

TAX INFORMATION BULLETIN

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Inland Revenue
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RENT DEEMED TO BE PAYABLE – DEDUCTIBILITY

PUBLIC RULING – BR Pub 01/03

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

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of sections BD 2 and GD 10.

The Arrangement to which this Ruling applies

The Arrangement to which this ruling applies is a “lease” of property (whether real property or personal property), at less than an “adequate rent,” where the property is used by the lessee in the derivation of gross income or exempt income. This ruling applies when the property is owned by any person, any 2 or more persons, or partnership and is leased:

- to a “relative” of any of those persons or of any member of the partnership; or
- to a “related company”; or
- by a company to any person.

For the purposes of this Ruling the terms “lease”, “adequate rent”, and “related company” have the meanings attributed to them by section GD 10(4), and “relative” has the meaning attributed to it by section OB 1.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Rent deemed under section GD 10 to be payable by the lessee to the lessor is expenditure incurred by the lessee for the purposes of section BD 2(1)(b).

The period for which this Ruling applies

This Ruling will apply to leases entered into within the period 1 February 2001 to 31 January 2006.

This Ruling is signed by me on the 10th day of April 2001.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 01/03

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 01/03 (“the ruling”).

The ruling is a reissue of public binding ruling BR Pub 97/13, issued on 12 December 1997. The Commissioner’s view, as expressed in this ruling, is not intended to differ from BR Pub 97/13. Any changes between this ruling and the previous ruling are only intended to assist the reader’s understanding.

Background

Section GD 10 applies to leases, between a lessor and certain specified classes of lessee, where the rent payable under the lease is “less than an adequate rent”. Section GD 10 allows the Commissioner to notionally increase the amount of rent payable by the lessee to the lessor to an amount equal to an “adequate rent” and the section deems the rent thus payable to be gross income of the lessor.

Section GD 10 is directed against tax avoidance. It controls the shifting of income between family members to take advantage of different marginal tax rates, but is not limited to familial transactions. Progressive tax scales give advantages to the family unit to spread income, resulting in a reduction in the overall amount of tax paid by that unit, or the rate of tax applying to an income stream. Section GD 10 operates to limit this opportunity when related parties lease income-producing property. The effect of deeming income to be derived, based on a rent that should have been paid rather than what was paid, unwinds any advantage.

Section GD 10 applies where property (both personal and real) owned by any person, by any 2 or more persons (whether jointly or in common) or by any partnership is leased:

- to a relative of any of those persons;
- to a relative of any member of the partnership;
- to a related company;
- by a company to any person;

and the rent is either less than an adequate rent for the property or the lease makes no provision for the payment of rent.

Where those circumstances apply, section GD 10 allows the Commissioner to determine an amount of “adequate rent”, being in broad terms an amount of rent considered by the Commissioner to be adequate for the property being leased. This ruling does not consider the basis of such a determination or what is meant by either adequate or inadequate rent.

The amount of adequate rent so determined is, pursuant to section GD 10, deemed to be payable by the lessee to the lessor and is deemed to be gross income of the lessor.

This ruling considers the position of the lessee and, specifically, whether the adequate rent that is deemed payable by the lessee to the lessor is an allowable deduction of the lessee for the purposes of section BD 2.

The ruling concludes that rent deemed to be payable is an expenditure or loss incurred by the lessee under section BD 2(1)(b). It is therefore an allowable deduction if the exclusions in section BD 2(2) do not apply (such as, the exclusion of expenditure to the extent that it is of a private or capital nature, incurred in deriving exempt income, etc).

Legislation

Section BD 2(1) states:

- An amount is an allowable deduction of a taxpayer
- (a) ...
 - (b) to the extent that it is an expenditure or loss
 - (i) incurred by the taxpayer in deriving the taxpayer’s gross income, or
 - (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer’s gross income, ...

Section GD 10 states:

- (1) Where any property owned by any person or by 2 or more persons (whether jointly or in common) or by any partnership is leased to a relative of any of those persons or of any member of the partnership or to a related company or by a company to any person and the rent is less than an adequate rent for that property or the lease makes no provision for the payment of rent, -
 - (a) There shall be deemed to be payable under the lease a rent that is equal to an adequate rent for the property, and that rent shall be deemed to be payable by the lessee to the lessor on the days provided in the lease for payment of the rent, or, if no rent is payable under the lease, on such days as the Commissioner determines, and shall be deemed to be gross income derived by the lessor on the days on which the rent is deemed to be payable under this paragraph; and
 - (b) The rent deemed to be payable under paragraph (a) shall be deemed to accrue from day to day during the period in respect of which it is payable, and shall be apportioned accordingly.
- (2) This section shall apply with respect to any leased property only if and to the extent that it is used by the lessee in the derivation of gross income or exempt income.
- (3) This section shall apply whether the lease was granted before or after the commencement of the income year.

- (4) In this section-
“**Adequate rent**”, in relation to any property, means the amount of rent that the Commissioner determines to be adequate for that property during the period in respect of which the determination is made:

“**Lease**” means a tenancy of any duration, whether in writing or otherwise; and includes a sublease; and also includes a bailment; and “lessor” and “lessee” have corresponding meanings:

“**Related company**” means a company that is under the control of the lessor or any relative or relatives of the lessor or any one or more of them, or, where there are several lessors or the lessor is a partnership, under the control of any of the lessors or partners or any relative or relatives of any of the lessors or partners:

“**Rent**” includes any premium or other consideration for the lease.

Section OB 1 defines “relative” as:

“**Relative**” –

- (a) ...in relation to any person, means any other person connected with the first-mentioned person by blood relationship, marriage, or adoption; and includes a trustee of a trust under which a relative has benefited or is eligible to benefit; and for the purposes of this paragraph –
- (i) Persons are connected by blood relationship if within the fourth degree of relationship;
- (ii) Persons are connected by marriage if one is married to the other or to a person who is connected by blood relationship to the other;
- (iii) Persons are connected by adoption if one has been adopted as the child of the other or as a child of a person who is within the third degree of relationship to the other....

Application of the legislation

How section GD 10 operates

When does the section apply?

Section GD 10 operates, in limited circumstances, following a determination by the Commissioner. In order for section GD 10 to apply, the following requirements must be satisfied:

- There must be the leasing of property;
- The owner of the property must be:
 - A person (as defined in the Act, and includes a company); or
 - Any 2 or more persons (whether jointly or in common); or
 - A partnership.
- The lessee must be:
 - a relative of an owner (where the owner is a natural person); or
 - a relative of any member of the partnership that owns the property; or
 - a related company of the owner; or
 - where the lessor is a company, any person.

- Where either the stipulated rent is less than adequate or the lease is silent on the payment of rent; and
- The lessee uses the property in the derivation of gross income or exempt income.

What leased property is covered?

“Property” is not defined for the purposes of section GD 10, but in the Commissioner’s view it includes both real property (land and buildings) and personal property (property other than land and buildings). This is the usual legal meaning of “property”, but the definition of “lease” in section GD 10 also supports this interpretation.

“Lease” is defined in section GD 10(4) as a tenancy of any duration, including a sublease, and a bailment. A lease and a tenancy usually only relate to land, i.e. real property. However, a bailment only ever refers to personal property. Therefore, it is clear that section GD 10 is intended to apply to, and the word “property” is meant to refer to, both real and personal property.

Who is a relative?

“Relative” is defined in section OB 1. A relative is a person connected by “blood relationship”, marriage, or adoption. “Blood relationship” means a relationship within the fourth degree, which is ascertained by counting the relationship steps between the two people. For example, A and B are first cousins, so they are within the fourth degree of relationship, as follows:

A – A’s parent (1) – Grandparent (2) – B’s parent (3) – B (4)

Any person who marries another person within the fourth degree of relationship automatically assumes the same relationship. For example, B’s spouse is within the fourth degree of relationship to A. Similarly, both A and B’s spouses are within the fourth degree of relationship to each other.

Children adopted by a person within the third degree of relationship are also relatives.

The deeming effect of section GD 10

If the section applies to a transaction, section GD 10(1)(a) explicitly deems:

- An adequate rent to be payable under the lease;
- That adequate rent to be payable by the lessee to the lessor on the days provided in the lease for rent payment, or, where no rent is payable under the lease, on such days as the Commissioner determines; and
- Rent to be gross income of the lessor derived on the days on which it is deemed to be payable.

“Deemed” means adding to the normal meaning of words

If the Commissioner determines an adequate rent, the amount of rent payable by the lessee to the lessor is increased by the deeming effect of section GD 10 to reflect the Commissioner’s determination. In a Canadian decision, *R v Vermette* [1978] 2 SCR 838 at page 845, the Court gave a useful description of the legal effect of a deeming provision. It said:

A deeming provision is a statutory fiction; as a rule it implicitly admits that a thing is not what it is deemed to be but decrees that for some particular purpose it shall be taken as if it were that thing although it is not or there is doubt as to whether it is. A deeming provision artificially imports into a word or expression an additional meaning which they would not otherwise convey beside the normal meaning which they retain where they are used; it plays a function of enlargement analogous to the word “includes” in certain definitions; however, “includes” would be logically inappropriate and would sound unreal because of the fictional aspect of the provision.

In this case, section GD 10 deems an amount of adequate rent to be payable, even though in terms of the contract between the lessor and the lessee it is not. The section then further deems the fictional rent to be payable on specified days and finally deems the rent to be gross income of the lessor.

The section applies to a lessee

Although the section deems the rent determined by the Commissioner to be gross income of the lessor, it does not expressly state that the deemed rent is deductible by the lessee. The absence of a specified mirror treatment for the lessee could arguably support an interpretation of the section based on the proposition that it does not apply to a lessee. However, in the Commissioner’s view this is not a correct interpretation because:

1. An adequate rent is deemed by the section to be payable under the lease. The section further deems the rent to be payable by the lessee to the lessor.
2. The application of the section is dependent on the lessee’s use of the leased property for the derivation of gross income or exempt income.
3. Subsection (2) is directly concerned with the use of leased property by the lessee.
4. Section GD 10 was originally introduced as section 17 of the Land and Income Tax Amendment Act 1951. Introductory Notes supplied to the Minister on introduction of the Bill said:

This clause is designed to cover the position where a taxpayer owning an income producing property, enters into a lease under which a relative becomes entitled to the full rent or income from the property, and is required to pay to the lessor only a nominal or peppercorn rental.

...The provisions of the clause will not be applied to bona fide leases of property, even though the lessee is a relative, and will be operated by the Commissioner only where it is evident that the lease has the effect of transferring income from the taxpayer to a relative.

This demonstrates that the purpose of the provision was to prevent income splitting and the consequential reduction of tax paid. Allowing a deduction to the lessee would not negate this purpose.

These provisions support the conclusion that section GD 10 is intended to apply to both parties to a transaction.

Deeming not limited to section GD 10

The application of the deeming provisions contained in section GD 10 is not limited by the inclusion of any qualification. Elsewhere in the Act, where the effect of a provision is intended to be restricted, such sections contain a qualification such as, “For the purposes of this section...”. The absence of such a qualification indicates that the deeming provisions are intended to have effect over the rest of the Act.

In other words, having deemed an amount of adequate rent to be payable by the lessee to the lessor, that rent is payable for the wider purposes of the Act. It is not restricted to only applying to section GD 10.

Section BD 2: “incurred” requires a legal obligation to pay

An amount is an allowable deduction under section BD 2 only if it is “incurred” by the taxpayer. For the deemed adequate rent to be an allowable deduction, it must have been “incurred” by the lessee.

The term “incurred” has been held to mean that the taxpayer has either paid the expenditure or loss, or is otherwise definitively committed to pay it: (see *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351). A taxpayer is said to be definitively committed when a legal obligation to make a payment in the future can be said to have accrued.

Section GD 10 does not specifically deem the adequate rent to have been incurred by the lessee. Rather, the section deems the rent to be payable. In *Re Howell’s Application* [1972] Ch. 509, the phrase “payable by way of rent” was interpreted as meaning “... rent the tenant is under an enforceable obligation to pay...”. New Zealand courts have taken the same view. In *AM Bisley & Co Ltd v C of IR* (1985) 7 NZTC 5,082 at page 5,096, Henry J said:

...that the expenditure is not payable until some future date does not of itself destroy its nature as an existing obligation.

Therefore, where an amount is said to be “payable”, it means that the payer has an enforceable obligation to pay the amount, even where that obligation does not crystallise until some future date.

Under section GD 10(1)(a), adequate rent is deemed to be payable on the days provided in the lease for payment, or on such days as the Commissioner determines. This means that the Act operates as if there was an obligation to pay the rent. The Commissioner's view is that by deeming the amount to be payable, that has the same effect as deeming that a legal obligation has been created and therefore as far as section BD 2(1)(b) is concerned an expenditure has been incurred.

The obligation in *Bisley* was an existing legal obligation to make expenditure that became payable on a future date. Thus, there are two types of expenditure that qualify as "incurred": existing legal obligations payable now, and those that will become payable in the future. For expenditure either to be payable or to become payable, there must be an existing obligation to pay either now or later. Rent deemed to be payable falls within the first category, and is clearly "incurred".

The nexus between expenditure and income is not affected by deeming

If the leased property is used in the derivation of gross income, any rental paid by the lessee, including a less than adequate rent, is deductible (unless specifically excluded by section BD 2(2)). The required statutory nexus establishing deductibility is therefore present between the expenditure and the income. A determination by the Commissioner does not alter the quality of that expenditure, but merely alters the amount of the expenditure.

Conclusion

Rent deemed to be payable under section GD 10 is expenditure incurred by the lessee under section BD 2(1)(b).

Examples

Example 1

A leases a flat to her daughter B for \$10 per week. B then rents it to tenants for \$400 per week. A has other income of \$50,000 and is on a marginal tax rate of 33c in the dollar. B has no other income and pays 19.5c in the dollar. As B's tax bracket is lower than A's, there is less tax being paid overall than if A rented the flat to the tenants directly.

The Commissioner may determine that an adequate rent is higher than \$10 per week. Section GD 10 will apply to deem the determined rent to be the rent payable by B to A. The adequate rent is deemed to be gross income derived by A. The rent deemed payable is expenditure incurred by B, as there is deemed to be a legal obligation to pay.

Example 2

C Ltd, a company, leases a property to X, a charitable body, at an inadequate rental. X uses the property in the derivation of exempt income.

A "person" includes a company and an unincorporated body of persons (section OB 1) and therefore X. Section GD 10(1) applies to a lease of property "by a company to any person" at an inadequate rent. Under subsection (2), the section applies to the extent that the property is used by the lessee in the derivation of gross income or exempt income. An adequate rent determined by the Commissioner is therefore deemed payable. Although a deduction is allowed under section BD 2(1), this is denied by section BD 2(2)(b) as the expenditure is incurred in the derivation of exempt income. In this case, C derives gross income in the amount of the adequate rent, but X is unable to claim a matching deduction.

ASSESSABILITY OF PAYMENTS UNDER THE EMPLOYMENT RELATIONS ACT FOR HUMILIATION, LOSS OF DIGNITY, AND INJURY TO FEELINGS

PUBLIC RULING – BR Pub 01/04

Note (not part of ruling): This ruling replaces Public Rulings BR Pub 97/3 and 97/3A published in *TIB* Vol 9, No 3 (March 1997). This new ruling is essentially the same as the previous rulings. The main changes take into account the new employment legislation, update relevant case references, and the ruling clarifies the Commissioner's approach to out of court settlements where he has some doubt about the amount attributed to humiliation, loss of dignity, or injury to feelings. The ruling applies from 1 October 2000 to 30 September 2005.

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 1994 unless otherwise stated.

This Ruling applies in respect of sections CD 5, CH 3, NC 2, and the definition of "monetary remuneration" in section OB 1 of the Income Tax Act 1994.

The Arrangement to which this Ruling applies

The Arrangement is:

- The making of a payment to an employee or former employee for humiliation, loss of dignity, or injury to feelings under section 123(c)(i) of the Employment Relations Act 2000; or
- The making of a payment to an employee or former employee pursuant to an out of court settlement genuinely based on the employee's rights to compensation under section 123(c)(i) of the Employment Relations Act 2000.

This Ruling does not, however, apply to such payments that are in reality for lost wages or other income, but which are merely characterised by the parties as being for humiliation, loss of dignity, or injury to feelings (irrespective of whether such an agreement is signed by a mediator under the Employment Relations Act).

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- Payments that are genuinely and entirely for compensation for humiliation, loss of dignity, or injury to feelings under section 123(c)(i) of the Employment Relations Act 2000 are not "monetary remuneration" in terms of the definition in section OB 1 of the Income Tax Act 1994. Consequently, such payments do not form part of the gross income of the employee under section CH 3.
- Such compensation payments are not gross income under ordinary concepts under section CD 5.
- There is consequently no liability under section NC 2 for employers or former employers to deduct PAYE from these payments.

The period for which this Ruling applies

This Ruling will apply to payments received between 1 October 2000 and 30 September 2005.

This Ruling is signed by me on the 18th day of April 2001.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 01/04

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 01/04 (“the Ruling”).

The subject matter covered in the Ruling was previously dealt with in Public Rulings BR Pub 97/3 and 97/3A published in *TIB* Vol 9, No 3 (March 1997) at page 7. The Ruling applies for the period from 1 October 2000 to 30 September 2005.

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 humiliation, loss of dignity, or injury to the feelings of the employee.

The Employment Relations Act also establishes specialist institutions with exclusive jurisdiction to deal with the rights of parties litigating on employment contracts: the Employment Relations Authority and the Employment Court. The Employment Relations Service of the Department of Labour has jurisdiction to provide mediation services.

Section 103(1) of the Employment Relations Act 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 123 of the Employment Relations Act provides a number of remedies available to the Authority or Court when the Authority or Court determines that an employee has a “personal grievance” including:

- ...
- (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:
- (c) the payment to the employee of compensation by the employee’s employer, including compensation for -
 - (i) humiliation, loss of dignity, and injury to the feelings of the employee; and
 - (ii) loss of any benefit, whether or not of a monetary kind, which the employee might reasonably have been expected to obtain if the personal grievance had not arisen:

The Ruling considers whether such payments for humiliation, loss of dignity, or injury to the feelings of the employee are “monetary remuneration”. Paragraph (a) of the definition of “monetary remuneration” in section OB 1 states:

“Monetary remuneration” ...means any salary, wage, allowance, bonus, gratuity, extra salary, 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;...

Section CH 3 states that “all monetary remuneration derived by a person is gross income”.

Section CD 5 also states that “the gross income of a person includes any amount that is included in gross income under ordinary concepts”.

Application of the Legislation

If payments for humiliation, loss of dignity, or injury to feelings, under section 123(c)(i) of the Employment Relations Act 2000 are “monetary remuneration”, they would be included under section CH 3 as gross income. They would be included in the calculation of “net income” under section BC 6 and would consequently form part of “taxable income” as calculated under section BC 7.

Section OB 1 defines “monetary remuneration” to include any “other benefit in money, in respect of or in relation to the employment or service of the taxpayer...”.

Payments under section 123(c)(i) of the Employment Relations Act are a benefit in money. The issue is, therefore, whether these payments are made “in respect of or in relation to the employment or service of” the recipient.

The meaning of “in respect of or in relation to”

The phrase “in respect of or in relation to” is capable of having a very wide meaning. For example, in *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11,303, the Court of Appeal was dealing with certain lump sum payments made by Shell to employees who transferred at the request of Shell. The Court discussed the definition of “monetary remuneration”. The case concerned the part of the definition of “monetary remuneration” which says:

... emolument (of whatever kind), or other benefit in money in respect of or in relation to the employment or service of the taxpayer.

McKay J, delivering the judgment of the Court, said at page 11,306 that:

The words “in respect of or in relation to” are words of the widest import.

