

46. It is generally accepted that the OECD Model and Commentary, which is updated periodically, can be referred to for the purpose of interpreting a double taxation treaty, provided the amendments are intended to clarify, not change, the meaning of the relevant articles.[28]

Tie-breaker test under article 4 of the DTA

47. The parties to the dispute agreed that the Taxpayer was a tax resident of both New Zealand and the US under each country's domestic law. Consequently, the Taxpayer's tax residence for the purposes of the DTA was determined under the tie-breaker tests in article 4 of the DTA.[29]

48. The tie-breaker tests are applied in the following order until residence can be determined under one of them:

- Permanent home available.
- Centre of vital interests.
- Habitual abode.
- Citizenship.
- Mutual agreement between the competent authorities.

[26] *Anson v Commissioners for Her Majesty's Revenue and Customs* [2015] UKSC 44 at [58]; Chatfield & Co Limited v Commissioner of Inland Revenue [2015] NZHC 2099 at [53].

[27] *Commissioner of Inland Revenue v JFP Energy Inc* [1990] 3 NZLR 536 (CA).

[28] See OECD Commentary Introduction [33] and [36] at 1-10, 1-11; *R v Prévost Car Inc* 2009 FCA 57, [2010] 2 FC 65 at [10] to [11]; *Chatfield & Co.*

[29] The DTA overrides the provisions in the ITA. See s BH 1.

Article 4 - permanent home test

49. Determining whether a home is available involves assessing factors such as whether:

- the home is capable of being used by the person;[30]
- the person has a right to determine occupancy and possession of the property; and
- the person has the power to dispose of the property.

50. The parties agreed that the Taxpayer did not have a permanent home in New Zealand. CCS argued that the Taxpayer did not have a permanent home in the US either.

51. TCO considered that there was no evidence to support the Taxpayer's claim that the Taxpayer arranged and maintained accommodation in a family member's home in the US for their permanent use. It was considered the home was available as short-term accommodation while the Taxpayer was in the US. Further, the bank statements of Company B and the US LLC showed these companies paid for the Taxpayer's accommodation while they were in the US.

52. TCO concluded that the Taxpayer did not have a permanent home in either New Zealand or the US. Therefore, it was necessary to consider the personal and economic relations test.

Article 4 - personal and economic relations (centre of vital interests) test

53. Article 4 of the DTA gives preference to the country to which the Taxpayer's personal and economic relations (centre of vital interests) are closer. The Taxpayer's personal and economic relations with both countries must be considered.

54. The following are some key principles in applying the centre of vital interests test:

- Factors taken into account include the person's family and social relations, occupations, political, cultural or other activities, place of business, and place from which property is administered. The circumstances must be examined as a whole, but considerations based on the personal acts of the individual must be given special attention.[31]
- The depth of the roots of one's centre of vital interests is more important than the number of connections on each side.[32]

[30] *Case 12/2011* [2011] NZTRA 08, (2011) 25 NZTC 1-012, *Case J41* (1987) 9 NZTC 1,240.

[31] The OECD commentary on article 4 of the OECD Model Convention at [15].

[32] *Hertel v MNR* 93 DTC 721 at 723.

- If the economic factor is closer to one place and the personal factor closer to another, it will be resolved by which of the two localities is of greater significance to the taxpayer.[33]
- Commentators have suggested in the context of the permanent place of abode test in s YD 1(2) that where a person does not have a spouse or children, and no longer lives with their parents, the relevance of family ties is less important.[34] It was considered that the same logic is equally applicable in the context of the closer personal and economic relations test.

55. In relation to the Taxpayer's economic ties, TCO considered that:

- While the Taxpayer had business connections with both countries, the New Zealand connections were closer than the US connections.
- Significantly, all of Company B and the US LLC's business income was sourced from New Zealand and the activities that produced the income were carried on in New Zealand.
- The administration of the Taxpayer's properties, which included shares in various New Zealand companies, membership interest in the US LLC, and bank accounts used for private purposes, was more closely associated with New Zealand than the US in the disputed income year.
- The fact that the Taxpayer had spent significantly more time in New Zealand than in the US indicated the Taxpayer had more opportunity to carry out administrative activities in New Zealand.

