

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

# Receipt of a one-off payment

Decision date | Rā o te Whakatau: 15 December 2023

Issue date | Rā Tuku: 25 March 2024

TDS 24/04

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## Subjects | Kaupapa

Income tax: derivation, financial arrangement, loan, money lent, one-off payment.

## Taxation laws | Ture tāke

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

## Facts | Meka

1. The Taxpayer is an experienced real estate agent. They had entered into a contract (Contract) with an agency (Agency) as an individual contractor.
2. The Contract included a one-off payment (Payment) that was payable by the Agency upon the signing of the Contract. This was required to be repaid by the Taxpayer if the Agency or the Taxpayer terminated the Contract within two years.
3. The Agency deducted withholding tax from the Payment, which was passed to Inland Revenue.
4. The Taxpayer filed their return showing the withholding deduction but did not include the Payment as income.
5. Customer and Compliance Services, Inland Revenue (CCS) issued a notice of proposed adjustment to include the omitted income.
6. The Taxpayer argued that the Payment was a loan and that the Payment was only taxable after the expiry of the potential termination event.

## Issues | Take

7. The main issues considered in this dispute were:
  - whether the Payment was a loan; and
  - when the Payment was derived.

## Decisions | Whakatau

8. TCO concluded that:
  - the Payment received by the Taxpayer was not a loan; and

- the Payment was derived on receipt and should have been included in the relevant return.

## Reasons for decisions | Pūnga o ngā whakatau

### Issue 1 | Take tuatahi: Whether the payment was a loan

9. The Taxpayer argued that the Payment was a loan of capital at nil interest over a 2-year period.
10. CCS disagreed and considered that the Payment did not meet the statutory definition of a loan and the contractual terms did not describe the Payment as a loan.
11. If the Payment was a loan from the Agency, the amount of principal is not treated as income under the ITA 2007.

### Onus of proof

12. Section 149A of the Tax Administration Act 1994 places the onus of proof on the taxpayer and not the Commissioner.<sup>1</sup> The onus is on the taxpayer to show that an assessment is wrong, why it is wrong, and by how much it is wrong.
13. The courts have also held that the standard of proof required is the balance of probabilities.<sup>2</sup>

### What is a loan?

14. To understand whether the Payment is a loan it is necessary to consider the legal arrangements entered into by the parties:
  - It is necessary to consider, objectively, the true nature of the legal arrangements that were entered into and carried out and not the overall economic consequences. This is determined by the contract that embodies the transaction.<sup>3</sup>

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<sup>1</sup> *Case V17* (2002) 20 NZTC 10,192; *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC); *Vinelight Nominees Ltd v CIR* (No 2) (2005) 22 NZTC 19,519 (HC)

<sup>2</sup> *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Case Y3* (2007) 23 NZTC 13,028; *Case X16* (2005) 22 NZTC 12,216.

<sup>3</sup> *Buckley and Young Ltd v CIR* (1975) 2 NZTC 61,036; *CIR v Molloy* (1990) 12 NZTC 7,146.

- The aim is to ascertain the meaning the document would convey to a reasonable person having the background knowledge which would have been available to the parties at the time. Context provided by the contract as a whole and relevant background inform meaning.<sup>4</sup>
  - While context is important the text of the document remains centrally important, rather than particular words. When looking at the surrounding circumstances it is necessary to determine the agreement entered into as reflected in the documents. These circumstances cannot be used to alter the agreement.<sup>5</sup>
  - This interpretive approach to contracts is no different for tax cases.<sup>6</sup>
15. Loans are typically taxed under the financial arrangement rules in the ITA 2007. Included under the financial arrangement rules is a “debt” (s EW 3).
16. “Debt” is not defined in the ITA 2007, so it takes on its ordinary meaning. A debt can be summarised as an amount of money payable or due and that is recoverable by action.<sup>7</sup>
17. TCO also considered the definitions of “loan” and “money lent” in s YA 1. “Loan” has the same meaning as “money lent”. The definition of “money lent” specifically includes an amount that a person lends, including by depositing it in an account, whether or not secured or evidenced in writing. It also includes an amount of credit a person gives, including by not enforcing a debt, whether or not the giving of credit is secured or evidenced in writing.
18. Further, the Concise Oxford English Dictionary defines an advance and loan as follows:
- advance** ... 4. hand over (payment) to (someone) as a loan or before it is due.
- loan** n. a thing that is borrowed, especially a sum of money that is expected to be paid back with interest.