Although McKay J acknowledged that the payments in *Shell* were not made under the contract of employment in that case, this did not mean that the employees received the payment outside the employment relationship. The learned Judge had earlier referred to the fact that the payments were not expressly provided under the employees’ written employment contracts but were made pursuant to Shell’s employment policy as a matter of discretion. They were still made “because he or she is an employee”.

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”.

Context may affect the meaning

However, many cases have demonstrated that the meaning to be given to the phrase “in respect of or in relation to” may vary according to the context in which it appears.

In *State Government Insurance Office v Rees* (1979) 144 CLR 549, the High Court of Australia considered the meaning of the phrase “in respect of” in determining whether the debt due to the Government Insurance Office fell within section 292(1)(c) of the Companies Act 1961-1975 (Q.) as “amounts ... due in respect of workers’ compensation under any law relating to workers’ compensation accrued before the relevant date”. The Court held that amounts which could be recovered by the Government Insurance Office from an uninsured company pursuant to section 8(5) of the Workers’ Compensation Act 1916-1974(Q.) for money paid to workers employed by the uninsured company were **not** amounts due “in respect of” workers’ compensation under the Companies Act.

At page 561 Mason J observed that:

... as with other words and expressions, the meaning to be ascribed to “in respect of” depends very much on the context in which it is found.

Stephen J also discussed the meaning of the phrase “in respect of”, noting at pages 553-554 that it was capable of describing relationships over a very wide range of proximity, and went on to say:

Were the phrase devoid of significant context, it could, I think, be taken to be descriptive of the relationship between the present indebtedness owed to the State Government Insurance Office and the subject matter of workers’ compensation. However a context does exist which is in my view sufficient to confine the operation of s 292(1)(c) to bounds too narrow to be of service to the appellant.

In *TRA Case R34* (1994) 16 NZTC 6,190, certain payments were made to a New Zealand distributor by its overseas parent in relation to repairs which had to be made to cars sold to the New Zealand subsidiary and then sold to dealers. The issue was whether the payments were zero-rated. The definition of “consideration” in section 2 of the Goods and Services Tax Act 1985 was relevant. Part of the definition of “consideration” states:

...any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services ...

The TRA stated at page 6,200 that:

A sub-issue is whether the reimbursing payment from the overseas manufacturer (MC) was made “in respect of, in response to, or for the inducement of” the repair work in the sense required by the definition of “consideration” in s 2 of the Act. ... Although the definition of consideration creates a very wide potential link between a payment and a particular supply it is, in any case, a matter of degree, commonsense, and commercial reality whether a payment is direct enough to have the necessary nexus with a service, i.e, whether the link is strong enough.

The High Court’s decision on the appeal of *Case R34* is *CIR v Suzuki New Zealand Ltd* (2000) 19 NZTC 15,819. McGechan J said:

...it is necessary there be a genuine connection. The legislature is not to be taken as taxing on an unrealistic or tenuous connection basis.

Not all payments to employees are “monetary remuneration”

While it is true that an employee would not receive a payment under section 123(c)(i) of the Employment Relations Act if he or she were not an employee, it would seem clear that this type of “but for” approach to “in respect of or in relation to” is not universally applied in the context of employment, and that not all payments to employees which have a connection with their work are within the definition of “monetary remuneration”. In *Fraser v CIR* (1995) 17 NZTC 12,356, at page 12,363, Doogue J in the High Court said:

There is no dispute that the words “emolument (of whatever kind), or other benefit in money, in respect of or in relation to the employment or service of the taxpayer” are words of the widest possible scope: see *Shell New Zealand Ltd v C of IR* (1994) 16 NZTC 11,303 at p 11,306, and *Smith v FC of T* 87 ATC 4883; (1987) 164 CLR 513; (1987) 19 ATR 274. Mr Harley does, however, submit, correctly, that it does not follow that all payments made are necessarily income and refers, for example, to reimbursement payments.

In *Shell*, McKay J highlighted the fact that the payments in that case were **both**:

- made to the recipients because they were employees, **and**
- paid to compensate for the loss incurred by the employee in having to relocate in order to take up a new position with the employer.

Many cases have concluded that, in appropriate circumstances, amounts received were not income, or assessable, even though paid by an employer to an employee.

In *FC of T v Rowe* (1995) ATC 4,691, for example, the taxpayer was employed as an engineer for the Livingston Shire Council. As a result of a number of complaints against him he was suspended. An inquiry was commenced, and he incurred legal costs as a result of engaging counsel to defend himself against dismissal during the course of the inquiry. The taxpayer was cleared of any charges of misconduct but was dismissed a year later. The taxpayer claimed his legal costs as a deduction. Although the Council refused to reimburse the taxpayer for his legal costs, the Queensland government subsequently made an *ex gratia* payment to him.

The Full Federal Court considered, amongst other things, whether the *ex gratia* payment constituted assessable income. By majority, the Court concluded that the payment was not assessable under section 25(1) of the Australian Income Tax Assessment Act 1936 as income in accordance with ordinary concepts, nor was it assessable under section 26(e) of that Act as being compensation “in respect of, or for or in relation directly or indirectly to” any employment.

Accordingly, Burchett and Drummond JJ (with Beaumont J dissenting) held that the payment was not assessable. Burchett J held that the payment was **not a reward for the taxpayer’s services but was a recognition for the wrong done to him**. The payments were not remuneration but a reparation, and they were not sufficiently related to the performance of income-earning activities. On the same reasoning, it was too remote from the employment to be caught by section 26(e). Further, the payment was not assessable under section 26(e) because the employer/employee relationship between the Council and the taxpayer was **merely part of the background facts** against which the *ex gratia* payment was made. On appeal, the majority of the Full High Court confirmed the Federal Court’s decision: *FC of T v Rowe* (1997) ATC 4,317.

Other cases, relating to wartime service, have also shown that payments made to present or former employees for reasons unconnected with their service as an employee will not necessarily be assessable income on a “but for” basis. In *Louisson v Commissioner of Taxes* [1943] NZLR 1, at page 9 Myers CJ and Northcroft J said of payments made by an employer to a former employee who had enlisted in the New Zealand Expeditionary Force in World War II:

In our opinion, such payments were personal gifts to each of the employees coming within the description in the resolution - gifts made simply as an acknowledgment of personal appreciation of the sacrifice made in the service of the Country by persons whose employment with the company has ceased and who are under no engagement to return to that employment.

Similarly, in the Australian case of *FCT v Dixon* (1954) 5 AITR 443, the taxpayer received payments from his prior employer topping up his military pay. It would appear from the judgment that the Australian Commissioner argued that even a slight relationship to employment was sufficient to satisfy the test in section 26(e) of the Australian Income Tax Assessment Act 1936 [which made assessable certain sums granted to the taxpayer “in respect of, or for or in relation directly or indirectly to, any employment...”]. This argument was rejected by Dixon CJ and Williams J, who stated at page 446 that:

We are not prepared to give effect to this view of the operation of s.26(e) ...There can, of course, be no doubt that the sum of £104 represented an allowance, gratuity or benefit allowed or given to the taxpayer by Macdonald, Hamilton and Company. Our difficulty is in agreeing with the view that it was allowed or given to him in respect of, or in relation directly or indirectly to, any employment of, or services rendered by him ...We are not prepared to give s.26(e) a construction which makes it unnecessary that the allowance, gratuity, compensation, benefit, bonus or premium shall in any sense be a recompense or consequence of the continued or contemporaneous existence of the relation of employer and employee or a reward for services rendered given either during the employment or at or in consequence of its termination.

In the same case, at page 450, McTiernan J stated that:

The words of paragraph (e) are wide, but, I think, not wide enough to prevent an employer from giving money or money's worth to an employee continuing in his service or leaving it, without incurring liability to tax in respect of the gift. The relationship of employer and employee is a matter of contract. The contractual relations are not so total and all embracing that there cannot be personal or social relations between employer and employee. A payment arising from those relations may have no connexion with the donee's employment.

These principles have also been applied by the courts in cases involving contracts for services. In *Scott v FCT* (1969) 10 AITR 367, Windeyer J in the High Court of Australia, considered the meaning of the words "in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him" in section 26(e) of the Income Tax and Social Services Contribution Assessment Act 1936–1961. The case concerned a solicitor who received a gift of £10,000 from a grateful client. Windeyer J stated at page 374 that the meaning of the words of the legislation "must be sought in the nature of the topic concerning which they are used". Windeyer J at page 376 referred to a passage from the judgment of Kitto J in *Squatting Investment Co Ltd v FCT* (1953) 5 AITR 496, at 524, where Kitto J (speaking of certain English cases) said:

The distinction these decisions have drawn between taxable and non-taxable gifts is the distinction between, on the one hand, gifts made in relation to some activity or occupation of the donee of an income-producing character ... and, on the other hand, gifts referable to the attitude of the donor personally to the donee personally.

Adopting this as a general principle, his Honour held that the £10,000 was not given or received as remuneration for services rendered and it did not form part of the taxpayer's assessable income.

A recent case discusses the words "in respect of the employment" in the Australian FBT legislation: *J & G Knowles & Associates Pty Ltd v FC of T* (2000) ATC 4,151. The case concerned interest-free loans to directors of a corporate trustee. Units in the trust fund were held by discretionary family trusts established by the directors. The lower courts were satisfied by a causal relationship, or a discernible and rational link between the loans and each director's employment. However, the Full Federal Court said that there had to be more than just *any* causal relationship between the benefit and the employment: the link had to be *sufficient* or *material*.

The nature and context of the payments

Looking at the nature and context of payments contemplated by section 123(c)(i), it is strongly arguable that they do not intrinsically result from the employee and employer relationship. It is true that if the employee were not an employee then there would

be no entitlement to receive the payment, but payments under section 123(c)(i) of the Employment Relations Act for humiliation, loss of dignity, or injury to feelings are **not** compensation for services rendered or for actions that occur in the normal course of the employment relationship. They are based on the existence of a personal grievance.

Provisions for such compensation can be seen as being included in the Employment Relations Act because the sometimes unequal power of the parties to the employment contract means that such personal grievances may be likely to occur in that setting. It is noteworthy that the Human Rights Act 1993 also includes provisions for dealing with discrimination and sexual harassment of employees, even though that is not "employment legislation" at all.

It is also possible to analyse a breach of the terms of the employment contract giving rise to the personal grievance (and the subsequent compensation) as literally being outside the employment contract because of the breach of the terms of the contract.

Payments of compensation under section 123(c)(i) of the Employment Relations Act differ markedly from the situation in *Shell v CIR*. In that case at page 11,306, McKay J said:

It is true ...that the payment is not made under the contract of employment...It is nevertheless paid to an employee only because he or she is an employee, **and** is paid to compensate for the loss incurred in having to change the employee's place of residence in order to take up a new position in the company. (Emphasis added)

Thus, in the *Shell* case, the employees received the payments as employees, **and** in order to compensate for the loss sustained as a result of the employment-related relocation.

In the ordinary course, the Commissioner considers genuine payments under section 123(c)(i) to be too remote from the employment relationship to be within the definition of monetary remuneration. The Commissioner considers that the employment relationship in such instances is merely part of the background facts against which the compensation payments are made. The payments are not made "in respect of or in relation to the employment or service of the taxpayer".

At first glance, it may be thought that this approach conflicts with the outcome in *Case L78* (1989) 11 NZTC 1,451, where Barber DJ held that an *ex gratia* payment, to compensate for the employer's failure to give adequate notice of redundancy, was assessable as "monetary remuneration". However, the result in that case turned substantially on the objector's evidence as to the receipt being in the nature of "extra wages".

Barber DJ stated at page 1,455 that:

The objector himself related the \$7,009.52 to extra holiday pay and sick leave. ... At the end of his cross-examination he said that it was “really a bonus” and he regarded \$7,009.52 as “extra wages”. The character of the payment must be of a revenue nature. It is not a payment in the nature of capital. I consider that it is clearly within the definition of monetary remuneration in sec 2.

There is also the later TRA decision in *Case L92* (1989) 11 NZTC 1,530, where Barber DJ again considered the definition of “monetary remuneration”. This case also concerned an employee who was made redundant and an employer who did not comply with the requirement to give adequate notice. Barber DJ held that the payment came within the definition of “monetary remuneration” and was assessable income. However, the Authority did not consider any cases (other than his own previous decision in *Case L78*) on the correct characterisation of receipts for tax purposes, but rather concentrated upon the need to interpret “monetary remuneration” in a “wide manner” and the fact that the amount was received as compensation for loss of employment. Such compensation is specifically referred to in the definition of monetary remuneration. Recognising that it was possible for some receipts of a capital nature to be assessable income under a specific provision, Barber DJ at page 1,537 stated:

In this case, the words in sec 2 “compensation for loss of office or employment, emolument (of whatever kind), or other benefit in money” must surely cover not only a revenue type of payment such as a payment for lost wages, but also any other form of compensation for loss of employment.

It may also be relevant to observe that both of these TRA decisions concerned settlements under the Industrial Relations Act 1973. This earlier legislation made no specific and separate provision for compensation payments for humiliation, loss of dignity, or injury to feelings.

It is also thought that payments of the type under consideration in this Ruling are to be distinguished from those considered in American cases such as the *Commissioner v Schleier* 95-USTC 50,309. In that case, the United States Supreme Court held that certain punitive damages were assessable to the recipient employee. However, apart from the differing statutory context in the United States Internal Revenue Code, these damages were punitive because they related to a deliberate breach of the Age Discrimination in Employment Act and that Act does not provide for a separate recovery of compensatory damages for pain and suffering or emotional distress. The New Zealand Court of Appeal in *Air New Zealand Ltd v Johnston* [1992] 1 NZLR 159 seemingly rejected the view that humiliation type payments to employees are punitive in nature rather than compensatory. In that case Cooke J held at page 168 that “the emphasis

evidently placed by the Labour Court on the punitive aspect does justify, in my opinion, a radical interference with their award.” The award of \$135,000 was replaced with one of \$25,000, made up of \$15,000 for future economic loss and \$10,000 for injury to feelings.

Income under ordinary concepts

Compensation payments genuinely made under section 123(c)(i) of the Employment Relations Act 2000 are not “gross income under ordinary concepts” under section CD 5. Unlike the statutory definition of “monetary remuneration”, section CD 5 can only apply when the payments received are “income” according to ordinary concepts.

Although the legislation does not define “gross income under ordinary concepts”, a great number of decided cases has variously identified the concept by reference to such characteristics as periodicity, recurrence, and regularity, or by its resulting from business activities, the deliberate seeking of profit, or the performance of services. Nor do capital receipts form part of “gross income” unless there is a specific legislative provision to the contrary. It is clear that payments under section 123(c)(i) will not generally be made periodically or regularly, or generally recur. Nor as we have seen above, are they compensation for services. And by analogy with common law damages, they are of a capital nature.

This point is acknowledged by Barber DJ in *Case L92*, where he stated at page 1,536 that:

I appreciate only too well that it is possible to interpret the evidence as showing that the \$7,179.30 was formulated as a payment in the nature of common law damages for human hurt and breach and unfairness... I appreciate that the latter concepts are akin more to payments of capital than to wage revenue.

Out of court settlements

Sometimes, an employee and an employer negotiate a settlement out of court. The settlement agreement may state that the payment is for humiliation, loss of dignity, or injury to feelings. In return for the employee surrendering his or her rights under the Employment Relations Act, the employer will agree to pay a sum of money. There should be no difference in the tax treatment of the payments dependent on whether or not the parties use the Employment Relations Authority or Employment Court. A payment can be for humiliation, loss of dignity, or injury to the feelings of the employee whether the Authority or Court are involved or not.

Shams

The Ruling will not apply to payments which are akin to sham payments. A sham is a transaction set up to conceal the true intention of the parties and is inherently ineffective. The nature of a sham was discussed by Diplock LJ in *Snook v London and West Riding Investment Ltd* [1967] 1 All ER 518 at 528 where he stated:

I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the “sham”, which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.

Richardson J, in the New Zealand case of *Mills v Dowdall* [1983] NZLR 154, stated that the “essential genuineness of the transaction is challenged” in a sham situation.

It is noteworthy that in the Taxation Review Authority decision *Case S 96* (1996) 17 NZTC 7,603, Judge Barber stated at page 7,606:

Of course, seemingly excessive allocations to compensation for feelings injury should be reopened by the IRD.

If the parties to an agreement agree to characterise or describe payments as being for humiliation, loss of dignity, or injury to feelings when they are in reality for lost wages, this transaction would be a sham which would be open to challenge by the Commissioner. Where the Commissioner has some doubt about the amount attributed to humiliation, loss of dignity, or injury to feelings, he may ask the parties to an agreement what steps they took to evaluate objectively what would be a reasonable amount to attribute to humiliation, loss of dignity, or injury to feelings. This would be so regardless of whether the payment was made as a result of an out of court settlement and whether or not the agreement is signed by a mediator under the Employment Relations Act. Further, as provided by section 18 of the Taxation Review Authorities Act 1994 and section 136(16) of the Tax Administration Act 1994, the onus of proof in a hearing regarding the assessability of any such payment would be on the taxpayer.

NEW LEGISLATION

TAX IMPLICATIONS OF THE PROPERTY (RELATIONSHIPS) AMENDMENT ACT 2001

Summary

As a result of the enactment of the Property (Relationships) Amendment Act 2001 on 3 April 2001, the Matrimonial Property Act 1976 has been extended to de facto relationships (including same sex couples) and renamed the Property (Relationships) Act 1976. Provisions in the Revenue Acts dealing with matrimonial transfers, including a gift duty exemption in section 75A of the Estate and Gift Duties Act 1968, have also been extended to de facto relationships.

Background

Public Information Bulletin 126, published in April 1984, explains the income tax treatment of matrimonial transfers. The principal effect of specific tax provisions is that such transfers of income producing property will, as far as possible, not create a liability for income tax at the time the transfer is made.

The Estate and Gift Duties Act 1968 also contains a gift duty exemption for matrimonial transfers. The exemption provides that no gift will arise when a distribution of matrimonial property:

- is made by and in accordance with a matrimonial agreement, and
- does not result in a person to whom the disposition is made having legal and equitable interest in more than half of the matrimonial property of the couple.

These provisions applied only to married couples. There was no legislative provision for the division of property when a de facto relationship ended. On the breakdown of such relationships, the partner with legal title of the property retained it unless the other partner could establish a beneficial interest in it. To establish an interest, the non-owning partner had to rely on general law, particularly trust law.

Property (Relationships) Amendment Act 2001

The Property (Relationships) Amendment Act 2001 establishes one rule for the division of relationship property which will apply to both married couples and de facto couples. On the division of relationship property, each of the partners will be entitled to share equally in the family home, the family chattels, and any

other relationship property. However, if there are extraordinary circumstances that make equal sharing of the relationship property “repugnant to justice”, or the relationship is of short duration, each partner’s share is to be determined in accordance with his or her contribution to the partnership relationship.

People who enter into de facto relationships choose not to marry, and may wish to enter into contracting out agreements to preserve their autonomy in property terms. The Amendment Act recognises contracting out agreements entered into by de facto couples from 1 August 2001. The intention is to ensure that such agreements will have effect as soon as the rest of the Act comes into effect on 1 February 2002.

Tax implications

The gift duty exemption in section 75A of the Estate and Gift Duties Act 1968 has been extended to de facto couples.

The definition of “matrimonial agreement” in section OB 1 of the Income Tax Act 1976 has been amended to include:

- an agreement made under Part 6 of the Property (Relationships) Act 1976: or
- an order of the Court made under section 25 of the Property (Relationships) Act 1976.

This has the effect of extending references to “matrimonial agreement” to include agreements and court orders applying to de facto couples.