56. As to the Taxpayer's personal relations, TCO considered that:

- The Taxpayer had family and social relations with the US. Even though the Taxpayer had spent more time in New Zealand than in the US and could stay with friends and clients rent free, this circumstance is outweighed by the Taxpayer's US origins, their strong family connections with the US and the fact they do not have family in New Zealand.
- There was no evidence of any political, cultural or other activities undertaken in either of the countries during the disputed income year.

57. In weighing up all the relevant considerations, TCO concluded that the strength of the Taxpayer's economic relations to New Zealand tipped the balance in favour of New

[33] *Case 12/2011* at [62].

[34] See Craig Elliffe, *International and Cross-Border Taxation in New Zealand* (2nd ed, Thomas Reuters, Wellington, 2018) at 7.2(d), citing *Case U17* (1999) 19 NZTC 9,174 in support.

Zealand. It was noted that as the Taxpayer did not have a spouse or children and no longer lived with their parents, the relevance of family ties is less important.

58. Accordingly, it was decided that the Taxpayer's centre of vital interests was in New Zealand. This meant that the Taxpayer was treated as a New Zealand resident for the purposes of the DTA.

Article 4 – habitual abode test

59. For completeness, TCO considered the habitual abode test briefly, in case it was subsequently found that the Taxpayer's centre of vital interests could not be determined.

60. The following principles apply to the habitual abode test:

- The concept of habitual abode involves notions of frequency, duration and regularity of stays of a quality that is more than transient. A person will have a habitual abode in a country if they live there habitually or normally. A person may habitually live in more than one country.[35]
- In assessing whether a stay is more than transient, the reasons for the stay are relevant.
- The test is applied by taking into account all of a person's stays in a country, not only those at a home the person owns or rents there.[36]
- The test is not applied by focusing only on the income year concerned but must cover a sufficient length of time.

61. TCO considered that the amount of time the Taxpayer spent in New Zealand, the pattern of residing here over an extended period of time, and the reasons for coming to New Zealand all support a conclusion that the Taxpayer had a habitual abode in New Zealand in the disputed income year. The frequency, duration and regularity of the Taxpayer's stays were more than transient. This was contrasted with the relatively short periods of time that the Taxpayer spent in the US.

Article 4 tie-breaker test – conclusion

62. It was concluded that the Taxpayer was a New Zealand resident under the tie-break test in article 4 for these reasons:

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[35] *Lingle v R* 2010 FCA 152.

[36] OECD commentary on article 4 of the OECD Model Convention.

- The Taxpayer did not have a permanent home available in New Zealand or in the US.
- The Taxpayer's personal and economic relations with New Zealand were closer than they were with the US.
- If it was necessary to do so, it would also be concluded that the Taxpayer had a habitual abode in New Zealand and not in the US.

Article 15 (dependent personal services) of the DTA

63. Article 15(1) would give New Zealand the exclusive right to tax the disputed payments if the following criteria were met:
    - the Taxpayer was a New Zealand resident under the DTA;
    - the income was salary or wages or other similar remuneration from employment; and
    - the income was not derived from services performed in the US.
64. As had previously been concluded, the Taxpayer was a New Zealand resident for the purposes of the DTA; the Taxpayer's income from Company B had the character of salary and wages from employment; and the income was derived from personal services performed by the Taxpayer in New Zealand. It followed that the disputed payments derived by the Taxpayer from Company B were only taxable in New Zealand.
65. However, in case it was found that the Taxpayer performed services from both New Zealand and the US, TCO also considered the application of the proviso in article 15(2). Article 15(2) provides that remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if all three requirements in article 15(2)(a)-(c) are met.
66. For the current dispute, if the Taxpayer derived income from services performed in the US, the Taxpayer's income would be taxable only in New Zealand if all these requirements were met:
    - the Taxpayer was present in the US for no more than 183 days in any consecutive 12 month period;
    - the Taxpayer's remuneration was paid by an employer who was not a US resident; and
    - the remuneration was not borne by a permanent establishment which the Taxpayer's employer had in the US.

67. The Taxpayer was only present in the US for 16 days during the disputed income year; Company B was not a US resident; and Company B did not have a permanent establishment in the US. Consequently, it was decided that all the disputed payments were only taxable in New Zealand, even if the Taxpayer performed some services in the US.