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<sup>4</sup> *Firm PI 1 Ltd v Zurich Australian Insurance and Body Corporate* 398983 [2014] NZSC 147, (2014) 10 NZBLC 99–716 and see also *Firm PI 1 Ltd v Zurich Australian Insurance and Body Corporate* 398983 [2014] NZSC 147, (2014) 10 NZBLC 99–716; *Pendarves Packaging Ltd v Baitworx Ltd* [2014] NZHC 3,327, (2015) 1 NZBLC 99–718. [2014] NZHC 3,327, (2015) 1 NZBLC 99–718; *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, (2010) 9 NZBLC 102,874; *Buckley and Young Ltd v CIR* (1975) 2 NZTC 61,036; *CIR v Molloy* (1990) 12 NZTC 7,146.

<sup>5</sup> *Firm PI 1 Ltd v Zurich Australian Insurance and Body Corporate* 398983 [2014] NZSC 147, (2014) 10 NZBLC 99–716

<sup>6</sup> *CIR v John Curtis Developments Ltd* [2014] NZHC 3,034, 26 NZTC 21-113 and see also *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* [1964] AC 948 (PC).

<sup>7</sup> The Concise Oxford Dictionary (12ed, 2011); *Case Q2* (1993) NZTC 5,005; *Colonial Mutual Life Assurance Society Limited v CIR* (1999) NZTC 1,573.

19. Similarly, the Black's Law Dictionary defines the terms as follows:
- advance**, n (17c) 1. The furnishing of money or goods before any consideration is received in return. 2. The money or goods furnished,..
- loan** 1. An act of lending; a grant of something for temporary use ... 2. A thing lent for the borrower's temporary use; esp., a sum of money lent at interest ...
20. In *CIR v Molloy*<sup>8</sup> it was found that the advance paid to the life insurance agent was not derived under the principles in *Arthur Murray*<sup>9</sup> (discussed further in Issue 2) due to the inherent risk of repayment that he held. This was based, at least in part, on the contract recording the advance as a debt.
21. Similarly, in *Case U4*<sup>10</sup> the contractual arrangements provided evidence that the advances the agent received were a loan from the outset and would only convert to revenue over time as it was progressively forgiven.

## Application

22. TCO concluded that the Payment is not a loan because:
- The substance of the Payment is determined by the terms of the Contract between the Taxpayer and the Agency, which describes the Payment as remuneration.
  - To receive the Payment, the Taxpayer was only obliged to sign the Contract and then the Agency was obliged to make the Payment. The Taxpayer's obligation to refund the Payment only arises if the Contract is terminated by the Taxpayer or the Agency within 2 years, not on signing the Contract. The potential repayment at a future time does not make the Payment a loan.
  - The Payment does not meet the definitions under the ITA 2007 for a financial arrangement, loan or money lent and does not meet the ordinary definitions of advance or loan. The terms of the Contract do not show the Payment was given to the Taxpayer temporarily with an expectation of repayment.
  - The case *Molloy* is not analogous to the current dispute. The risk of repayment in *Molloy* was significant as it was based on commissions yet to be earned and was secured by a mortgage over Molloy's assets. Additionally, the risk in *Molloy* was entirely out of the taxpayer's control as it could be triggered by unrelated third

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<sup>8</sup> *CIR v Molloy* (1990) 12 NZTC 7,146.

<sup>9</sup> *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 14 CLR 314.

<sup>10</sup> *TRA No 98/010* (1999) 19 NZTC 9,021 (*Case U4*).

parties. However, the Taxpayer in this dispute did not provide evidence that the risk of termination was significant at the time the Contract was entered into.

- *Case U4* is distinguished on the facts because in that case the amount advanced was progressively forgiven over time which was consistent with the advance being a loan. In contrast, the Contract does not provide for any forgiveness of the Payment, which suggests it was not considered a loan by the Agency.