Section CL 6 of the Income Tax Act 1994 provides an exception to the imposition of income tax on withdrawals from superannuation funds if the withdrawal is necessary to settle the division of matrimonial property. This section has also been extended to withdrawals for the purpose of property settlements following the end of a de facto relationship.

Application date

The extension of the gift duty exemption to de facto couples applies from 1 August 2001, the date from which agreements can be made by those couples.

Other changes apply from 1 February 2002, the date the Property (Relationships) Amendment Act 2001 comes into force.

NO TAX ON *EX GRATIA* PAYMENTS TO JAPANESE EX-PRISONERS OF WAR AND CIVILIAN INTERNEES

The Government announced on 24 April 2001 that it would make *ex gratia* payments to Japanese ex-prisoners of war and civilian internees. These payments are not in the nature of income, so they will not be subject to income tax.

The payments are in recognition of unique and extreme hardship endured in Japanese prison camps. The UK Government recently announced it would make similar payments.

The nature of a payment is a significant factor in determining its tax status. Case law (*Reid v CIR* [1985] 7 NZTC 5,176) confirms that when examining the quality of a receipt in the hands of the recipient consideration must be given to the relationship between the person making the payment and the recipient and the purpose behind the payment.

None of these considerations suggests that the payments are in the nature of income. Accordingly, the payments are not subject to income tax.

TAXATION (BENEFICIARY INCOME OF MINORS, SERVICES-RELATED PAYMENTS AND REMEDIAL MATTERS) ACT 2001 01/4

The Taxation (Beneficiary Income of Minors, Services-related Payments and Remedial Matters) Bill was introduced into Parliament on 16 October 2000. Legislation resulting from the bill's passage through Parliament was enacted on 27 March 2001.

The main features of the bill as introduced were measures to tax certain trust distributions to minors at 33% and to make restrictive covenant and exit inducement payments taxable. Legislation added to the bill at the select committee stage of its passage included remedial amendments to the multi-rate fringe benefit tax rules enacted last year.

The Taxation (Beneficiary Income of Minors, Services-related Payments and Remedial Matters) Act 2001 amends the following: the Income Tax Act 1994, the Income Tax Act 1976, the Tax Administration Act 1994, the Goods and Services Tax Act 1985, the Stamp and Cheque Duties Act 1971, and the Taxation (GST and Miscellaneous Provisions) Act 2000.

CHANGES TO INCOME TAX ACT 1994

TAX ON STAKE MONEY WON ON OVERSEAS RACES

Section CB 9

Introduction

Stake money won by horses or greyhounds competing in overseas races is exempt from income tax.

Background

Stake money is the prize money paid to the owner of a horse or greyhound that wins a race. Stake money paid in respect of a race held in New Zealand has been exempt from income tax since 1965. Stake money won in an overseas race was taxable, however, if the owner participated in the race as part of a business, expenses incurred in racing, whether in New Zealand or overseas, were generally not deductible.

Overseas racing was not considered when the tax exemption for stake money won domestically was introduced in 1965. This was probably because sending horses overseas to race at this time was not as common as it is today.

A key tax principle is that business activities are subject to income tax whereas hobbies are not. Racing can be undertaken either to increase the value of bloodstock (breeding-related racing) or for the

personal entertainment of the owner (non-breeding related racing). As, on average, an owner can expect that the expenses incurred in racing exceed the stake money won, the Government considered that non-breeding related racing, undertaken domestically or internationally, is more like a hobby than a business activity, so should not be subject to income tax.

Although breeding-related racing may be closely associated with a breeding business, to limit avoidance opportunities and tax-driven behaviour, it was considered that stake money won in breeding related racing, whether undertaken domestically or internationally, should also not be subject to income tax.

Key features

Section CB 9(ca) treats as exempt income stake money won by a horse or greyhound in an overseas race.

Application date

The amendment has been backdated to apply from the 1995–1996 income year.

SERVICES-RELATED PAYMENTS: RESTRICTIVE COVENANTS AND EXIT INDUCEMENTS

Introduction

Amendments have been made to the Income Tax Act 1994 to tax certain services-related payments, namely “restrictive covenant” and “exit inducement” payments. A “restrictive covenant” payment is the consideration given for a restriction on a person’s ability to perform services. An “exit inducement” payment is the consideration given by a prospective employer or contractor to a person for giving up a particular status or position.

These payments posed a risk to the personal services income tax base because they were previously non-taxable to the recipient and could be paid in substitution for taxable personal services income¹ (including salary or wages), and they may have been deductible in some cases to the payer.

In addition to the amendments making restrictive covenant and exit inducement payments taxable, there are a number of associated amendments. These include excluding restrictive covenant payments connected with the sale of a business from the charging provision, excluding expenditure on restrictive covenants and exit inducements from the capital prohibition rule, and including restrictive covenant and exit inducement payments made to employees within the PAYE rules.

Background

The New Zealand tax system generally maintains a capital-revenue boundary: capital receipts are generally not taxed, whereas revenue receipts are taxed. This boundary became problematic in the context of certain services-related payments, in particular, restrictive covenant and exit inducement payments.

The New Zealand courts had held that payments for restrictive covenants² and exit inducements³ were non-taxable capital receipts. Payments that would generally be taxable in the same manner as wages and salary were therefore capable of being characterised as these non-taxable capital payments.

¹ In this article “personal services income” means payments made under both contracts of service (employment contracts) and contracts for services. It also includes payments made to office holders. References in this article to “services” or “personal services” generally include employment, and being an independent contractor and office holder. Also, examples of employment situations generally include independent contracting and office holding.

² *Henwood v Commissioner of Inland Revenue* (1995) 17 NZTC 12,271, *Commissioner of Inland Revenue v Fraser* (1996) 17 NZTC 12,607.

³ *Commissioner of Inland Revenue v Fraser, Case U8* (1999) 19 NZTC 9,068.

This created a risk to the personal services income tax base, which was increased by the possibility that the payments were deductible in some cases to the payer.

The Committee of Experts on Tax Compliance (1998) reviewed the treatment of restrictive covenant and exit inducement payments and recommended that the Government consider legislation to make them taxable.

In June 2000, the Government released an issues paper containing proposals to address the revenue risk posed by these services-related payments by making them taxable.

Key features

The main amendments are the restrictive covenant charging provision (new sections CHA 1 and GC 14F of the Income Tax Act 1994), the exit inducement charging provision (new section CHA 2), deductibility matters (new sections DJ 20, DJ 21 and EO 6) and the PAYE rules (section OB 1).

Under the amendments relating to restrictive covenants (sections CHA 1 and GC 14F):

- If a person gives an undertaking that restricts, or is intended to restrict, the person’s ability to perform services as an employee, office holder or independent contractor, any amount derived by that person or any other person in respect of the undertaking is taxable to that person.
- A restrictive covenant payment received on the sale of a business is excluded from the restrictive covenant charging provision. (This exclusion applies only if a number of conditions are satisfied.)
- A specific anti-avoidance provision is intended to ensure that the charging provision cannot be circumvented by an arrangement such as an employee making a restrictive covenant agreement with a wholly-owned company, the shares in which the employee subsequently sells to his or her employer.

The charging provision for exit inducements (section CHA 2) taxes any amount derived by a person for a loss of a vocation, position or status, or for leaving a position.

Under the deductibility amendments (sections DJ 20, DJ 21 and EO 6):

- Express relief from the exclusion for capital expenditure is provided for persons who incur expenditure on making restrictive covenant and exit inducement payments. This facilitates their being able to deduct such payments, thereby maintaining consistency with the treatment of expenditure on salary and wages and other payments for services.
- Restrictive covenant and exit inducement payments are non-deductible to the extent that the payments relate to work of a capital nature undertaken by the recipient employee, office holder or independent contractor. (Ordinary remuneration is similarly non-deductible in such a situation.)

Employee recipients of restrictive covenant payments who have been taxed on them are allowed a deduction to the extent that they have to refund the payment because they do not comply with the covenant for its full term.

Restrictive covenant and exit inducement payments made to employees are included within the PAYE rules (section OB 1).

The ordinary tax accounting principles and provisions of the Income Tax Act 1994 apply to determine the time at which services-related payments are included in gross income or allowed as a deduction.

Application date

The new charging provisions apply to amounts derived on and after 27 March 2001. This includes such amounts derived in respect of arrangements made before 27 March 2001.

The deductibility amendments generally apply to expenditure incurred on and after 27 March 2001. These amendments also apply to expenditure incurred on restrictive covenant and exit inducement payments before this date if those payments are gross income to another person under either section CHA 1 or section CHA 2.

Restrictive covenant payments

Restrictive covenant charging provision

New section CHA 1(1) provides that if a person gives an undertaking that restricts, or is intended to restrict, the person's ability to perform services as an employee, office holder or independent contractor, any amount derived by that person or any other person in respect of the undertaking is taxable to that person.

This charging provision is quite broad in that the contract to provide services and the restrictive covenant undertaking can be with different persons. It should cover any combination of payment and agreement between multiple entities by focusing on the restrictive covenant payment itself. This would include, for example, an arrangement such as that in the *Fraser* case, in which four entities were involved in the transaction.

The charging provision applies to any undertaking (not just a contract), whether or not the undertaking is legally valid.

The reference to "amount" in section CHA 1 uses the definition of "amount" in section OB 1, which includes any amount in money's worth. The charging provision is, therefore, sufficiently broad to cover in-kind consideration, not just monetary payments.

Sale of business exclusion from restrictive covenant charging provision

Section CHA 1(2) contains a specific exclusion for restrictive covenant payments made in connection with the sale of a business. This exclusion has been made because the main focus of the amendment is to tax restrictive covenant payments that can be substituted for taxable income from services. Restrictive covenant payments received on the sale of a business are part of a larger capital receipt (the purchase price of a business) and are less likely to be substituted for taxable income from services.

The exclusion for restrictive covenant payments made on the sale of a business applies only if four conditions are satisfied. These conditions are designed to ensure that the exclusion cannot be used to undermine the reform to tax restrictive covenant payments that can be substituted for income from services. These conditions are that:

1. The restrictive covenant amount is derived as a result of the sale of a business by the person who gives the undertaking or an associated person (section CHA 1(2)(a)).
2. The restrictive covenant amount is consideration for an undertaking by a person not to provide goods or services in competition with the goods or services provided by the purchaser of the business (section CHA 1(2)(b)).
3. The person who gives the restrictive covenant undertaking must not provide any services to the purchaser after the sale of the business, other than services that are incidental to the sale and are temporary in nature (section CHA 1(2)(c)).

4. The vendor and purchaser of the business agree in writing that the transaction is a sale of a business (section CHA 1(2)(d)).

The sale of a business includes the sale of part of a business, if that part is capable of separate operation (section CHA 1(3)(a)).

The sale of a business also includes the sale of all of the shares in a company, if the company, or another company directly or indirectly wholly owned by the company, carries on a business (section CHA 1(3)(b)). If the sale of a business is by way of share sale, then the purchaser in conditions 2 and 3 includes the company that carries on the business (section CHA 1(4)).

The following examples show how the sale of business exclusion can apply to different forms of business sales.

Example 1: Asset sale

The vendor sells their business by way of asset sale to a purchaser. The vendor also gives a restrictive covenant undertaking to the purchaser and receives a payment in consideration. (It is this straightforward sale of business situation that the main legislation is based on; modifications are made to these main rules to cater for other forms of business sales.)

Example 2: Company sells assets

A company sells its business by way of asset sale to a purchaser. The owner of the company gives a restrictive covenant undertaking to the purchaser and receives a payment in consideration. In terms of condition 1, an associated person (the company) of the person who gives the restrictive covenant undertaking (the owner of the company) is selling the business to the purchaser. In terms of condition 4, it is the vendor company that would need to agree with the purchaser in writing that the transaction is a sale of a business. The same treatment would apply if a number of wholly-owned companies were interposed between the ultimate owner (who gives the restrictive covenant undertaking) and the vendor company which sells the assets of the business. The main difference between example 2 and example 1 is that in example 2 the vendor of the business (the company) and the provider of the restrictive covenant (the owner) are different persons, whereas in example 1 they are the same person.

Example 3: Owner sells company

A vendor-shareholder sells the shares in a company which carries on a business to a purchasing shareholder. The vendor-shareholder gives a restrictive covenant undertaking to the purchasing shareholder and receives a payment in consideration.

In terms of condition 2, the vendor-shareholder must agree not to provide goods and services in competition with those provided by the company. In terms of condition 3, the vendor-shareholder must not provide services to the company after its sale, other than services that are incidental to the sale and are temporary in nature. In terms of condition 4, it is the vendor-shareholder that would need to agree in writing with the purchasing shareholder that the transaction is a sale of a business.

Example 4: Owner sells holding company

A vendor-shareholder sells to a purchasing shareholder a holding company which owns a subsidiary which carries on a business. The vendor-shareholder gives a restrictive covenant undertaking to the purchasing shareholder and receives a payment in consideration. The same treatment would apply if there was a chain of wholly-owned companies interposed between the holding company whose shares are being sold by the vendor-shareholder and the subsidiary carrying on the relevant business. In terms of condition 2, the vendor-shareholder must agree not to provide goods or services in competition with those provided by the subsidiary company which carries on the business. In terms of condition 3, the vendor-shareholder must not provide services to the subsidiary after the sale of the holding company, other than services that are incidental to the sale and are temporary in nature.

Example 5: Holding company sells subsidiary

A holding company sells a subsidiary which carries on a business to a purchasing shareholder. The owner of the holding company gives a restrictive covenant undertaking to the purchasing shareholder and receives a payment in consideration. In terms of condition 1, the sale is conducted by an associated person (i.e. the holding company) of the person giving the restrictive covenant undertaking (the holding company owner). In terms of condition 4, it is the holding company that is required to agree in writing with the purchasing shareholder that the transaction is a sale of a business. The same treatment applies in relation to conditions 2 and 3 as in example 4. The main difference between example 5 and examples 3 and 4 is that in example 5 the vendor (the holding company) of the subsidiary and the provider of the restrictive covenant (the owner of the holding company) are different persons, whereas in examples 3 and 4 they are the same person.

Incidental and temporary services exception in third condition

The third condition that must be satisfied for the sale of business exclusion to apply is that the person who gives the restrictive undertaking must not provide any services to the purchaser after the sale of the business, other than services that are “incidental to the sale and are temporary in nature”.

Inland Revenue considers that the exception in this condition applying to services that are incidental to the sale and are temporary in nature can include “earn-out” clauses in sale and purchase agreements, and other similar types of exit arrangements, whereby the vendor works in the business for a period of time to facilitate the transfer of the business to the new owners. An example could be the sale of an interest in a professional firm by a retiring partner who works out his or her term by working a decreasing number of hours for 12 months as clients are systematically handed over to a new partner.

The reference to “incidental” in the exception relates to the transfer of the business to the new owners and does not restrict the quantum of services that can be provided during the transfer period. Therefore, substantial assistance can be provided by the vendor to the purchaser under the exception so long as it is provided in the context of facilitating the transfer of the business to the new owners.

The length of the period during which services can be provided by the vendor, while still being regarded as “temporary in nature”, would be governed by the prevailing commercial circumstances surrounding a particular sale. In the example above involving the retiring partner in a professional firm, the 12-month period would qualify as being temporary in nature provided it was the standard practice in that profession for earn-out clauses to be of that period.

The fact that the sale price for the business might be affected by the profit earned during the transition period and the vendor being a principal participant during the transition period should not be relevant to the issue of whether the incidental and temporary exception applies.

In conclusion, Inland Revenue considers that the main factor to be taken into account in determining the application of the incidental and temporary exception in the third condition is whether the arrangement involving the vendor providing services after the sale can be regarded as facilitating the transfer of the business to the new owners. If the services can be so regarded then the exception should apply.

Restrictive covenant anti-avoidance provision

New section GC 14F is a specific anti-avoidance provision which is designed to buttress the restrictive covenant charging provision in section CHA 1.

Under this specific anti-avoidance provision, if an arrangement has been entered into which has an effect of avoiding the application of section CHA 1, the Commissioner may treat an amount under the arrangement as an amount to which section CHA 1 applies. The Commissioner may also treat any person affected by the arrangement as the person liable under section CHA 1.

This anti-avoidance provision is designed to address, in particular, the situation of an employee making a restrictive covenant agreement with a wholly-owned company, the shares in which the employee subsequently sells to his or her employer. This arrangement transforms a payment for a restrictive covenant into a payment for shares and the payment received by the employee from the sale of the shares may not be taxed under the other provisions of the Income Tax Act 1994. Section GC 14F would ensure that an amount derived under such an arrangement is taxable under section CHA 1.

The enactment of section GC 14F does not preclude the application of the general anti-avoidance provisions in the Income Tax Act 1994.

Exit inducement payments

New section CHA 2 is the specific charging provision for exit inducements. The provision taxes any amount derived by a person for a loss of a vocation, position or status, or for leaving a position.

The charging provision focuses on payments for vacating a position. This is consistent with the nature of an exit inducement payment as compensation for giving something up in the course of starting a new position. It is not necessary for the provision to apply to inducements to take up a position because these are generally taxable as monetary remuneration to an employee or as business income to an independent contractor.

Section CHA 2 applies to an exit inducement payment made to compensate the payee for leaving a position of employment. The provision is also broad enough to cover the situation where the position being vacated is not an employment one—for example, a position as an independent contractor or an office such as a board membership.

The exit inducement cases of *Vaughan-Neil*⁴ and *Pritchard v Arundale*⁵ involved a barrister and a partner in a firm of chartered accountants respectively, both being positions where the payee was not an employee. The *Fraser* and *Case U8* cases involved taxpayers leaving positions of employment.

Section CHA 2 covers a situation like that in the *Fraser* case, where the emphasis in the judgments was that the taxpayer was being compensated for the loss of his career as a television presenter, as well as the traditional type of exit inducement case which involves a loss of status.⁶ The provision also encompasses a situation like that in *Case U8*, which represents an extension to previous exit inducement cases. That situation did not involve a distinct change of career or loss of social status, but only a change of employment or position within the same industry. It is necessary, therefore, for the charging provision to include compensation for a simple loss of a particular contract of services or contract for services.

The charging provision also includes an amount derived as consideration for simply leaving a position as it may be argued that in some cases there is no loss as such.

The ordering of the words “vocation”, “position” and “status” in the charging provision helps to indicate its services-related nature and thus its scope.

The reference to “amount” in section CHA 2 uses the definition of “amount” in section OB 1, which includes any amount in money’s worth. The charging provision is, therefore, sufficiently broad to cover in-kind consideration, not just monetary payments.

The exit inducement charging provision does not apply to injury to feelings payments relating to employment disputes made under section 123(c)(i) of the Employment Relations Act 2000 or section 88(l)(c) of the Human Rights Act 1993.

Deductibility of services-related payments

New section DJ 20(1) ensures that restrictive covenant and exit inducement payments that are gross income of another person are deductible to the payer in the same circumstances as salary and wages and other payments for services. This deductibility provision, in conjunction with the charging provisions for restrictive covenant and exit inducement payments, provides for symmetry in the tax treatment of these payments.

Section DJ 20(1) follows the model of providing express relief from the exclusion for capital expenditure, which is used in other places in the income tax legislation, such as section DJ 13. This means that, in order to be deductible, a payment will still need to have the connection with gross income required by the general deductibility rule in section BD 2(1)(b)(i) and (ii).

Section DJ 20(1) does not constitute a code in relation to whether expenditure on restrictive covenants and exit inducements is expenditure of a capital nature. In particular, the general deductibility rules in section BD 2 are not excluded and still operate normally.