68. Further, TCO agreed with CCS's alternative argument that if it were found that the Taxpayer was a US resident under the DTA, article 15(1) would give New Zealand the right to tax the Taxpayer's income because the income was derived from an employment exercised in New Zealand. However, this is subject to the proviso in article 15(2). The effect of the proviso is that the Taxpayer's income would be taxable only in the US if the following requirements were met:

- the Taxpayer was present in New Zealand for no more than 183 days in any 12 month period; and
- the payer of the Taxpayer's remuneration (i.e. Company B) was not a resident of New Zealand; and
- the Taxpayer's remuneration was not borne by a permanent establishment that the Taxpayer's employer (Company B) had in New Zealand.

69. CCS conceded that the first of these requirements was met but argued the second two were not. The Taxpayer did not dispute CCS's position, and no evidence was provided to support a conclusion the second two requirements would be met. Consequently, if it was found that the Taxpayer was a resident of the US, their income would still be taxable in New Zealand.

New Zealand's tax rights under the DTA – overall conclusion

70. It was concluded that New Zealand was allocated taxing rights under the DTA. If, and to the extent that, the Taxpayer was liable to tax in both New Zealand and the US on the same income, article 22 of the DTA may require the US to provide a tax credit for tax paid in New Zealand.

Issue 4 | Take tuawhā: Shortfall penalties

71. In Issue 4, all legislative references are to the TAA unless stated otherwise.

72. CCS argued that the Taxpayer was liable under s 141C to pay a gross carelessness shortfall penalty in relation to the tax shortfalls that occurred in the disputed income year. Alternatively, if the Taxpayer was not liable for a gross carelessness shortfall penalty, they were liable for a shortfall penalty for not taking reasonable care under

s 141A. In either case, CCS considered that the Taxpayer was not entitled to a penalty reduction under s 141FB because the Taxpayer was liable for a disqualifying penalty within the applicable qualifying period.

73. The Taxpayer argued that they were not liable to pay any shortfall penalties because they had correctly filed a return and declared their income in the US, as required by the provisions of the DTA.

Shortfall penalty for gross carelessness

74. Section 141C imposes a shortfall penalty for gross carelessness on a taxpayer if the following requirements are satisfied:[37]

- The taxpayer has taken a tax position.
- Taking the tax position has resulted in a tax shortfall.
- The taxpayer has been grossly careless in taking the taxpayer's tax position. Gross carelessness means doing or not doing something in a way that, in all of the circumstances, suggests or implies a complete or high level of disregard for the consequences (s 141C(3)):
    - Gross carelessness is characterised by conduct which creates a high risk of a tax shortfall occurring where that risk and its consequences would have been foreseen by a reasonable person in the circumstances.[38]
    - The test for gross carelessness is not whether the taxpayer actually foresaw the probability that their act or omission would cause a tax shortfall but whether a reasonable person would have foreseen that probability.[39] Whether the taxpayer has acted intentionally is not a consideration.[40]
    - Gross carelessness is similar to recklessness, which covers a range of states of mind from failing to give any thought to whether there is a risk to recognising the existence of a risk and deciding to ignore it.[41]
    - A person who takes reasonable care is not grossly careless. Taking reasonable care includes exercising reasonable diligence to determine the

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

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

[39] *Case 9/2014* (2014) 26 NZTC 2,019 at [88].

[40] *Case W4* at [60].

[41] *Case W4* at [48]; *R v Caldwell* [1982] AC 341 (HL); *R v Howe* [1982] 1 NZLR 618 (CA).

correctness of a return, keeping adequate records, and generally making a reasonable attempt to comply with tax law.[42]

- A taxpayer who adequately informs and follows the advice of a qualified tax agent takes reasonable care and is not careless.[43]

75. The following factors may be relevant in determining whether a reasonable person would have foreseen that their conduct created a high risk of a tax shortfall occurring:[44]

- the significance of the transaction leading to the tax shortfall;
- the taxpayer's level of experience in the relevant tax laws;
- previous warnings given by Inland Revenue or advisors in relation to the risk of the tax shortfall.

76. The penalty payable for gross carelessness is 40% of the resulting tax shortfall.

77. However, under s 141C(4) a taxpayer who takes an acceptable tax position is not grossly careless in taking their tax position. A tax position is an acceptable tax position if it is "about as likely as not to be correct". This is determined objectively. [45]

78. A tax position will be "about as likely as not to be correct" and, therefore, an acceptable tax position, if:

- The tax position is close to or around 50% likely to be correct.[46]
- The merits of the arguments supporting the tax position are substantial.[47]
- On balance, the tax position is one that, while wrong, could be argued on rational grounds to be right.[48]
- There is room for a real and rational difference of opinion.[49]
- The taxpayer's tax position is one about which "reasonable minds could differ".[50]

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[42] *Case W4* at [60].