## Issue 2 | Take tuarua: When was the payment derived

23. The Taxpayer argued that the Payment is derived after the expiry of the potential termination event, while CCS argued that it was derived on receipt.
24. Section BD 3 allocates income to income years. Income is allocated to the income year in which it is derived (s BD 3(2)). To gain an understanding of when income might be derived and whether it is returned on a cash or accruals basis, case law must be considered (s BD 3(3)).
25. TCO identified the following principles from case law:<sup>11</sup>
  - Income is derived when it flows, springs, emanates, arises, or accrues from a particular source. (*Philips case, Hawke's Bay Power*)
  - When income is derived depends on the facts of the particular case. (*Carden's case, Arthur Murray*)
  - The two methods of recognising when income is derived are the cash or accruals methods. The choice of method should show the correct reflex of the taxpayer's true income. (*Carden's case*)
  - The gains must "come home" to the taxpayer in a realised or immediately realisable form to be assessed as income. (*Carden's case, Arthur Murray*)
  - "Income" is defined by the use of the term in the practical affairs of business life. (*Carden's case; Arthur Murray*)
  - The income must be unaffected by any legal restrictions or qualifications. (*Arthur Murray*)

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<sup>11</sup> *CIR v NV Philips' Gloeilampenfabrieken* [1955] NZLR 868 (CA) (*Philips case*); *Hawke's Bay Power Distribution Limited v CIR* (1999) 19 NZTC 15,226 (CA) (*Hawkes Bay Power*); *C of T (SA) v Executor Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 (HCA) (*Carden's case*); *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 14 CLR 314 (*Arthur Murray*); *CIR v Molloy* (1990) 12 NZTC 7,146 (HC) (*Molloy*); *Bowcock v CIR* (1981) 5 NZTC 61,062 (HC) (*Bowcock*).

- The relevance of accounting practice depends on whether it gives a true reflex of income as understood in business affairs (*Arthur Murray*) and is the main consideration in determining assessable income for tax purposes. (*Carden's case*)
  - A taxpayer will not derive an advance payment received until they have rendered the contractual quid pro quo associated with the payment. This applies whether the advance payment is a true deposit or a prepayment. (*Arthur Murray*)
  - Where a receipt has significant risk of repayment that is an integral part of the receipt and even in circumstances where there is no legal requirement for repayment the amount will not have "come home". (*Arthur Murray; Molloy*)
  - Income is derived when received when the amount received becomes the absolute property of the taxpayer. This also applies when a future liability to repay the income arises because of a course of action the taxpayer chooses to take. (*Bowcock*)
26. The Taxpayer also referred to *Prices Tailors*<sup>12</sup> and *Country Magazine*<sup>13</sup> judgments to support their view that the Payment was derived upon the expiry of the possible termination event.
27. In *Prices Tailors* the court found that the payments the taxpayer received belonged to them when they had received them as there was no legal requirement to refund them. This case is also cited in *Arthur Murray* (and *Country Magazine*). TCO considered that while the Federal Commissioner relied on *Prices Tailors* in *Arthur Murray* this decision would not be persuasive law as *Arthur Murray* is the settled law.
28. *Country Magazine* accepted the general application of the *Arthur Murray* principle of delaying derivation when the taxpayer received subscriptions in advance for future magazine issues. However, in this case the Court noted that the taxpayer had not argued the matter with any substance to distinguish those principles, and TCO considered that the case provided no additional authority to that already given by *Arthur Murray*.
29. The Taxpayer referred to paragraph [65] in the Commissioner's Interpretation Statement "IS 16/06 Income tax – timing when is income from professional services derived?" to support their view that the Payment is not derived on receipt. This paragraph discusses prepayments, that is payments received in advance of any services being performed.

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<sup>12</sup> *Elson (IT) v Prices Tailors Ltd* [1963] 1 All ER 231 (ChD).

<sup>13</sup> *Country Magazine Pty Limited v FCT* (1968) 15 ADT 86.

## Application

30. TCO concluded that the Taxpayer derived the Payment at the time it was paid to them because:

- The Payment came home to the Taxpayer on receipt, there were no restrictions on the use of the Payment. (*Carden's case*)
- The Payment was not received in advance of the provision of services. It is not a prepayment. There is no nexus between the Payment and the Taxpayer's income from commissions, and therefore derivation cannot be deferred on that basis. (*Arthur Murray*)
- The fact that repayment may occur at a future time does not change the character of the Payment. (*Bowcock*)
- The risk of repayment is not entirely out of the Taxpayer's control and until a triggering event (termination of the Contract) occurs to crystallise a subsequent debt no liability exists to defer derivation of the Payment. (*Bowcock* applies; *Prices Tailors* distinguished)
- Paragraph [65] of IS 16/06 is distinguishable from the present dispute because the Payment is not a prepayment for services, it is a one-off payment for signing the Contract. This paragraph does not suggest that derivation should be deferred because it is solely concerned with the treatment of prepayments for services.