New section DJ 20(2) ensures that the deductibility treatment of restrictive covenant and exit inducement payments is not concessionary in comparison with salary and wages. Salary and wages are non-deductible capital expenditure to the extent they relate to work of a capital nature undertaken by recipient employees, as in *Christchurch Press Company Ltd*.⁷ If outright relief from the exclusion for capital expenditure were provided for restrictive covenant and exit inducement payments, these payments could never be characterised as capital expenditure, even when the work was of a capital nature. Employers could, therefore, prefer to make these payments instead of salary and wage payments if capital works were involved.

To prevent such different treatment, section DJ 20(2) provides that the relief from the exclusion for capital expenditure does not apply to the extent that:

- services are performed for the payer by the employee, office holder or independent contractor who derives the restrictive covenant or exit inducement amount, and
- any expenditure would have been incurred in respect of those services but for the payment of the restrictive covenant or exit inducement amount, and
- that expenditure would have been of a capital nature.

The focus of section DJ 20(2) is not on the particular services whose performance is restricted under the restrictive covenant. Instead, the focus is on restrictive covenant and exit inducement payments being substituted for income from services in cases where expenditure on those services would have been of a capital nature because, for example, the services relate to capital works. The provision is anti-avoidance in nature.

⁴ *Vaughan-Neil v Inland Revenue Commissioners* (1979) STC 644.

⁵ *Pritchard v Arundale* (1971) 47 TC 680.

⁶ For example, *Jarroll v Boustead* (1964) 41 TC 701, *Pritchard v Arundale* and *Vaughan-Neil v Inland Revenue Commissioners*. In these cases, a consequence of the taxpayers changing their occupations was a loss of valued social status.

⁷ *Christchurch Press Company Ltd v Commissioner of Inland Revenue* (1993) 15 NZTC 10,206.

New section DJ 21 allows a deduction to employees who have been taxed on a restrictive covenant payment if they have to refund part or all of that payment because they do not comply with the terms of the restrictive covenant.

The deduction allowed under section DJ 21 is limited to the lesser of the amount that is refunded and the amount that was taxed to the employee under the restrictive covenant charging provision.

Also, no deduction is allowed for any payment in respect of punitive or exemplary damages, interest or the legal costs or other expenses of the person who paid the restrictive covenant amount to the employee claiming the deduction.

The time for determining whether a person is an employee for the purpose of section DJ 21 is when the restrictive covenant payment is derived.

Section DJ 21 overrides section BD 2(2)(c), which prohibits a deduction for expenditure incurred in deriving income from employment.

New section EO 6 provides that the deduction under new section DJ 21 is allowed in the income year that the refund is paid (it is intended that this section will be renumbered as section EO 7).

PAYE amendments

The definition of “extra emolument” in section OB 1 has been amended to ensure that restrictive covenant and exit inducement payments made to employees are subject to withholding at source under the PAYE rules. This includes payments made to previous, current or prospective employees.

Because of the inclusion of these payments in the definition of “extra emolument”, along with their consequent inclusion in the definition of “income from employment”, an employee recipient of a restrictive covenant or exit inducement payment is not allowed a deduction, except under section DJ 21, for any related expenditure (sections BD 2(2)(c) and DE 1).

Timing of income and expenditure

The ordinary tax accounting principles and provisions of the Income Tax Act 1994 apply to determine the time at which services-related payments are included in gross income or allowed as a deduction.

The particular tax accounting principles that apply to determine when a restrictive covenant or exit inducement payment is included in a recipient’s gross income depend on the type of taxpayer involved.

In the case of cash method taxpayers, derivation of income is based on the actual receipt of income.⁸

⁸ *Bowcock v Commissioner of Inland Revenue* (1981) 5 NZTC 61,062.

So if a payment for a restrictive covenant with a three-year term is paid to an employee as a lump sum in year one, the entire amount is derived, and therefore taxed, in that year of receipt.

In the case of most taxpayers carrying on a business, the accrual or earnings method applies to determine when an amount is derived. This method is based on the right to receive income (an entitlement to bill) rather than actual receipt.⁹ An up-front restrictive covenant payment received by an independent contractor could be spread over the term of the covenant. However, an exit inducement payment would be taxed completely in the year of receipt if the contractor is entitled to the whole payment at the start of the new contract.

The ordinary statutory rules apply to determine the timing of deductibility of these services-related payments. In particular, section EF 1 effectively requires a deduction for expenditure to be spread over the term to which the expenditure relates.¹⁰ For example, in respect of an up-front \$30,000 payment made under a restrictive covenant agreement with a three-year term, the allowable deduction for each of the three years would be \$10,000.

In the case of exit inducement payments, payment is likely to be deducted in full in the year of payment. That is because section EF 1, which requires expenditure to be spread over the contract term, would not be applicable.¹¹ There is usually no enduring aspect to an exit inducement beyond the requirement that the payee start a service relationship.

⁹ *Arthur Murray v Commissioner of Taxes* (1965) 114 CIR 314.

¹⁰ Section BD 4 of the core provisions governs the timing of allowable deductions. Section BD 4(2) provides that if an allowable deduction is subject to a timing regime, the deduction must be allocated to an income year in accordance with that regime. “Timing regime” is defined in section OB 1 to include a regime for allocating allowable deductions to an income year other than the income year to which the allowable deduction would have been allocated in the absence of the regime. Thus, in the absence of a timing regime, a payment under a restrictive covenant agreement with a three-year term would be incurred in year one when the agreement is entered into and, therefore, would have been deductible in that year. However, the timing regime in section EF 1, relating to “accrual expenditure”, would require the expenditure on the restrictive covenant to be spread over its three-year term. “Accrual expenditure” is defined very broadly in section OB 1 to mean any expenditure that is allowed as a deduction other than expenditure covered by other specific timing regimes, such as the trading stock or accrual rules. Section EF 1(5)(d), applying to choses in action, would be used to determine the unexpired portion of any amount of accrual expenditure relating to restrictive covenants that would need to be added back into the recipient’s income, by reference to the unexpired part of the period in relation to which the restrictive covenant is enforceable. This mechanism achieves the spread of income.

¹¹ Once the payment is made there is generally no unexpired portion to be added back to income in future years in terms of section EF 1.

AMENDMENTS TO THE FRINGE BENEFIT TAX MULTI-RATE RULES

Sections GC 15, ND 3, ND 4, ND 5, ND5A, ND 7 and ND 7A

Introduction

The fringe benefit tax (FBT) rules in subpart ND of the Income Tax Act 1994 have been amended by:

- Introducing rules to deal with the situation of a shareholder-employee's cash remuneration not being known for the year when the multi-rate calculation return is due. (This rule also applies to employees who receive income under the attribution rule.)
- Including income distributed under the attribution rule in the definition of "remuneration" for the purposes of the multi-rate FBT rules.
- Introducing an alternative, simplified method for calculating the FBT payable under the multi-rate rules.

A number of remedial amendments have also been made.

Background

The multi-rate FBT rules were enacted as part of the Taxation (FBT, SSCWT and Remedial Matters) Act 2000. These rules generally allow employers to elect to pay FBT on benefits received by a particular employee (attributed benefits) at an FBT rate based on the remuneration paid (including the taxable value of those benefits) to that employee. These new rules apply for fringe benefits provided on or after 1 April 2000 and in the case of employers who file on an income year basis, the 2000–2001 income year.

A number of remedial problems with these rules were identified after the Finance and Expenditure Committee reported the Taxation (FBT, SSCWT and Remedial Matters) Bill back to Parliament. These were:

- The need for amounts distributed under the attribution rule (attributed income) as provided for in the Taxation (GST and Miscellaneous Provisions) Act 2000 to be included in the definition of "remuneration" for the purposes of the multi-rate FBT rules.
- The need for rules for the calculation of a salary and wage paid to a shareholder-employee that is not subject to PAYE ("non-deduction salary and wages") and attributed income to an "employee". "Non-deduction salary and wages" are calculated and paid after the end of

the income year once the company's profits for the year have been calculated. This can be up to 12 months after the end of the income year. Such amounts are taxable to the shareholder-employee in the same income year as the expenditure is deductible to the company. The same issue arises for amounts distributed in accordance with the attribution rule by a company or a trust in that such amounts will be calculated up to 12 months after the end of the income year. This amount will be taxed in the "employee's" hands in the income year the income was derived by the interposed entity. Under the optional multi-rate FBT rules, employers will be required to determine an employee's cash remuneration (including the remuneration of a shareholder-employee) for the year in which the fringe benefits were provided within two months of the end of the year (thus, by 31 May). This is to enable the employer to undertake the square-up calculation for attributed benefits. Information about an employee's cash remuneration for the year is unlikely to be available within this timeframe if he or she has received "non-deduction salary and wages" or had an amount distributed under the attribution rule.

- The need for an extension of the rule that allows subsidised transport benefits to be treated as non-attributed benefits to apply to all employers who provide such benefits. The provision as originally enacted was limited to employers who were not a close company.
- The need to ensure that only interest and dividends from a major shareholder-employee's employer or a related employer are required to be included in the cash remuneration.
- The need to ensure that low-interest loans provided by life insurers to policyholders are not treated as attributed benefits.
- The need to maintain consistency between the general FBT rules and the multi-rate FBT rules in how an associate of an employee is treated for FBT purposes.
- The need to clarify that employers, in calculating the tax payable on the employee's cash remuneration, take into account the full low-income rebate irrespective of the employee's tax residency.

- The need to ensure that the threshold for fringe benefits to which section CH 1(h) (benefits of any other kind) applies is \$2,000 or more in total and not \$2,000 or more per type of benefit.

A submission received by the Finance and Expenditure Committee in relation to the Taxation (Beneficiary Income of Minors, Service-related payments and Remedial Matters) Bill suggested that an alternative method of calculating FBT under the multi-rate rules should be provided for whereby the FBT should be calculated as follows:

- attributed benefits would be subject to a flat FBT rate of 63.93%, and
- non-attributed benefits (pooled benefits) would either be subject to FBT at the rate of 49% or 64%, depending on whether a major shareholder-employee or associate was a recipient of the non-attributed benefits.

Key features

Attributed income

The definition of “remuneration” in section ND 7(4) has been amended by including any amount of income distributed in accordance with the attribution rule (section GC 14 D). The amendment means that any attributed income will need to be included in the cash remuneration of an employee if the attributed income is attributed from that employee’s employer or a related employer.

Multi-rate calculation for shareholder-employees and employees receiving attributed income

A new section ND 5A has been introduced to deal with the problem of when an employer, a close company, does not have the details of the cash remuneration that will be paid to a shareholder-employee because the “non-deduction salary and wages” could not be determined at the time of the multi-rate calculation. This is the salary, wages or gross income to which section OB 2(2) applies. These provisions also apply in the case of an employee receiving attributed income from his or her employer, when it is a company or a trust. If cash remuneration information details are available to the employer at the time the employer furnishes an FBT return incorporating the multi-rate calculation, the employer must calculate their FBT liability on that basis, in the usual manner.

In the year in which the fringe benefits are granted or provided, the employer has the choice of either paying FBT on the taxable value of the attributed benefits at the rate of 49% or at the rate of 63.93%. If the employer chooses to pay FBT at 49%, the employer is required to undertake a square-up calculation in the following year when the cash remuneration details are

known. Alternatively, the employer can choose to make a final FBT payment at 63.93% and avoid the lagged square-up.

Employers who choose to pay FBT at the rate of 49% are required, in the year following that in which the fringe benefits were provided or granted to such employees, to undertake as part of the multi-rate calculation for that subsequent year, a square-up as if those benefits had been provided in that year and the cash remuneration has been paid in that year. In other words, the multi-rate calculation using the cash remuneration of such employees is lagged one year. An example of how these rules work is set out at the end of this item. A new section ND 7A provides for the purposes of the multi-rate calculation in section ND 5 that the cash remuneration of such employees is treated as being the cash remuneration in the year following the year in which the amount was derived or attributed.

In undertaking this multi-rate calculation for such employees, a new subsection ND 5(5) allows the employer to deduct from this calculation, the FBT payable at the rate of 49% on the value of attributed benefits. This deduction is made in the year in which the lagged multi-rate calculation is made, reflecting the FBT that has already been paid.

Alternative multi-rate calculation

Section ND 5 has been amended by inserting a new subsection (5) to provide an additional method of calculating an employer’s FBT liability under the multi-rate calculation. Under this method, an employer who is required to undertake the multi-rate calculation can elect to pay FBT at the rate of 63.93% on the taxable value of the attributed fringe benefits. This avoids the need to calculate the FBT payable for each employee on the basis of their cash remuneration and value of attributed benefits under the multi-rate calculation.

For non-attributed benefits (pooled benefits), FBT will still be payable at either 49% or 64% depending on whether a major shareholder-employee is a recipient of the pooled benefits.

Subsidised transport

Section ND 4 allows an employer to elect to treat subsidised transport benefits with a taxable value of \$1,000 or more as non-attributed benefits, provided all employees have the same or similar entitlement to that benefit. The section has been amended so that this option is available to all employers, including close companies, which were previously excluded.

Major shareholder-employee's cash remuneration

Section ND 7(2), which deals with the cash remuneration of a major shareholder-employee, has been amended to clarify when interest and dividends should be included. It is only the interest and dividends paid by the employer concerned that are required to be included. Furthermore, interest and dividends of a related employer are required to be included only if that related employer pays remuneration such as salary or wages to the major shareholder-employee.

Low-interest loans provided by life insurers to policyholders

Section ND 3 has been amended by inserting a subsection (1A) to ensure that low-interest loans provided by a life insurer to policyholders or associates of policyholders are a low-interest loan that is not required to be attributed. Such low-interest loans are treated as non-attributed benefits.

Associated persons rules

Section GC 15 has been amended by adding a new subsection (4), which provides, for the purposes of the multi-rate calculation, that subsection (3) of that section does not apply. This means that, in all cases, fringe benefits received by an associate of an employee are deemed to have been received by the employee, and therefore the employee's cash remuneration is used to calculate the FBT payable on such benefits. Section GC 15(3) deemed the associated persons to be an employee in his or her own right.

Calculation of tax payable on cash remuneration

Section ND 5(2) has been amended to ensure that in calculating the tax payable on a major shareholder-employee's cash remuneration, as part of the multi-rate calculation, the low-income rebate is calculated as if the employee were resident in New Zealand for the full income year. This prevents the employer from having to determine whether an employee is entitled to the full low income rebate for the year based on the employee's tax residency.

A similar amendment should have been made to section ND 5(1) but was overlooked. Officials propose to report to the Government seeking that a similar amendment be included in the next available tax bill, to ensure that this requirement applies for the purposes of section ND 5(1). It is proposed that this amendment apply from the start of the FBT multi-rate rules.

Category (h) benefits

Section ND 3 has been amended to ensure that the threshold for fringe benefits to which section CI 1(h) (fringe benefits of any other kind) applies is \$2,000 or more in total and not \$2,000 or more per type of benefit. This means if the total value of all category (h) benefits provided or granted to an employee is \$2,000 or more, those benefits will be treated as attributed benefits.

Application date

The amendments relating to the multi-rate calculation for shareholder-employees and employees receiving attributed income apply to fringe benefits provided or granted by an employer on or after 1 April 2000 for an employer who pays FBT on a quarterly or annual basis. This coincides with the start date of the multi-rate FBT rules.

All the other amendments apply to fringe benefits provided or granted by an employer on or after 1 April 2000 for an employer who pays FBT on a quarterly or annual basis, and for an employer who pays FBT on an income year basis from the start of the 2000–2001 income year. This coincides with the start date of the multi-rate FBT rules.

The amendment relating to the alternative method for calculating FBT payable under the multi-rate rules applies to fringe benefits provided or granted by employers on or after 1 April 2001 for those who pay FBT on a quarterly or annual basis. This amendment applies to employers who pay FBT on an income year basis from the start of the 2001–2002 income year.

Example of the multi-rate calculation for shareholder-employees and employees receiving attributed income

A shareholder-employee is provided with a motor vehicle for private use. The annual taxable value of that benefit is \$10,000. The employer has other employees who are provided fringe benefits and files on a quarterly basis. To keep the example simple, it deals only with the shareholder-employee. In the 2000–2001 year, the employer pays FBT on that benefit as follows:

Quarter	Taxable value	FBT rate	FBT payable
Quarter 1	\$2,500	64%	\$1,600
Quarter 2	\$2,500	64%	\$1,600
Quarter 3	\$2,500	49%	\$1,225

At the time of filing the company's FBT return for the final quarter for the 2000–2001 year, the cash remuneration payable to the shareholder-employee has not been determined as the company's financial accounts have not been finalised. The employer chooses to pay FBT at the rate of 49% and undertake the lagged square-up the following year. The multi-rate calculation for the value of this attributed benefit in the year in which the benefit is granted or provided is:

Taxable value of attributed benefit	FBT tax rate	FBT payable	less FBT payable in Quarters 1–3	FBT payable
\$10,000	49%	\$4,900	\$4,425	\$475

This amount of \$475 is included in the FBT return for the final quarter (the return for all employees) and is payable by 31 May 2001.

As the employer chose to undertake the lagged square-up the following calculation is required to be made in final quarterly return for the 2001–2002 year. The employer will require the following information to undertake this calculation – the value of the attributed benefits provided to the shareholder-employee in the 2000–2001 year and the amount of cash remuneration paid for that year:

Cash remuneration of the shareholder-employee for the 2000–2001 year	\$55,000.00
Value of attributed benefits provided to the shareholder-employee for the 2000–2001 year	\$10,000.00
FBT payable using the multi-rate calculation	\$5,900.50
Less FBT payable on that attributed benefit in 2000–2001 year (49% of the taxable value of the attributed benefits)	\$4,900.00
FBT payable as part of the multi-rate calculation due 31 May 2002	\$1,000.50

This amount of \$1,000.50 is included in the FBT return for the final quarter of the 2001–2002 year and is due on 31 May 2002. No use-of-money interest applies in respect of this deferral.

If the employer chose to pay FBT at the rate of 63.93% on the value of the attributed benefits in the year in which the benefits were granted or provided, the employer would have paid FBT of \$6,393 compared with \$5,900.50 using the lagged square-up process.

TAXING BENEFICIARY INCOME OF MINORS AT 33% – THE “MINOR BENEFICIARY RULE”

Sections HH 1A, HH 3A, HH 3B, HH 3C, HH 3D, HH 3E, HH 3F, LB 1, LB 1A, OB 1 and OD 7 of the Income Tax Act 1994.

Introduction

The minor beneficiary rule is intended to limit the ability of some families to pay considerably less tax than other families on similar incomes by meeting expenses of the children through the use of a trust. It ensures that certain distributions of beneficiary income to a child under the age of 16 years will be taxed at the trustee rate of 33%.

Background

In the 2000 Budget, the Government announced that it would introduce legislation to require distributions of beneficiary income to minors to be taxed at a rate of 33%, to prevent families with a trust from being able to gain a tax advantage over families without a trust. By arranging for a trust to derive income and distributing that income to children, families were able to meet expenses of the children from income taxed at the marginal tax rates of the children, instead of meeting those expenses from their own after-tax income.

An issues paper outlining the proposal in more detail and seeking public submissions was issued in June 2000. Following consideration of submissions and extensive consultation with the private sector, a number of changes were incorporated in the legislation that was introduced in October. In particular, the definition of a “minor” was changed from under the age of 18 to under the age of 16, and rather than applying the 39% tax rate when the total income (including beneficiary income) of the minor exceeded \$60,000, as proposed in the issues paper, minor beneficiary income would be taxed at a final tax rate of 33%.

Following submissions on the Bill, the Finance and Expenditure Committee recommended a number of changes to the legislation. In particular, the committee recommended that the minimum beneficiary income threshold be raised from \$200 to \$1,000, and that the rule apply to all income from mixed trusts unless the settlements that are covered by the rule are of a relatively small value.