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

[44] *Case W4*.

[45] See definition of "acceptable tax position" and "unacceptable tax position" in s 3(1) and s 141B.

[46] *Case U47* (2000) 19 NZTC 9,410.

[47] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115.

[48] *Ben Nevis* and *Walstern v FCT* [2003] FCA 1,428.

[49] *Walstern*.

[50] *Walstern* and *Case X25* (2006) 22 NZTC 12,303.

79. TCO considered that the Taxpayer was liable to pay a shortfall penalty for gross carelessness under s 141C because:

- The Taxpayer did not take adequate steps to determine if they had assessable income. There was no evidence of the Taxpayer seeking professional advice on the application of the DTA, which involved a degree of complexity. This conduct created a high risk of a shortfall occurring.
- The law regarding income under ordinary concepts and employment income and the application to the Taxpayer's situation was relatively straightforward. Further, the law on record keeping requirements that apply to taxpayers was also straightforward and easy to understand.[51]
- The Taxpayer's background indicated that they had a reasonably high level of commercial and financial awareness. A reasonable person in the Taxpayer's circumstances would have foreseen the risk of a tax shortfall.
- The Taxpayer had been the subject of previous audits in which they were found to have omitted income from their tax returns and became liable to pay a shortfall penalty. They were also involved in the audit of Company B in which it was found that the company had claimed deductions that it was not entitled to.
- It followed that in taking their tax position, the Taxpayer acted in a way that in all of the circumstances suggests or implies a complete or high level of disregard for the consequences.

Shortfall penalty for not taking reasonable care

80. Section 141A imposes a shortfall penalty on a taxpayer for not taking reasonable care if the following requirements are satisfied:[52]

- The taxpayer has taken a 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.

81. A taxpayer will be treated as having taken reasonable care in these two situations:

[51] The record keeping requirements are contained in ss 15B and 22 of the TAA.

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

- If the taxpayer has relied on the action or advice of a tax advisor engaged by the taxpayer.[53]
- If the taxpayer has taken an acceptable tax position.[54]

82. Case law has also developed the following principles about "reasonable care":

- The test of "reasonable care" is whether a reasonable person in the taxpayer's circumstances would have foreseen a tax shortfall as a reasonable probability.[55]
- Reasonable care includes exercising reasonable diligence to determine the correctness of a return, keeping adequate records to properly substantiate a return and generally making a reasonable attempt to comply with tax law.[56]
- What is considered "reasonable" may vary depending on a number of factors, including:[57]
    - the experience of the taxpayer;
    - the type of tax involved;
    - the size and nature of the business;
    - the complexity of the law;
    - the particular transaction;
    - the difficulty and expense of taking appropriate precautions.

83. A taxpayer is vicariously responsible for any tax position taken by its officers or employees.

84. The penalty payable for not taking reasonable care is 20% of the tax shortfall.

85. TCO concluded that the Taxpayer was liable for a shortfall penalty for not taking reasonable care under s 141A. The matters that established the Taxpayer was liable for a gross carelessness shortfall penalty also established that a reasonable person in the Taxpayer's circumstances would have foreseen the tax shortfall as a reasonable probability. The requirements for this shortfall penalty were, therefore, satisfied.

[53] Section 141A(2B).
[54] Section 141A(3).
[55] *Case W4* at [59].
[56] *Case W4* at [60]-[61].
[57] *Case W3* (2003) 21 NZTC 11,014.

Reduction for previous behaviour

86. Under section 141FB(2), a shortfall penalty (the current penalty) can be reduced by 50% if a taxpayer is not liable for another shortfall penalty that is a disqualifying penalty. A disqualifying penalty is defined in s 141FB(3)(b).

87. Given the shortfall penalties that were imposed in a previous dispute came within the definition of "disqualifying penalty", the Taxpayer did not qualify for the 50% reduction of the current penalty.

Shortfall penalties – conclusion

88. A taxpayer is liable to only one shortfall penalty for each tax shortfall. Where the requirements of more than one shortfall penalty are met, the higher shortfall penalty is imposed (s149(3)).

89. Therefore, the gross carelessness shortfall penalty was applied to the Taxpayer.