Key features

Distributions of beneficiary income to which the minor beneficiary rule applies will be treated as trustee income for tax rate, tax payment and tax return purposes.

A “minor” is defined as a New Zealand resident who is under the age of 16 years on the balance date of the trust.

In a related change, for the purposes of sub-part HH of the Income Tax Act 1994, multiple settlements made on the same terms may be treated by the trustee as one trust.

Exceptions

The minor beneficiary rule does not apply if:

- the minor is in receipt of a child disability allowance under the Social Security Act 1964, or
- the beneficiary income is derived directly from a group investment fund or from the Maori trustee or a Maori authority, or
- the beneficiary income distributed to each minor from the trust is \$1,000 or less in an income year.

Application of the minor beneficiary rule and further exceptions for specific settlements

The minor beneficiary rule applies to all beneficiary income distributed to a minor from a trust unless excepted above or unless all of the settlements on that trust were made:

- by a person who is neither a relative or legal guardian of the minor nor a person associated with a relative or legal guardian, or
- by a relative, legal guardian or associated person as an agent of the minor if that settlor has received the property from someone other than a relative, guardian or associated person, or
- by a relative, legal guardian or associated person if that settlor is required by a court order to pay damages or compensation to the minor, or
- by a relative, legal guardian or associated person against whom a protection order has been made under section 14 of the Domestic Violence Act 1995. This exception only applies if the minor is a protected person in relation to the protection order and the settlement on the trust is made before the protection order is made or during the time the protection order is in force, or

- under the terms of a will, codicil or intestacy if the minor is alive within 12 months of the date of the settlor's death, or the minor has a brother or sister, half-brother or half-sister who is alive within 12 months of the date of the settlor's death.

The definition of "settlement" is limited, for the purposes of this rule, so that:

- A loan for less than market value will constitute a settlement only if the loan is in existence on or after 1 April 2002.
- Financial assistance to a trust in the form of a guarantee for less than market value will not constitute a settlement unless and until the guarantee has been called upon.
- The provision of services which are incidental to the operation of the trust, such as bookkeeping or accounting services, or those provided in being a trustee will not constitute a settlement.

The definition of "settlement" has also been clarified in relation to low-interest loans. A loan will be provided for less than market value if the interest rate on the amount borrowed is, at any time during the income year, less than the interest rate set out in the Income Tax (FBT, Interest on Loans) Regulations on 31 March of the previous income year.

Mixed trusts

If a trust includes both settlements which do fit within any of the exceptions above and settlements which do not fit within any of the exceptions ("tainted settlements") it is referred to as a "mixed" trust. The minor beneficiary rule will apply to all beneficiary income distributed to the minor by a mixed trust unless all tainted settlements on the trust were either:

- dispositions of property the total value of which, at the date of settlement, does not exceed \$5,000, or
- the provision of financial assistance to the trust in the form of loans for less than market value and the underlying value of the loans themselves does not exceed \$1,000 in total at any time during the income year.

However, if a relative, guardian or their associate has provided services to the mixed trust, all minor beneficiary income from that trust is subject to the minor beneficiary rule, and this mixed trust relief rule does not apply. In this context, services do not include the provision of services which are incidental to the operation of the trust, such as bookkeeping or accounting services, or those provided in being a trustee.

Application date

The minor beneficiary rule applies to beneficiary income derived in relation to the 2001–2002 and subsequent income years.

Income earned by the trustee of a trust in an income year becomes beneficiary income if it vests absolutely in the beneficiary in that income year or is paid or applied to the beneficiary within six months of the income year. Beneficiary income is derived in the same income year as it was earned by the trust.

For example, a trust with a 31 March balance date can pay or apply income of the 2000–2001 income year up to 30 September 2001, for that trust's income to be treated as beneficiary income. If this occurs, the beneficiary is taxed in the 2000–2001 income year and not in the 2001–2002 income year, though this is the year in which the beneficiary actually receives the income. Therefore the minor beneficiary rule will not apply to this income.

Detailed analysis

Multiple settlements may be treated as one trust for tax purposes – section HH 1A

In law, each settlement is the creation of a separate trust. However, in practice two or more settlements which are covered by the same trust deed with the same trustees are often managed as one trust with one tax return filed. This disparity between the law and practice has been highlighted by the minor beneficiary rule, with its focus on the nature of different settlements.

Consequently, the new section HH 1A specifically allows for this practice by providing that for the purposes of sub-part HH of the Income Tax Act 1994, the trustees may choose to treat multiple settlements made on the same terms as one trust.

Operational Provisions – section HH 3A

Beneficiary income of a minor taxed as if it was trustee income

Section HH 3A(1)(a) provides that if a minor derives beneficiary income from a trust the trustee must pay income tax on that beneficiary income as if it were trustee income. Consequently, as with all other trustee income, minor beneficiary income will be:

- taxed at the trustee rate of 33%
- included in the trustee's provisional tax calculations along with other trustee income, and

- subject to the usual rules, use-of-money interest will be payable by the trustee on any underpayment and will be payable by the Commissioner on any overpayment of provisional tax.

There are no special transitional rules for provisional tax payments in the 2001–2002 income year.

Beneficiary income of a minor not gross income of the minor

Section HH 3A(1)(b) provides that the beneficiary income subject to the minor beneficiary rule is not gross income of the minor. This ensures that the minor is not required to include the income in his or her return.

Accounting treatment

Section HH 3A(2) is intended to clarify that although the income is taxed as beneficiary income, for the purposes of debiting and crediting a beneficiary's account within a trust, a trustee may continue to treat income tax paid by the trustee as paid on behalf of the beneficiary.

Exemption for beneficiary income of \$1,000 or less – section HH 3B

Section HH 3B provides that if the amount of beneficiary income derived by a minor from the trust in an income year is \$1,000 or less, the minor beneficiary rule does not apply to that income. If income is over \$1,000 all of the beneficiary income will be subject to the rule.

Application of the minor beneficiary rule – sections HH 3C and HH 3D

Sources of beneficiary income – section HH 3C

Section HH 3C ensures that the minor beneficiary rule applies to all beneficiary income of a minor from a trust unless all of the settlements on that trust fit within any of the exceptions specified in paragraphs (a)–(e).

These exceptions are for settlements which were made:

- (a) *By a person who is neither a relative or legal guardian of the minor nor a person associated with the relative or legal guardian; or*

This exception limits the application of the minor beneficiary rule to those trusts on which a settlement has been made by a relative or legal guardian of the minor or their associate. This ensures that the rule only applies in those situations where families can potentially gain a tax advantage.

- (b) *By a relative, legal guardian or associated person as an agent of the minor if that settlor has received the property from someone other than a relative, guardian or associated person; or*

This exception would apply for example, if ACC compensation is paid on behalf of a disabled child to the child's caregiver, who places that money on trust for the trust.

- (c) *By a relative, legal guardian or associated person if that settlor is required by a court order to pay damages or compensation to the minor; or*

- (d) *By a relative, legal guardian or associated person against whom a protection order has been made under section 14 of the Domestic Violence Act 1995. This exception applies only if the minor is a protected person in relation to the protection order and the settlement on the trust is made before the protection order is made or during the time the protection order is in force;*

If the protection order is subsequently lifted, those settlements remain subject to the exception. However, any subsequent settlements made after a protection order has been removed will not be subject to the exception.

If a settlement is made on the trust jointly by two persons, for example by both parents, and a protection order is in force against only one of the settlors, the exception will also apply.

- (e) *According to a will, codicil, intestacy or a court variation thereof, if:*
- *the minor is alive within 12 months of the date of the settlor's death; or*
 - *the minor has a brother or sister, half-brother or half-sister who is alive within 12 months of the date of the settlor's death.*

Beneficiary income derived from a testamentary trust will not be subject to the minor beneficiary rule if the minor, or their brother or sister (or half-brother or half-sister) is alive within 12 months of the settlor's death.

As discussed below, the definition of "settlement" has been limited for the purposes of this section and section HH 3D.

Mixed Trusts – section HH 3D

If all settlements on a trust fit within any of the exceptions in section HH 3C, the minor beneficiary rule does not apply. On the other hand, if none of the settlements fit within any of the exceptions, the minor beneficiary rule clearly does apply. However, limited special rules are provided to deal with trusts when settlements which do fit within the exceptions are managed as one trust along with settlements which do not fit within any of the exceptions ("tainted settlements"). This is referred to as a mixed trust.

All income distributed to a minor from a mixed trust will be subject to the minor beneficiary rule, unless the tainted settlements are of a relatively small value.

Section HH 3D(1) provides that if a trust includes both tainted settlements and settlements which do fit within one of the exceptions above, the minor beneficiary rule will apply to all beneficiary income distributed by the mixed trust to the minor unless paragraphs (a)–(c) are satisfied:

- (a) All tainted settlements on the trust are settlements of the type referred to in paragraph (b)(i) of the definition of settlor or paragraph (b)(ii) of the definition of settlor.

The definition of “settlement” in section OB 1 is defined by reference to the definition of “settlor”. Paragraph (b)(i) of the definition of settlor provides that a person will be a settlor if they make dispositions of property to the trust for less than market value.

Paragraph (b)(ii) provides that a person will be a settlor if they make any property available to a trust for less than market value, including the provision of financial assistance whether by way of a loan, guarantee, the provision of security or otherwise.

- (b) The total value of the dispositions of property does not exceed \$5,000 at the end of the trust’s income year. Section HH 3D(2) provides that the value of these settlements is their value at the date of their settlement. This avoids valuation difficulties arising if a tainted settled asset has later become mingled with an untainted asset, or if the value of the asset fluctuates from year to year.

- (c) The underlying value of the loans themselves does not exceed \$1,000 in total at any time during the income year. This ensures that the provision of a small, short-term loan will not by itself result in the minor beneficiary rule applying to all income from the mixed trust. Small, short-term loans can arise, for example, when a relative purchases a small item for use in the activities carried on by the trust and is not reimbursed by the trust until some time later.

The \$1,000 limit applies to the value of the loan itself, not to the value of the low-interest element of the loan. Consequently, this will not give rise to complex valuation issues.

If a relative, guardian or their associate has provided services to a trust, however, section HH 3D(3) provides that the mixed trust rules in section HH 3D(1) will not apply to offer relief from the application of the minor beneficiary rule. This means that the minor beneficiary rule will apply to all income from that mixed trust, unless the amount of beneficiary income is less

than \$1,000 in an income year. This applies whether the services are paid for or not, but only if the services are significant. Section HH 3D(4) provides that, for the purposes of section HH 3D(3), “services” do not include those that are incidental to the operation of the trust, such as bookkeeping or accounting services or which are provided in being a trustee.

Exceptions from the minor beneficiary rule – section HH 3E

The minor beneficiary rule does not apply if:

- (a) the minor is in receipt of a child disability allowance under the Social Security Act 1964, or
- (b) the beneficiary income is from the Maori trustee or a Maori authority or is derived directly from a group investment fund.

This ensures that distributions of beneficiary income directly from a group investment fund to a minor will not be subject to the rule, but the rule will still apply if a family trust invests in a group investment fund and the income earned by the trust from the fund is subsequently distributed to a minor beneficiary.

The taxation of beneficiary income distributed from the Maori trustee or a Maori authority to a minor is excluded from the minor beneficiary rule pending completion of the Government review of the taxation of Maori authorities.

The Definitions – sections HH 3F, OB 1 and OD 7

Definition of “guardian”

Section HH 3F(1) provides that, for the purposes of sections HH 3C and HH 3D, “guardian” has the corresponding meaning to the definition of “guardianship” in section 3 of the Guardianship Act 1968. Broadly, section 3 defines guardianship as the custody of a child and the right of control over the upbringing of a child.

Under a number of pieces of legislation, however, the chief executive of a government department or the court itself, for example, may be appointed guardian. It is not intended that the rule should apply to such guardians. Therefore a person or body will not be a guardian for the purposes of this rule when:

- the court (which has declared a child to be in need of care and protection) has appointed the chief executive, an iwi social service, a cultural social service, or the director of a child and family support service to be a guardian of that child under section 110(1)(a)–(d) of the Children, Young Persons, and their Families Act 1989
- the court has been appointed guardian of the child under section 10B of the Guardianship Act 1968

- the Public Trustee has been appointed guardian of an infant by an order of the court under section 53 of the Public Trust Office Act 1957, and
- a chief executive has been appointed guardian of the child under section 7(4) of the Adoption Act 1955.

Definition of a “minor”

Section HH 3F(2) defines a “minor” as a natural person who is a New Zealand resident, and who is under the age of 16 on the balance date of the trust making the distribution of beneficiary income. If the minor was under the age of 16 throughout the trust’s income year, the rule will apply to all income derived in that year. If the minor turned 16 in that income year, the rule will not apply to any income derived in that income year.

Definition of a “relative”

“Relative” is defined in section HH 3F(3), for the purposes of the minor beneficiary rule, as two persons connected by blood relationship, marriage or adoption. This includes the trustee of a trust under which a relative has benefited or is eligible to benefit.

Persons are connected by blood relationship if within the fourth degree of relationship.

Persons are connected by marriage if:

- one person is married to the other or to a person who is connected by blood relationship, adoption or guardianship to the other, or
- one person is in a relationship in the nature of marriage to the other or to a person who is connected by blood relationship, adoption or guardianship to the other.

Thus, a person who makes a settlement on a trust will be a relative if they are either married to or in a relationship in the nature of marriage with, a person who is connected to the minor by blood relationship, adoption or guardianship.

A settlor will also be a relative if they have either adopted the minor as their child, or the minor is the adopted child of a person who is a relative of the settlor within three degrees of relationship.

Persons are connected by guardianship if one is a guardian of the other.

The definition of “settlor”

A number of amendments have been made to the definition of settlor in section OB 1 specifically for the purposes of this rule. These amendments particularly relate to the term “settlement”, used in sections HH 3C and HH 3D.

The definition now defines when a loan is provided for less than market value. It is for less than market value if the interest rate on the amount borrowed is at any time during the income year less than the interest rate set out in the Income Tax (FBT, Interest on Loans) Regulations on 31 March of the previous income year.

The provision of financial assistance to a trust in the form of a loan for less than market value will only constitute a settlement for the purposes of the minor beneficiary rule if the loan is in existence on or after 1 April 2002. This avoids trustees having to place a value on loans that may have been provided many years ago. Trusts are provided with a period of one year following the application date of the rule to restructure the trust to ensure that no loans are provided to the trust for less than market value;

Financial assistance to a trust in the form of a guarantee for less than market value will not constitute a settlement to which this rule applies until the guarantee has been called upon. Once the guarantee has been called upon, it becomes a settlement on the trust in the form of a disposition of property.

The provision of services which are incidental to the operation of the trust, such as bookkeeping or accounting services or those provided in being a trustee, will not constitute a settlement for this rule.

Imputation credits – section LB 1 and LB 1A

Section LB 1(1)(ab) ensures that when a distribution of beneficiary income to a minor is in the form of a dividend, the imputation credits which attach to the dividend continue to be calculated under section LB 1(3), as if the minor beneficiary rule did not apply.

Section LB 1A ensures that the trustee, who is taxed on this beneficiary income, is allocated the imputation credits, not the beneficiary.

Children’s bank accounts

Whether a bank account will constitute a trust, and therefore come within the scope of the minor beneficiary rule, is dependent on the particular arrangement which exists.

The common law of trusts contains a number of well-established, essential elements that must be met in order for a trust to exist, including the division of legal and beneficial ownership of the trust property between the trustee and the beneficiary. For this division of legal and beneficial ownership to exist in respect of a bank account, as a minimum requirement the account would have to be in the name of a parent.

Arrangements involving bank accounts may fall into the following general categories:

- 1) A parent opens a bank account in the parent's own name, using funds that are the property of the child; the parent has signing authority over that account; and the parent either deposits additional funds from time to time and/or withdraws amounts periodically for the benefit of the child. This arrangement would constitute a "trust" on the basis that there is a separation of legal and beneficial ownership, with the parent holding legal title, and the child holding the beneficial interest.
- 2) An account is opened or operated in the name of the child, but the parent possesses signing authority either alone or together with the child. No express trust exists in this situation as both legal and beneficial ownership of the proceeds of the account are exclusively held by the child.
- 3) An account is opened or operated in the child's name, only the child has signing authority and the child makes withdrawals from the account. Again, there is no separation of legal and beneficial ownership of the property.

In the majority of situations involving a bank account, it is unlikely that there will be any such division of ownership. Rather, the income will be earned directly by the child, in which case the minor beneficiary rule will not apply. The number of bank accounts to which the rule is likely to apply is further limited by the fact that the minimum level of income threshold in section HH 3B ensures that the rule will apply only if the amount of income from a child's bank account in an income year is more than \$1,000 in an income year.

Examples of the application of the minor beneficiary rule

Example 1

Two settlements on the trust:

- a settlement by the grandmother of the child under the terms of the grandmother's will. The minor is alive at the time of grandmother's death. Therefore the settlement fits within the exception in paragraph (e) of section HH 3C.
- a settlement by the godparent of the child, who is not a relative or guardian of the child nor an associate of a relative or guardian. The exception in paragraph (a) applies.

All settlements on the trust fit within the exceptions. Section HH 3C is therefore satisfied, and consequently the minor beneficiary rule does not apply to any beneficiary income distributed by the trustees to the minor.

Example 2

Two settlements on the trust:

- a settlement of \$5,000 by the parent of minor, thus it is a tainted settlement.
- parent also provides a low-interest loan of \$800 to the trust, which is still in existence after 1 April 2002. The interest forgone on this loan is a settlement within paragraph (b)(ii) of the definition of "settlor". None of the exceptions apply, so it is a tainted settlement.

None of the settlements on the trust fit within the exceptions, so this is not a mixed trust, and section HH 3D will not apply. The effect of section HH 3C, therefore, is that the minor beneficiary rule applies to all income distributed from this trust.

Example 3

Three settlements on the trust:

- a settlement by the grandmother of the child under the terms of the grandmother's will. The minor is alive at the time of the grandmother's death. Therefore the settlement fits within exception in paragraph (e) of section HH 3C.
- two settlements of money made by the parents of the minor, of \$5,000 each settlement. These settlements do not fit within any of the exceptions in section HH 3C.

One of the settlements fits within the exceptions in section HH 3C and the other two settlements do not ("tainted settlements"). This is a mixed trust.

Therefore, the minor beneficiary rule applies unless paragraph (a)–(c) of section HH 3D(1) are satisfied.

The two tainted settlements each satisfy paragraph (a) of section HH 3D(1) as they are settlements of the type in paragraph (b)(i) of the definition of settlor, being dispositions of property. However, paragraph (b) of section HH 3D(1) is not satisfied because the total value of these settlements at their date of settlement is \$10,000. Consequently, section HH 3D(1) is not satisfied, and the minor beneficiary rule applies to all income distributed to a minor from this trust.

Example 4

Two settlements on the trust:

- an initial settlement of \$100 by the parent of the child. None of the exceptions apply (“tainted settlement”).
- a settlement is also made on the trust by the grandmother of the child under the terms of her will. The minor is alive at the time of the grandmother’s death. Therefore the settlement fits within exception in paragraph (e) of section HH 3C.

The parent is also a full-time employee of the trust and is paid a market value salary. Because it is for market value, this provision of services is not a settlement.

Because there are two settlements on the trust, one of which is a tainted settlement, the other within an exception, this is a mixed trust. Therefore the minor beneficiary rule applies to all income from this trust unless the requirements of section HH 3D are met.

Paragraphs (a)–(c) of section HH 3D(1) are satisfied because the only tainted settlement is a disposition of property, and its value at the date of settlement is less than \$5,000. However, the effect of section HH 3D(3) is that HH 3D does not apply because services (other than incidental services) have been provided to the trust by a relative. As a result, the minor beneficiary rule applies to all beneficiary income of a minor from that trust.

Example 5

Three settlements on the trust:

- a parent has provided two low-interest loans to the trust which have a value of \$2,000 and \$5,000 respectively. These loans are both in existence on 1 April 2002 and the interest forgone on these loans constitutes a settlement. These settlement do not fit within any of the exceptions, so they are both tainted.
- settlement by the grandmother of the child under the terms of the grandmother’s will. The minor is alive at the time of the grandmother’s death. Therefore the settlement fits within the exception in paragraph (e) of section HH 3C.

The parent has previously provided another low-interest loan of \$1,000 to the trust. This loan is no longer in existence on 1 April 2002, so there is no settlement in terms of section OB 1 for the purposes of the minor beneficiary rule.

This is a mixed trust. The minor beneficiary rule applies to all income from this trust unless the requirements of section HH 3D are met.

Paragraph (a) of section HH 3D(1) is met because all tainted dispositions are the provision of financial assistance by way of loan for less than market value.

Paragraph (b) is met because there are no dispositions of property.

Paragraph (c), however, is not met. The underlying value of the low-interest loans provided by a relative to the trust is in total greater than \$5,000.

Consequently, section HH 3D(1) is not satisfied, and the minor beneficiary rule applies to all income distributed to a minor from this trust.

DISTRIBUTIONS MADE BY THE TREATY OF WAITANGI FISHERIES COMMISSION – SECTION 19

Introduction

The amendment treats the Treaty of Waitangi Fisheries Commission as being “in the course of termination” for tax purposes when the Commission allocates the fisheries settlement assets to iwi. The purpose of this amendment is to remove the potential for these distributions to be subject to double taxation under the Maori authority rules.

Background

The role of the Treaty of Waitangi Fisheries Commission is to administer the fisheries assets that were returned to iwi by the Crown, and to arrange for their eventual allocation to iwi.

The Commission is treated as a Maori authority for tax purposes. The potential for double taxation of Maori authority income under Maori authority rules is a known problem. Double taxation arises because any income that a Maori authority retains for more than four years is subject to tax at the rate of 25%, and when that income is ultimately distributed it would almost always be subject to tax again in the hands of the recipient.

The problem of double taxation was inevitable for the Commission because it has been prevented from distributing the fisheries assets until an agreed allocation model for determining how they should be distributed among iwi has been finalised.

Under the current Maori authority rules, the Commissioner of Inland Revenue can determine to the extent that distributions made “in the course of termination of a Maori authority” are sourced from income that has previously been taxed to the Commission. Such distributions are not treated as taxable distributions under the Maori authority rules. This discretion ensures that Maori authority income is not subject to double taxation when a Maori authority is “in the course of termination”. Treating the Commission as being in the course of termination (in line with this provision) would ensure that distributions that have been previously taxed would not be distributions under the Maori authority rules.

Key features

New section HH IA is added to treat the Treaty of Waitangi Fisheries Commission as being “in the course of termination”, on or after the date on which the Commission allocates the settlement assets to iwi, for the purposes of section HI 1(2) of the Income Tax Act 1994. The effect of this provision is to ensure that distributions made from tax-paid income will not be a distribution under the Maori authority rules.

Application date

The amendment applies to the 2001–2002 and subsequent income years.

DEFINITION OF “QUALIFYING PERSON” FOR FAMILY ASSISTANCE

Sections KD 3(1), KD 3B, and OB 1 of the Income Tax Act 1994; sections 374A and 374E(1) of the Income Tax Act 1976

Introduction

The amendments will ensure that families who were once in New Zealand for a 12-month period and are currently resident overseas cannot claim family assistance whilst non-resident.

Background

The current family assistance legislation provides that a qualifying person, amongst other criteria, is a person who has either been both resident and present in New Zealand for a continuous period of 12 months at any time, or is the principal caregiver of a dependent child who is both resident and present in New Zealand.

This has potentially enabled families who were once resident in New Zealand for a 12-month period and who are permanently resident overseas to claim full family assistance whilst overseas.

Key features

The definition of “qualifying person” in sections OB 1 and KD 3 are amended and a new section KD 3B is inserted to require that the family be tax-resident here at the time they claim the credits. This means that a family must be resident in New Zealand for tax purposes and therefore it will not preclude armed service personnel who are overseas or those on voluntary service abroad or overseas business from claiming the family assistance credits if they are resident in New Zealand for tax purposes.

Similar amendments are made to sections 374A and 374E(1) of the Income Tax Act 1976.

Application date

To ensure overseas families cannot retrospectively seek a refund, the amendment has been backdated to apply from the 1992–1993 income year, being the earliest date for which a family can seek a refund. However, a savings provision will ensure that this amendment will not affect claims made on or before 16 October 2000 (date of introduction of the Bill).

INTERNATIONAL TAX – REMEDIAL AMENDMENTS

Sections LB 1(4A) to (4B), NG 9(1), OB 1, and OE 8(1)

Introduction

Clarifying amendments have been made to the international tax rules to correctly allocate imputation credits between resident and non-resident partners when shares are owned by a partnership, as well as ensure that the correct rate of non-resident withholding tax (NRWT) is deducted from conduit tax relief credited non-cash dividends. Additionally the amendments ensure conduit tax relief arises when a non-resident holds an interest in a New Zealand company through a wholly owned chain of holding companies.

Background

The following aspects of the international tax rules had been identified when the law was not consistent with its underlying policy intent.

- The formula in section LB 1(4) allocates imputation credits between partners when shares are owned by a partnership. The formula, however, only allocated credits correctly if all the partners were either resident or non-resident. This was because the formula did not adequately deal with the effect of supplementary dividends paid under the foreign investor tax credit rules when there was a mixture of resident and non-resident partners.
- Dividends with full conduit tax relief credits are subject to NRWT at a rate of 15%. However, the rules in section NG 9 for determining the amount of NRWT to be deducted in respect of non-cash dividends did not previously reflect this rate.
- The conduit tax relief rules relieve a company from New Zealand tax on certain foreign income to the extent that it is derived on behalf of non-resident shareholders. When the rules were introduced, New Zealand holding companies wholly owned by a non-resident were allowed to be treated as non-resident shareholders, to allow the companies they invest in to receive conduit tax relief. It was intended that relief would also be allowed when a non-resident holds an interest in a company through a wholly owned chain of companies. Previous legislation did not, however, achieve this effect.

Key features

- New sections LB 1(4A) and 4B of the Income Tax Act 1994 ensure that imputation credits are correctly allocated between resident and non-resident partners by recognising the effect of supplementary dividends paid under the foreign investor tax credit rules.
- Sections NG 9(1) and OB 1 have been amended to ensure that the 15% rate of NRWT applies to fully conduit tax relief credited non-cash dividends. New section NG 9(1A) confirms that the NRWT required to be paid on the dividend is treated as part of the dividend when determining the extent to which a dividend is fully conduit tax relief credited and for credit allocation purposes.
- Section OE 8(1) has been amended to treat conduit tax relief holding companies as non-resident companies for section OE 7(1)(b) purposes.

Application date

The correction to section OE 8(1) applies retrospectively from 1 October 1997, the date of the inception of the conduit rules. The other amendments apply from the date of Royal assent, 27 March 2001.

REQUIREMENT ON COMPANIES TO ADOPT MINIMUM 33% WITHHOLDING TAX RATE

Sections NF 2B, NF 2C, and NF 2D

Introduction

Companies will no longer be able to elect the 19.5% resident withholding tax (RWT) rate.

The change will remove the timing advantage gained by companies that choose this rate, rather than a 33% withholding rate matching the corporate tax rate, before making good the discrepancy by way of provisional or terminal tax. It does not apply to companies that are trustees.

Background

The Income Tax Act 1994 allows a person receiving an interest payment to elect, in the manner prescribed by the interest payer, to make that payment subject to withholding tax at 19.5%, 33% or 39%.

The 2000 Budget included an announcement that the Government would legislate to remove the ability of companies to adopt the 19.5% RWT rate. Choosing this rate gave companies a short-term timing advantage before they make good the discrepancy by paying provisional or terminal tax.

Key features

- A new section NF 2B is inserted into the Income Tax Act 1994 to require companies that begin receiving interest on or after 1 April 2001 to notify the interest payer that they are a company. This notification must be made on becoming entitled to receive interest.
- Interest payers must deduct RWT at the appropriate rate on or after receiving a notice. The appropriate rate is dependent on the election made by the company and whether it has provided a tax file number.
- The current treatment continues to apply until a company notifies interest payers of its status. To minimise compliance costs, the onus of notification lies on the company receiving the interest to determine its status, not the interest payer.

- A new section NF 2C provides that those with an entitlement to receive interest as at 31 March 2001 have until 31 May 2001 to notify their company status. Interest payers have one month after the date on which the notice is received to apply that notice. However, provision is made for the interest payer to apply a 33% or 39% withholding rate any time from receipt of the notice. This provision is intended to provide a transitional period during which interest payers can process notifications.
- The new section NF 2D provides that a company entitled to receive interest payments may elect the 33% and 39% withholding rates. A non-declaration rate of 39% applies to those companies that have not provided a tax file number. The election rules mirror those applying currently, although the 19.5% RWT rate option is excluded.
- Companies that are trustees are not required to notify their company status and may continue to use the 19.5% rate. This reflects the obligation on trustees to have regard to the tax position of the trust's beneficiaries.

Application date

This measure applies from 1 April 2001.

EARNINGS-RELATED COMPENSATION AND DEFINITIONS OF EMPLOYEE, EMPLOYER AND EMPLOYMENT

Section OB 1

Application date

These amendments apply from 19 December 1998.

Introduction

The definitions of “employee”, “employer” and “employment” are amended to ensure that the Accident Compensation Corporation is not treated as an employer for the purposes of the fringe benefit tax (FBT) rules in respect of earnings-related compensation it pays.

Background

For the purposes of the FBT rules, a person is an employer if that person pays a source deduction payment to another person and is therefore liable to pay FBT on any fringe benefits provided to employees (entitled to receive a source deduction payment). As earnings-related compensation is a source deduction payment, the Accident Compensation Corporation is potentially an employer for FBT purposes in respect of earnings-related compensation, and is therefore liable to FBT on any fringe benefits it provides to persons receiving earnings-related compensation such as medical benefits.

To avoid this, the definitions of “employee”, “employer” and “employment” exclude earnings-related compensation payable under the Accident Compensation Act 1982 and the Accident Rehabilitation and Compensation Insurance Act 1992 as being a source deduction payment. However, when the Accident Insurance Act 1998 was enacted, consequential amendments to these definitions were not made to exclude weekly compensation and other payments made under that Act.

Key features

The definitions of “employee”, “employer” and “employment” in section OB 1 are amended to ensure that the Accident Compensation Corporation is not treated as an employer for the purposes of the fringe benefit tax (FBT) rules in respect of earnings-related compensation it pays under the Accident Insurance Act 1998. These definitions are amended by excluding weekly compensation and other payments payable under that Act from being a source deduction payment for the purposes of the FBT rules.

MINOR REMEDIAL AMENDMENTS

Sections BB 2, BC 2, OB 1 of the Income Tax Act 1994; sections 15B, 33A, and 141JA of the Tax Administration Act 1994; sections 60 and 80 of the Taxation (GST and Miscellaneous Provisions) Act 2000

Introduction

Minor remedial amendments have been made to the Income Tax Act 1994, the Tax Administration Act 1994, and the Taxation (GST and Miscellaneous Provisions) Act 2000. They do not involve policy changes.

The amendments to the Income Tax Act 1994 are:

- Sections BB 2 has been amended to make it clear that non-filing taxpayers are not required to file income tax returns.
- Section BC 2 has been amended to ensure that the tax liability of non-filing taxpayers is the total of the tax deductions required to be made from their income.
- Section LD 1 has been clarified so that non-filing taxpayers with excess or a shortage of tax credits do not lose their status as non-filers.
- The definition of non-filing taxpayer in section OB 1 has been amended to make it clear that it includes those to whom the Commissioner is not required to send an income statement.

The amendments to the Tax Administration Act 1994 are:

- Section 15B has been expanded to clarify that non-filing taxpayers are not obliged to calculate their tax.
- Section 33A has been corrected to make it clear that the Commissioner may not issue an income statement to a non-filing taxpayer.
- A new section 141JA has been inserted to ensure that penalties for non-payment of tax do not apply to non-filing taxpayers.

All of the amendments to the Income Tax Act 1994 and the amendments to sections 15B and 141JA apply to the 1999–2000 and subsequent income years. The amendment to section 33A(4) applies from 27 March 2001.

The amendments to the Taxation (GST and Miscellaneous Provisions) Act 2000 are:

- Section 60(7) has been replaced to correct the application date of the extensions made by that Act to the serious hardship and financial difficulty provisions in the Tax Administration Act (sections 176 and 177).
- Section 80(2) has been replaced to correct the application date of a new definition of “tax” in section 184A of the Tax Administration Act that requires rebates to be refunded by direct credit.

These amendments apply on or after 10 October 2000.

CHANGES TO TAX ADMINISTRATION ACT 1994

OFFSETTING USE-OF-MONEY INTEREST AGAINST UNPAID TAX

Section 120F(2)

Introduction

An amendment allows Inland Revenue to offset use-of-money interest payable to a taxpayer (credit interest) against a taxpayer's unpaid tax before the terminal tax due date. This reduces a taxpayer's exposure to debit use-of-money interest and penalties.

Background

Under previous legislation, Inland Revenue was entitled to apply credit interest against a taxpayer's unpaid tax only if the taxpayer had failed to pay the tax by the due date. This means the tax must first have become overdue, exposing the taxpayer to penalties.

Key features

Section 120F(2) has been amended to allow Inland Revenue to offset credit interest against a taxpayer's unpaid tax liability at the time an initial assessment is able to be made, that is, the date a tax return is filed.

This amendment does not prevent taxpayers from requesting that credit use-of-money interest be paid out directly.

Application date

Because the rules relating to offsetting credit interest applied from 1 April 1998, this amendment is retrospective from that date.

TAX SIMPLIFICATION FOR BUSINESS

Sections 139B, 183B of the Tax Administration Act 1994 and sections 20, 21IC, and 23A of the Goods and Services Tax Act 1985

Introduction

Several amendments have been made to improve voluntary compliance by preventing small failures from creating significant compliance costs. The amendments will:

- provide substantial relief from the initial late payment penalty for those who pay a few days late
- cancel incremental late payment penalties when obligations under an instalment arrangement are being met, and
- move the payment of GST on fringe benefits from GST returns to fringe benefit tax returns.

Background

The *Less Taxing Tax* discussion document, released in September 1999, outlined tax simplification measures for businesses. Some of those measures were enacted by the Taxation (FBT, SSCWT and Remedial Matters) Act and the Taxation (GST and Miscellaneous Provisions) Act last year. The initiatives in this Act also implement measures outlined in that document and continue the programme of tax simplification for businesses.

Key features

Phased application of the initial late payment penalty

Section 139B of the Tax Administration Act 1994 imposes an initial late payment penalty of 5% when the due date for payment passes. The penalty reinforces a fundamental obligation of the tax system—the requirement to pay taxes by the due date. New subsections (2), (2A), (2B), (3), (3A) have been inserted into the section so that the initial late payment penalty applies in two stages:

- as a 1% penalty the day after the due date, and
- if the amount outstanding is not paid within a week of the due date, as a further 4% penalty of the total outstanding amount.

Example

If a GST payment of \$6,500 due 31 May 2002 was not paid until 3 June 2002 a 1% penalty of \$65 would be imposed on 1 June 2002.

If, however, the tax was not paid until 9 April 2002, in addition to the 1% penalty of \$65, a 4% penalty of \$262.60 would be imposed at the end of 7 April 2002.

The 1% penalty supports the original due date while not overly penalising those who pay just a few days late. If overdue payments are not paid within a week after the due date, the taxpayer will be in nearly the same position as arises under the current rules. Providing some relief to those who pay just a few days late prevents the penalty becoming disproportionate to the underlying omission. It also reduces the costs associated with applications for remission.

The initiative responds to some of the concerns expressed during the Finance and Expenditure Committee's inquiry into the powers and operations of the Inland Revenue Department. The penalty was seen as harsh when applied to basically honest taxpayers who have failed to pay their tax by only a few days. The Committee of Experts on Tax Compliance also expressed similar concerns.

The initial late payment penalty will apply in a phased way on and after 1 April 2002.

cancelling incremental late payment penalties during instalment arrangements

Under the previous law incremental penalties continued to accrue on outstanding tax even if the taxpayer had entered into an instalment arrangement with Inland Revenue to meet their debt. On the successful completion of the arrangement, those penalties were cancelled. However, if a taxpayer defaulted on any of the terms of the arrangement, the whole arrangement was cancelled and all the accumulated incremental penalties that would otherwise have been cancelled were reinstated.

As discussed in *Less Taxing Tax*, the effect of this policy was that a partial, possibly small, failure to comply with the provisions of an instalment arrangement could result in a disproportionate penalty.

A new subsection (3B) has been inserted into section 139B of the Tax Administration Act 1994 to prevent the second phase of the initial late payment penalty from being imposed if:

- the taxpayer enters an instalment arrangement before the due date, or
- Inland Revenue has exercised powers of compulsory deduction before the second phase of the initial late payment penalty is imposed.

Similarly, a new subsection (5A) has been inserted into section 139B of the Tax Administration Act 1994 to prevent incremental late payment penalties from being imposed for any month that:

- the taxpayer has met all of the terms of the instalment arrangement, or
- Inland Revenue has exercised powers of compulsory deduction.

Example

A taxpayer who anticipates that she will not be able to meet a GST payment due 31 May 2002 of \$13,000 enters into an instalment arrangement on 28 May 2002 to pay \$1,000 on the first day of each of the next thirteen months. The taxpayer fails to make the tenth payment but meets all her other tax obligations.

A 1% penalty of \$130 would be imposed on 1 June 2002 (the first phase of the initial late payment penalty). The second phase of the initial late payment penalty would not be imposed because the instalment arrangement would have been in place before the due date. No incremental late payment penalties would be imposed for the first nine months of the arrangement. However, in relation to the tenth month, a 1% penalty of \$40 would be imposed. No incremental late payment penalties would apply after that.

Removing incremental penalties as taxpayers meet the terms of their instalment arrangements will reduce compliance costs by helping to create a more simple and certain tax treatment for those with overdue tax. It will also reward compliance and prevent the imposition of penalties disproportionate to the underlying failure.

Obligations that taxpayers will need to meet to have incremental late payment penalties cancelled include:

- paying the agreed instalments by the due date
- paying future payments by the due date
- filing future returns by the due date, and
- informing Inland Revenue if their financial circumstances change.

These changes apply to late payment penalties imposed on and after 1 April 2002 and instalment arrangements entered into on and after 1 April 2002.

Consequential amendments have been made to section 183B of the Tax Administration Act 1994:

- to make it clear that from 1 April 2001 arrangements of one payment are eligible for relief, and
- to repeal it from the time that the reforms described earlier take effect.

GST on the value of fringe benefits

Employers are required to account for GST on some fringe benefits they provide. This is because the provision of the benefit is a supply for GST purposes. Under the previous law, the GST adjustment was calculated and returned with GST. However, to calculate it employers had to refer to their FBT returns to determine the value of output credits associated with the fringe benefits.

As outlined in *Less Taxing Tax*, the omission to make this adjustment is a common discrepancy identified in GST audits. The Committee of Experts on Tax Compliance noted that while the omission may be the taxpayer's fault, the tax system should be designed to minimise the likelihood of its occurrence.

The legislation has been amended to require this adjustment to be returned with FBT rather than GST. Three amendments have been made to the Goods and Services Tax Act 1985 to:

- exclude GST on fringe benefits from output tax (new section 20(3A))
- deem that the supply of goods and services takes place at the time the fringe benefits are provided (replaced section 21C(3)), and
- require the adjustment to be paid with the underlying FBT (new section 23A).

Including the payment of GST on the value of fringe benefits into FBT returns should reduce compliance costs. While eliminating the risk of an employer forgetting to include the payment in a GST return, and thereby incurring penalties for the oversight, it will also reduce the need for employers to keep records to ensure that they correctly account for GST on the fringe benefits that they provide. It should simplify accounting procedures, because, like fringe benefit tax itself, GST on fringe benefits is an expense.

The new policy applies to fringe benefit tax returns due on and after 31 May 2002 for quarterly or annual filers, and by the terminal tax date for the 2001–2002 income year for income year filers.

Some taxpayers may have to make a transitional payment to realign the payment of the adjustment with FBT returns from GST returns. Adjustments that have not been included in GST returns before these changes are due with the first FBT return, which includes a GST payment under the new rules.

SHORTFALL PENALTIES ON REFUNDS

Sections 141E(1)(d), (e) and 141E(3)

Introduction

Sections 141E(1)(d), (e) and 141E(3) have been amended to re-establish that a shortfall penalty for evasion can be imposed in all cases where someone wrongfully attempts to obtain a refund.

Background

Section 141E(1)(d) of the Tax Administration Act 1994 imposes a shortfall penalty for evasion of 150% in cases where taxpayers obtain a refund or payment of tax knowing that that they are not lawfully entitled to it. Section 141E(1)(e) imposes a similar penalty if a taxpayer enables another person to obtain the refund or payment of tax knowing that that they are not lawfully entitled to the refund or payment.

However, if, for example, someone attempted to obtain a refund knowing that they were not entitled to it, but the refund was halted by Inland Revenue, a penalty for evasion was not imposed simply because Inland Revenue did not make the refund.

The position that a taxpayer may attempt evasion and not be subject to a penalty if Inland Revenue detects that evasion, represented a significant deficiency in the tax legislation. All taxpayers who knowingly seek to obtain a refund or payment to which they are not lawfully entitled should be subject to the evasion penalty. Taxpayers should not benefit from Inland Revenue actions that result in the refund or payment not being made.

This amendment was included in the Bill at the select committee stage as a matter raised by officials.

Key features

The legislation has been amended to reflect its underlying intent. Penalties for attempted evasion have always been part of the tax system. Sections 141E(1)(d), (e) and 141E(3) have been corrected to re-establish that in cases where the taxpayer attempts to obtain a refund or payment of tax, an evasion penalty can be imposed.

Application date

The amendment applies from 1 April 1997, the date the compliance and penalties legislation took effect, apart from cases where the taxpayer has been advised by the Commissioner that a penalty for evasion cannot be imposed.

CANCELLATION OF INTEREST

Section 183C(5)

Introduction

This amendment clarifies the period for which taxpayers who receive both a notice of assessment and a statement of account are eligible for a cancellation of use-of-money interest.

Background

Taxpayers with unpaid tax who receive either a notice of assessment or a statement of account may be eligible for a cancellation of use-of-money interest if they pay the full amount outstanding within a defined grace period. In some instances taxpayers were issued with both a notice of assessment and a statement of account, which resulted in the grace periods overlapping. Previous legislation was unclear as to the period for which a taxpayer in this situation is eligible for an interest cancellation.

Key features

Section 183C(5) has been amended to clarify the period for which taxpayers are eligible for a cancellation of interest when they make payments of unpaid tax within overlapping grace periods. The period for which interest can be cancelled will begin the day after the date that the first notice or statement is issued and will end on the day that the payment is made, providing the payment is made within the overlapping grace period.

Application date

The amendment applies from 27 March 2001.

CHANGES TO GOODS AND SERVICES TAX ACT 1985

TOKENS, STAMPS AND VOUCHERS

Sections 5(11D) to 5(11I)

Introduction

Amendments have been made to section 5 of the Goods and Services Tax Act 1985, which applies to transactions involving the supply of tokens, stamps or vouchers. The amendments are to deal with issues that have arisen with the new rules enacted in the Taxation (GST and Miscellaneous Provisions) Act 2000.

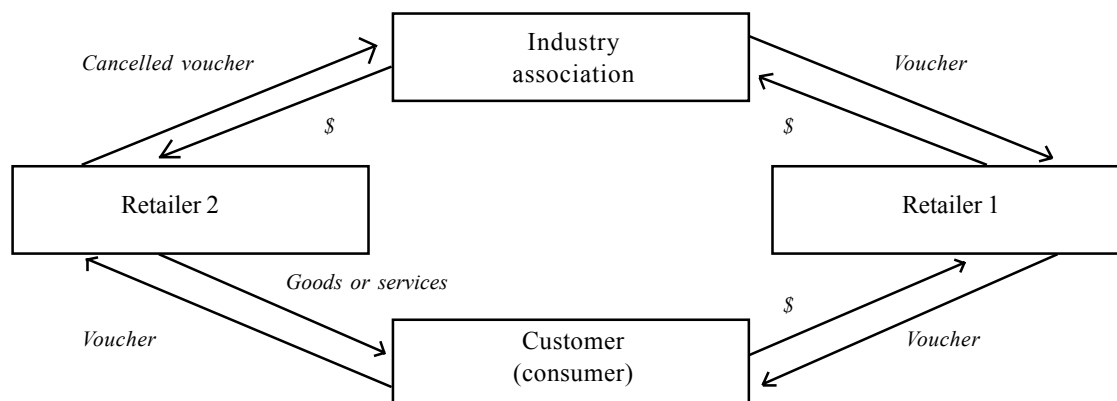
The changes removed difficulties with the GST treatment of progressively redeemed tokens, stamps or vouchers and aligned the treatment of tokens, stamps or vouchers with the GST time of supply rules.

The main difficulty with the new rules was in relation to multi-party arrangements, as illustrated below:

Background

Sections 5(11D) to 5(11I) replaced sections 10(16) to 10(17A) in relation to supplies of tokens, stamps and vouchers. Before the rules were introduced a supply in relation to a token, stamp or voucher was generally recognised, if there was no face value at the time of issue, or if there was a face value at the time of redemption. Under the new rules the supply of a token, stamp or voucher (regardless of whether it has a face value) is recognised at the time the token, stamp or voucher is issued. In relation to tokens, stamps or vouchers with a face value where it is not practical to recognise the supply on issue, GST may be recognised when the token, stamp or voucher is redeemed for goods and services.

A multi-party arrangement involving the supply of vouchers



In this illustration, the industry association issues a stock of vouchers, with a face value, for consideration to a participating retailer—retailer 1. Retailer 1 records the purchase of the voucher stock in its accounts. A customer purchases one of the vouchers from retailer 1 and some time later presents the voucher as consideration at participating retailer 2. Retailer 2 accepts the voucher as consideration for goods and services and in the process cancels it. Retailer 2 seeks reimbursement from the Industry Association in respect of the cancelled voucher.

In accounting for GST, the industry association and the participating retailers agreed that GST should be accounted for when the voucher was redeemed rather than when it was issued.

The difficulties with the application of the new rules were:

- *The potential for double taxation to occur:* Although the rules were designed to ensure that GST was payable only once, the wording of the recent amendments arguably created the possibility, where GST is recognised at the time of redemption, that GST could be triggered on any subsequent transaction after a token, stamp or voucher was issued. Therefore the sale between retailer 1 and the customer could arguably be subject to GST.
- *The meaning of the word “redemption”:* There was also an argument that when participating retailer 2 seeks reimbursement from the Industry Association another imposition of GST could be triggered, as the word “redemption” was not limited to the redemption of the voucher for goods and services.
- *“Not practical”:* Another problem was that the “not practical” requirement for adopting the redemption basis did not extend to an issuer of tokens, stamps or vouchers who was also the supplier of the goods and services for which the tokens, stamps or vouchers were redeemed.

Key features

The amendments:

- Remove the potential for transactions involving the supply of tokens, stamps or vouchers to be taxed twice.
- Clarify that “redemption” does not include redemption of a token, stamp or voucher for money.
- Extend the “not practical” requirement to situations where the issuer of a token, stamp or voucher and the supplier of the goods and services are the same person.

Analysis

Issue or sale

One of the purposes of the amendments was to align the GST treatment of transactions involving the supply of tokens, stamps or vouchers with the general time of supply rule, being the earlier of invoice or payment. Therefore the general rule that is applicable to the supply of a token, stamp or voucher is that GST is recognised when the token, stamp or voucher is issued. The amendments confirm in relation to the general rule that GST should be recognised only when a token, stamp or voucher is issued or sold to a final consumer. The legislation achieves this by excluding from the term “supply” the issue or sale of a token, stamp or voucher to a person who will subsequently issue or sell that token, stamp or voucher.

Redemption

It has been clarified that redemption of a token, stamp or voucher for money does not give rise to further GST consequences. It has also been clarified that it is the bearer of the voucher who redeems the voucher rather than the supplier of the goods and services.

“Not practical”

In order to recognise GST on redemption of a token, stamp or voucher with a face value the supplier must establish that it is not practical to return GST when the token, stamp or voucher is issued. This exception to the general rule was included to reduce compliance costs. With regard to the interpretation of the words “not practical”, in some cases it was considered that the legislation could unjustifiably require taxpayers to change longstanding arrangements and account for GST when a token, stamp or voucher is issued.

The amendment clarifies that when the issuer of a token, stamp or voucher and the person supplying the goods or services in exchange for the voucher are not the same person, they may elect to recognise GST at the time of redemption rather than issue. The application of the amendment still requires that there be an agreement between the taxpayers to this effect but now, in the alternative, requires that they are party to such an agreement.

The amendment also allows the redemption basis when the issuer and the supplier are the same person provided it is impractical for the taxpayer to account for GST when the token, stamp or voucher is issued.

The following situations are examples of where the “not practical” requirement is likely to have been met:

- *The supplier of the voucher and supplier of the goods and services are different persons and are parties to an agreement:* A member of a franchise chain of food stores sells a gift voucher to a customer. The voucher is redeemable at any of the franchise stores throughout New Zealand. Neither the customer nor the store selling the voucher has control over where the voucher is redeemed. The franchise stores are all party to an agreement to use the redemption method.
- *The supplier of the voucher and the supplier of the goods and services are branches of the same company:* A department store sells a gift certificate to a customer. At the time of sale the department store cannot tell whether the voucher will be redeemed at its store, or a related branch. The store and its affiliated branch are legally the same person but have separate accounting systems.
- *The supplier of the voucher is the same person as the supplier of the goods and services but the vouchers are regularly used as part payment for goods and services:* A fashion retailer sells gift vouchers to customers. The vouchers can only be redeemed with that particular fashion retailer as it is the only store of its kind. The vouchers are regularly used in conjunction with cash to purchase clothing of a greater value than the face value of the voucher.

Variations of these examples may also meet the requirements where it is “not practical” to recognise GST at the time when a token, stamp or voucher is issued.

No consideration

Some tokens, stamps or vouchers such as those that received in the mail will allow consumers to receive goods and services to a specified value. These vouchers have been excluded from the scope of sections 5(11D) to 5(11I). If a token, stamp or voucher is issued for no consideration, no GST consequences will arise on the issue of that token, stamp or voucher. However, when the token, stamp or voucher is redeemed it will be treated under the general GST provisions as consideration for the supply of goods and services at the time it is converted.

Application date

The amendments to sections 5(11D) to 5(11I) apply from 10 October 2000.

OTHER REMEDIAL CHANGES

Definition of “associated persons”

Section 2A of the Goods and Services Tax Act 1985 has been amended to exclude from the definition of “associated persons” the relationship between a settlor of a trust and a trustee that is a charitable or non-profit body.

A settlor of a trust is widely defined to include any person that provides anything to a trust for less than market value. The wide ambit of the definition is necessary to prevent the trustee–settlor associated persons test being circumvented. Before the amendment, the definition of “settlor” could have resulted in a donor to a non-profit body or a charitable trust being associated with that body or trust. This outcome was not intended.

Zero-rated supplies

Section 11(1)(f) allows goods to retain their zero-rated status in the event that the goods are destroyed or die. The section has been amended so that the circumstances leading to the death or destruction of the goods must be beyond the control of both the supplier and the recipient. Before the amendment, the section referred to the event being out of the control of either the supplier or the recipient.

Adjustments

Remedial amendments have been made to sections 21A and 21B, which require taxpayers to make GST adjustments when goods and services are used for a purpose other than that of making taxable supplies.

Fair and reasonable

Section 21A sets out the methods for allocating input tax credits between taxable and non-taxable uses of goods and services:

- Section 21A(1) sets out the two general methods of allocation—actual use (direct attribution) and a Commissioner-approved alternative method if the method results in a fair and reasonable allocation.
- Section 21A(2) allows the use of either of the two methods in section 21A(1) or the turnover method for ascertaining the proportion by which input tax credits should be allocated where the taxpayer makes exempt supplies. This method is generally used when the actual use method is difficult to apply—for example, in the case of overhead expenses.

The amendment clarifies that the method of allocation chosen by taxpayers under section 21A(1) or (2) should give a fair and reasonable result.

New assets

Section 21B(3) determines the method of allocation that taxpayers apply when they have elected to make a one-off adjustment. The amendment to section 21B(3) widens its application to include assets acquired as new when there is no existing pattern of use. In circumstances where an existing pattern does not exist the taxpayer will need to revise the estimate twelve months after the date of purchase or production.

Cross-references and minor corrections

Further amendments have been made to correct cross-references to the Customs and Excise Act 1996 in section 21E and to correct minor drafting errors in sections 5(13A) and 42 of the GST Act.

Application date

The amendments to the GST Act apply on or after 10 October 2000.

CHANGES TO THE STAMP AND CHEQUE DUTIES ACT 1971

APPROVED ISSUER LEVY

Sections 86I, 86K, 86KA and 86M of the Stamp and Cheque Duties Act 1971; and section 3(1) of the Tax Administration Act 1994

Introduction

Amendments have been made to the approved issuer levy (AIL) rules in order to improve their equity as well as to ensure more consistent administration with other revenues. They allow the compliance and penalty rules to apply to payments made after the due date of AIL, consistent with other revenues, rather than imposing non-resident withholding tax (NRWT) as was previously the case. Also, consistent with similar provisions in the resident and non-resident withholding tax rules, it is now possible to make payments of AIL six-monthly rather than monthly when the expected annual liability to AIL is less than \$500. Additionally, the amendments clarify that persons other than the approved issuer may make payments of AIL, from the date a security has been registered with Inland Revenue, and have NRWT zero-rated. This amendment has been passed retrospectively to the inception of the AIL rules, 1 August 1991.

Background

As the AIL rules are concessionary, the original intent was that they apply only if the borrower complied with strict conditions, including payment on time. Although there was limited scope for payments made after the due date to stay within the AIL rules, a payment made after the due date of AIL usually meant the full rate of NRWT was payable. Payment of NRWT at the full rate was not originally considered a penalty, as in 1991 NRWT was the norm, and AIL was a concession. Over time, however, as the payment of AIL has become the norm, in relation to interest derived from New Zealand by non-residents, the imposition of NRWT had come to be seen as a penalty for late payment out of line with other penalties for payments made after the due date. Thus for consistency with all other revenues administered by Inland Revenue, an amendment has been made to incorporate AIL within the compliance and penalty rules.

It was envisaged at the time AIL was introduced that persons other than the approved issuer (borrower), such as nominee companies, should be able to make payments of AIL, and still comply with the conditions for NRWT to be zero-rated. Tax practitioners, however, recently highlighted that this policy was not reflected in the legislation. Consistent with the original policy, amendments have been made, retrospectively to the inception of AIL, to allow zero-rating of NRWT when a person other than the approved issuer makes the payment of AIL.

As a simplification measure consistent with the resident and non-resident withholding tax rules, an additional amendment has been made to allow taxpayers with expected annual liabilities of under \$500 to make payments of AIL six-monthly rather than monthly as was the case.

Key features

Paragraphs (a)(vii) and (d)(vii) of the definition of “tax” in section 3(1) of the Tax Administration Act 1994 and section 86M of the Stamp and Cheque Duties Act 1971 have been repealed, and section 86I(b) of the Stamp and Cheque Duties Act amended. This is to allow non-resident withholding tax to be zero-rated when AIL is paid late, on the condition that accrued penalties and interest are paid in accordance with the compliance and penalty rules.

Sections 86I and 86K(1) of the Stamp and Cheque Duties Act 1971 are amended retrospectively to allow persons other than the approved issuer to make payments of AIL and still be zero-rated for NRWT.

Section 86KA of the Stamp and Cheque Duties Act 1971 is added to allow taxpayers with an expected annual AIL liability of \$500 or less to make payments every six months, rather than every month as previously.

Application dates

The change in policy to allow the compliance and penalty rules to apply to AIL paid after the due date applies to payments of interest on and after 27 March 2001.

The retrospective amendments to section 86I and 86K(1) of the Stamp and Cheque Duties Act 1971, apply from 1 August 1991.

The right to make payments of AIL six-monthly applies on and after 27 March 2001.

ORDER IN COUNCIL – THE GOODS AND SERVICES TAX (LOCAL AUTHORITIES ACCOUNTING ON PAYMENTS BASIS) ORDER 2001 (SR 2001/85)

A recent Order in Council, the Goods and Services Tax (Local Authorities Accounting on Payments Basis), made on 7 May, allows nine local authorities four years in which to change to an invoice basis of accounting for GST. It provides for the Far North, Gisborne, Kaipara, Opotiki, Ruapehu, Waitomo, Whakatane and Western Bay of Plenty District Councils and the Northland Regional Council to continue to account for GST on a payments basis until June 2005.

From 1 July 2001, the Goods and Services Tax Act 1985 requires all local authorities to account for GST on an invoice basis rather than a payments basis. The Order allows time for these local authorities to resolve transitional issues associated the shift to invoice basis accounting.

Notice of the Order was made on 10 May 2001 in the New Zealand Gazette. The Order will not come into force until 28 days after that date.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions that people have asked. We have published these as they may be of general interest to readers.

These items are based on letters we've received. A general similarity to items in this package will not necessarily lead to the same tax result. Each case will depend on its own facts.

CASH PRIZES IN SPORTING COMPETITIONS – GST IMPLICATIONS FOR ORGANISING CLUB

Sections 5(10) and 10(14), Goods and Services Tax Act 1985 – supply where game of chance etc

The secretary of a GST-registered amateur sports club has asked us to clarify whether or not the club is able to claim GST input tax deductions on cash prizes awarded to participants in bowls competitions organised by the club. They have noted that section 10(14) permits the amount of prizes paid in cash to be deducted from total proceeds in relation to certain games and competitions, thus reducing the net amount of GST payable in respect of the competition.

Many clubs run regular sporting competitions, and these competitions are part of the club's taxable activity. A membership fee allowing a person to use the club facilities may be payable, and this fee may also allow members to enter competitions.

Alternatively, a separate fee may apply for entry into the competition. In both cases such fees contribute towards the costs of administering and running the competition, as well as allowing the use of facilities.

As a registered person, the club will return output tax on membership fees and competition entry fees. The club will be able to claim input tax on all the goods and services purchased in order to provide the competition. "Goods" and "services" are both defined in section 2 of the Act.

"Goods" means all kinds of personal or real property; but does not include choses in action or money:

"Services" means anything which is not goods or money:

Trophies, bottles of wine, meat packs, or similar items fall within the definition of goods. As such input tax deductions can be made. If a prize is donated, there is no GST component as there is no consideration paid for that prize.

Cash prizes, however, are treated differently because they do not fall within either the definition of "goods" or "services". The section 2 definitions of "goods" and "services" specifically exclude money. Thus it is not possible for the club to claim GST on any money acquired for the purposes of awarding a prize, because money is not a good or service.

Having concluded that money is neither "goods" nor "services", a further question arises as to whether the sporting competition is a "game of chance", "lottery", "prize competition", etc, in order for sections 5(10) and 10(14) to apply.

Relevant sections of the Goods and Services Tax Act 1985 are:

Section 5:

(10) Notwithstanding anything in this Act, for the purposes of this Act where any person pays an amount in money to participate in a game of chance, lottery, New Zealand instant game, New Zealand lottery, New Zealand prize competition, or prize competition, the amount of money so paid to participate shall be deemed to be for a supply of services by the person, society, licensed promoter, or organiser who, pursuant to the Gaming and Lotteries Act 1977, conducts the game of chance, lottery New Zealand instant game, New Zealand lottery, New Zealand prize competition, or prize competition.

(11) For the purposes of subsection (10) of this section—

- (a) The terms "game of chance", "gaming machine", "lottery", "prize competition", and "society" have the same meanings as defined in section 2 of the Gaming and Lotteries Act 1977:
- (aa) The terms "New Zealand instant game", "New Zealand lottery" and "New Zealand prize competition" have the same meanings as defined in section 71 of the Gaming and Lotteries Act 1977:
- (b) The term "amusement device" has the same meaning as defined in section 10 of the Gaming and Lotteries Act 1977:

- (c) The term “licensed promoter” has the same meaning as defined in Part V of the Gaming and Lotteries Act 1977:
- (d) The term “organiser” means the New Zealand Lotteries Commission established by section 72 of the Gaming and Lotteries Act 1977.

Section 10:

(14) Where a supply of services is deemed to be made under section 5(10) of this Act, the consideration in money for the supply shall be deemed to be such portion of the amount in money a person pays to participate in a game of chance, lottery, New Zealand instant game, New Zealand lottery, New Zealand prize competition, or prize competition, as represents the total proceeds (after deducting the amount of all prizes paid and payable in money) in respect of that game of chance, lottery, New Zealand instant game, New Zealand lottery, New Zealand prize competition, or prize competition.

(15) For the purposes of subsection (14) of this section^{3/4}

- (a) The terms “game of chance”, “lottery”, and “prize competition” have the same meanings as defined in section 2 of the Gaming and Lotteries Act 1977:
- (b) The terms “New Zealand instant game”, “New Zealand lottery”, and “New Zealand prize competition” have the same meanings as defined in section 71 of the Gaming and Lotteries Act 1977.

In addition, the Gaming and Lotteries Act 1977 defines “game of chance” and “prize competition” in the following terms:

“Game of chance” means a game—

- (a) In respect of which direct or indirect consideration is paid to participate; and
- (b) That is played with a view to winning money or money’s worth; and
- (c) The outcome of which depends wholly or partly on chance;—

but does not include an athletic game, or a sporting event, or a New Zealand lottery, or a New Zealand prize competition:

“Prize competition” means a scheme or competition in respect of which direct or indirect consideration is paid to participate, and of which the result is determined partly by a considerable element of chance (whether chance plays the greater or lesser part), and partly by the performance by the contestants of some activity of a kind that may be performed more readily by contestants possessing or exercising some knowledge or skill, whether or not it may also be performed successfully by chance; but does not include—

- (a) An instant game; or
- (b) A New Zealand instant game; or
- (c) Any such scheme or competition to which Part VII of this Act applies:

Section 10(14) allows cash prizes to be deducted from the total proceeds of a “game of chance”, “lottery”, “prize competition”, etc, thus reducing the net amount of GST payable. However, section 10(14) only applies to taxable supplies under section 5(10).

Section 5(10) deals with supplies where there is a “game of chance”, “prize competition”, etc. Paying money to participate in any of the defined “games of chance”, “prize competition”, etc, is treated as payment for a supply of a service.

The particular activities listed in the section are all defined in the Gaming and Lotteries Act 1977, including the term “prize competition”. “Prize competition” has the same meaning in the GST Act as it does under the Gaming and Lotteries Act. Thus, if an event is a “prize competition”, the rules of the Gaming and Lotteries Act will apply.

The Gaming and Lotteries Act definition of “game of chance” excludes an “athletic game” and a “sporting event”. A “game of chance” by definition is one that depends on luck, and not the skill of the competitor. In the context of the Gaming and Lotteries Act, the definition of “game of chance” refers to “chance” in a gambling sense, i.e. the Gaming and Lotteries Act deals with the promoting, licensing, and regulation of gambling-related activities by a person, society, licensed promoter, or organiser pursuant to that Act.

A sports competition does not become a “prize competition” for the purposes of the Gaming and Lotteries Act, simply because prizes are awarded. A “prize competition” requires there to be a considerable element of chance, and some skill or knowledge. A sports competition will not generally come within the definition of “prize competition”, as the participants are competing on the basis of their skill or knowledge in the relevant sport. Nor will such sporting competitions come within any of the other definitions referred to in section 5(10) as they will not be organised, licensed, or promoted **pursuant to** the Gaming and Lotteries Act.

Because section 5(10) does not apply, section 10(14) will not apply either. Section 10(14) contains a particular concession for games of chance in which GST is only payable on the proceeds of the game of chance, prize competition, etc, after the amount of the prize money has been deducted.

Therefore, the sports club will not be able to rely on the provisions of sections 5(10) and 10(14) to deduct the amount of any cash prizes from the total proceeds received from the amateur sports (bowls) competitions. Accordingly, the GST payable in respect of the competition will not be reduced, or other GST relief obtained, in respect of cash prizes for clubs’ sports competitions.

While every case will depend on its own facts, the Commissioner does not generally consider the awarding of minor “spot” prizes as part of the sporting competition would alter this characteristic unless part of the fee could be seen to be attributed to the possibility of receiving such spot prizes.

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, the Court of Appeal and the Privy Council.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision. Where possible, we have indicated if an appeal will be forthcoming.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

WHETHER SALE OF VESSEL ATTRACTED GST – JUDICIAL REVIEW

Case:	Simunovich Fisheries Ltd v CIR and Owen Joseph Knock
Decision date:	26 April 2001
Act:	Judicature Amendment Act 1972, Goods and Services Tax Act 1985
Keywords:	<i>Judicial review</i>

Decision

His Honour, Priestly J, stated that so far as the substantive provisions of the GST Act are concerned, the December 1997 sale of the vessel should have attracted GST at the normal 12.5% rate. Since Simunovich **in fact** acquired the vessel as a secondhand good from a non-registered GST entity a section 11(1)(ag) zero rating provision was not available.

Having decided this, His Honour looked at whether there was anything arising out of the facts or any legal principles that would exonerate Simunovich from its GST liability for the 31 January 1998 period. In regards to the four-year time limit contained in section 108A(1), His Honour stated that this time limit must be seen in the context of that provision and the statutory regime generally. His Honour said that the legislative policy is to stipulate a period beyond which the Commissioner cannot issue further assessments that have the effect of **increasing** the amount of tax payable. In regards to the facts of this case His Honour found that the 10 August 1999 NOPA did not purport to alter or amend the assessment of the plaintiff's GST liability for the 31 July 1995 period. Nor does the treatment of the June 1995 purchase of the vessel as a purchase of a secondhand good from a non-registered entity, rather than as a taxable supply, alter the assessed figure for the 31 July 1995 period. In this case there has only potentially been a change of grounds and no increase in the assessment. On that analysis the four-year time limit contained in section 108A(1) does not apply.

Summary

Priestley J, found for the Commissioner on all issues.

Facts

In June 1995 Simunovich Fisheries Ltd ("Simunovich") purchased a fishing vessel (*Longva III* subsequently renamed *Kermadec*). Simunovich claimed the purchase price of the vessel as an input tax credit for the GST period ending 31 July 1995. In December 1997 Simunovich sold the vessel. For the GST period ending 31 January 1998 Simunovich claimed that the vessel was subject to GST at a 0% rate.

On 10 August 1999 the Commissioner issued Simunovich with a Notice of Proposed Adjustment ("NOPA") for the 31 January 1998 GST period. The NOPA proposed that the sale proceeds of the vessel should, so far as the 31 January 1998 taxable period was concerned, attract GST. The NOPA asserted that the transaction attracted GST because the vessel's acquisition by the plaintiff in January 1995 was the supply of a secondhand good by an entity that was not registered for GST. That assertion was contrary to the stance previously adopted by the Commissioner for the 31 July 1995 GST taxable period in respect of which the last Notice of Assessment, issued 6 November 1995, allowed the purchase price of the vessel as an input tax credit, that is as a taxable supply.

In response to Simunovich's submissions that the Commissioner's decision, signalled in the NOPA, to alter the ground on which the vessel's purchase price is treated as a taxable supply, has the effect of creating a new taxation liability on the wrong side of the four-year period where no liability had existed, His Honour stated that this argument is flawed.

His Honour found that the grounds for the assessment can properly be distinguished from the assessed figure. Such a distinction was recognised by the Court of Appeal in its recent decision of *Hyslop v Commissioner of Inland Revenue* where, in the context of objection procedures, the Court drew a distinction between making an assessment and giving notice of an assessment, such distinction being essentially the difference between coming to a decision and communicating a decision. The Court also made a distinction between giving notice of assessment and providing the taxpayer with details of such assessment to facilitate framing an objection. The 6 November 1995 Notice of Assessment and the resulting refund to Simunovich were based on the premise that the purchase price of the vessel entitled the plaintiff to an appropriate input tax figure because the vessel was acquired for the principal purpose of making taxable supplies. Neither Simunovich nor the Commissioner seek to resile from that situation.

His Honour concluded that section 108A(1) does not prevent the Commissioner from rejecting the plaintiff's claim that the sale of the vessel in December 1997 was not a zero-rated transaction but instead attracted GST at the normal rate. His Honour also stated that if he is wrong in that conclusion he would additionally hold against Simunovich on the basis that section 108A(1) applies on its face to amended assessments in respect of which there is none for the July 1995 period. Even if there were such an amended assessment on a new ground there has been no increase in the amount assessed. Court of Appeal's dicta in *Dandelion Investments Limited v Commissioner of Inland Revenue* and *Brierly Investments Limited v Commissioner of Inland Revenue* applied and require an increased amount of payable tax as an essential component of the section 108A(1) bar.

In regards to Simunovich's claim that the Commissioner's decisions were reviewable on the grounds of legitimate expectation and estoppel, His Honour stated that, since the passage of section 6 and section 6A of the Tax Administration Act, the door has not permanently been closed on the possibility that the Commissioner can be reviewable on these grounds. However, the facts of this case go nowhere close to being one in which relief on those grounds can seriously be contemplated. The facts of this case do not permit any finding that Simunovich has been misled by the Commissioner or his actions in the August to November 1995 period. His Honour also found that Simunovich's own actions have undoubtedly contributed to the dilemma in which it now finds itself.

WHETHER AWARD FOR LOSS OF WAGES AND BENEFITS WAS ASSESSABLE, WHETHER LEGAL EXPENSES DEDUCTIBLE

Case: Derek Earl Cleland v CIR
Decision date: 30 April 2001
Act: Income Tax Act 1976
Keywords: *Deductibility of legal expenses, monetary remuneration*

In his statement of claim the plaintiff sought the following remedies:

Loss of salaries 1/7/89 to 12/6/91 due to lower salary	\$4,059.42
Loss of capitalised retiring allowance	\$10,815.26
Loss of payment of retiring leave	\$3,113.05
Loss of income 13/6/91 to 18/7/95	\$183,516.16
Loss of annual retiring allowance during life expectancy	\$20,284.53
Loss of financial benefits	\$221,788.42

Summary

The plaintiff was unsuccessful in his appeal from the TRA.

Facts

The plaintiff was an Inland Revenue employee. The plaintiff's employment contract provided for an optional retirement date of 18 July 1990 and a compulsory retirement date of 18 July 1995.

As part of a restructuring process Inland Revenue placed the plaintiff in the position of technical officer to take effect from July 1989. This position attracted a lower salary than the plaintiff's previous position as a senior auditor and Inland Revenue paid him an abating equalisation allowance.

The plaintiff refused to accept the new position because he lost the benefits of any future salary increase and because any retirement lump sum or leave entitlement would have been based on the lower salary alone as would any capitalisation of government superannuation fund payments.

The plaintiff initiated a dispute of rights mediation and a personal grievance mediation. His complaints were not upheld. In February 1991 Inland Revenue issued an ultimatum to the plaintiff that he either work as a technical officer or be dismissed. On receiving this ultimatum the plaintiff resigned.

On 11 November 1991 the plaintiff filed a statement of claim in the Employment Court claiming that the termination of his employment amounted to an unjustified constructive dismissal and seeking compensation pursuant to the Labour Relations Act 1987 ("LRA").

The Employment Court found that the plaintiff had suffered a constructive dismissal and awarded him \$126,000 made up in the following way:

Loss of wages due to date of hearing (s 229 LRA)	\$46,000
Humiliation (section 227(c)(i) LRA)	\$30,000
Loss of benefits (section 227(c)(ii) LRA)	\$50,000
Total	\$126,000

The plaintiff sought to deduct the legal expenses he incurred in pursuing the Employment Court award. The Commissioner disallowed the deduction on the basis that the legal fees were income from employment and therefore prohibited from deduction. The Commissioner also assessed \$96,000 of the award made under section 227(c)(ii) and 229 of the LRA (being the loss of benefits and the loss of wages) as monetary remuneration as defined in section 2 of the Income Tax Act 1976.

The plaintiff objected to this assessment. A case was stated to the Taxation Review Authority ("TRA") and in a decision dated 20 March the TRA found in favour of the Commissioner. The plaintiff appealed the TRA decision.

Decision

His Honour, Hammond J, found for the Commissioner on all issues. His Honour stated that in this case the section 229 award was clearly for loss of wages due up to the date of hearing and easily came within the definition of monetary remuneration in section 2 of the Act. The section 227 award was “forward looking” and was for the loss of any benefit, monetary or otherwise, which the taxpayer might reasonably have expected to obtain had the personal grievance not arisen.

His Honour found that given the fact that a specific award had been made for humiliation, the section 227(c)(ii) portion of the award was of an economic character.

His Honour found that whether the section 227(c)(ii) portion of the award fell within the definition of monetary remuneration depended upon whether it could be said to be awarded “in respect of or in relation to the employment or service”. Hammond J concluded that the taxpayer would not have received the award at all had he not previously been employed by Inland Revenue and that the award was clearly in respect of or in relation to the taxpayer’s past employment.

Hammond J specifically found against the plaintiff’s argument that, because the award was calculated on future wages and benefits, it was not compensation for loss of office or employment.

In examining the issue of whether the award fell within the definition of a redundancy payment, his Honour said that it was necessary to look at the true nature of the legal arrangements pursuant to which the payment was made. His Honour found that the Employment Court did not compensate the taxpayer for redundancy and nor could it have done so under section 227 and 229 LRA had it wished.

His Honour also rejected the plaintiff’s argument that a redundancy payment need not necessarily be received upon the occasion of the termination of employment.

In respect of the legal fees, His Honour found that they were incurred in gaining or producing the award (which fell within the definition of “extra emolument” in section 2 of the Act) and were therefore prohibited from deduction by section 105 of the Act 1976 as expenses incurred in gaining or producing income from employment.

Costs of \$3,000 plus disbursements were awarded to the Commissioner.

WHETHER SUPPLY OF REPAIR SERVICES UNDER WARRANTY AGREEMENT ZERO-RATED FOR GST

Case: Suzuki New Zealand Ltd v CIR
Decision date: 7 May 2001
Act: Goods and Services Tax Act 1985

The dispute is focussed on the GST treatment of sums received by SNZ from SMC Japan. No issues arise in respect of the warranty payments from SNZ to dealers.

Summary

The taxpayer's appeal and Commissioner's cross-appeal were both dismissed, resulting in a win for the Commissioner.

Facts

Suzuki New Zealand ("SNZ") purchases Suzuki motor vehicles from Suzuki Motor Corporation ("SMC") which is the Japanese parent company. The terms of the sale and purchase agreement include a provision under which SMC warrants the goods to SNZ. The warranty is in respect of parts and labour for up to one year from the date the vehicle is sold to any particular customer. The beneficiary of the warranty is SNZ.

Once the Suzuki products arrive in NZ, they are sold to independent dealers. The dealers then sell to the public. Each vehicle is sold with a warranty provided by SNZ. This warranty is separate from the warranty agreement between SMC and SNZ. SNZ has an agreement with each dealer that if the dealer repairs a vehicle covered by the warranty provided by SNZ the dealer will be paid by SNZ at standard rates for the work. The warranty provided by SNZ covers any repairs specified in the agreement that are necessary within a period of three years after the purchase of the Suzuki product. The work is generally done by the same dealer that sold the vehicle to the customer.

SNZ contracts with the eventual purchaser of vehicles to provide the retail warranty. The dealers are authorised to offer the warranty to the purchasers.

When a customer has a problem with a vehicle, the customer normally returns it to a dealer, who assesses the vehicle to determine whether it is covered by the warranty. If he or she considers the repairs will cost more than \$250, authority from SNZ to begin work is needed. The dealer repairs the vehicle free of charge to the customer. The dealer seeks payment from SNZ, who pays according to their agreement. The dealer accounts for output tax on the payment from SNZ and SNZ claims an input tax credit. SNZ may only then, after the repairs have been completed, approach SMC under the warranty between SMC and SNZ. If SMC is satisfied it is liable, it pays SNZ under the terms of the agreement between SMC and SNZ.

Decision

A Full Bench upheld McGechan J's first finding that SNZ supplied repair services to SMC, which were not zero-rated. This was sufficient for the Commissioner to succeed.

It was not necessary to determine the cross appeal, but the Court indicated that had it been necessary, it would have been sympathetic to the Commissioner's cross-appeal. This meant that the Court of Appeal indicated it did not agree with the High Court finding in favour of the taxpayer that SMC's payments were not in consideration for SNZ's supply of repair services under the SNZ warranty.

Whether SNZ supplied repair services to SMC Japan

On the first issue, concerning whether SNZ made a supply of repair services to SMC, the taxpayer argued the payments were not for repair services, and the particular documentation should be interpreted as a mere obligation by SMC to pay compensation for defects.

The Court held on the documentation the payments by SMC were in respect of supplies of repair services by SNZ to SMC. The contracts were simply an illustration of a common situation where performance of an obligation under one contract is also performance under the other.

Whether repair services zero-rated under section 11(2)(c)

The second leg of the first issue concerned whether the repair services were zero-rated or standard-rated. Quite simply the court had no doubt repair services were carried out on cars in NZ, so the supply could not be zero-rated.

Whether payments by SMC Japan to SNZ consideration for repairs by SNZ for customers

The second issue concerned whether payments by SMC Japan were "consideration" for repairs by SNZ for the customers. The CIR relied on this as an alternative argument, which had already failed before the TRA and the HC.

The Court of Appeal indicated that it would have been sympathetic to the view that the payments by SMC could be held to be consideration of SNZ's supply of repair services under SNZ's warranty.

WHETHER LEGAL FEES IN RESPECT OF PERSONAL GRIEVANCE ACTIONS WERE DEDUCTIBLE

Case: TRA Number 00/026. Decision Number 4/2001

Decision date: 2 May 2001

Act: Income Tax Act 1994

Keywords: *Deduction, course of carrying on a business, reputation, capital, income from employment, gross income, nexus, apportionment*

Summary

The Authority found for the Commissioner, confirming all assessments.

Facts

The dispute concerned a claimed deduction for legal fees, which were incurred by the disputant after he was made redundant. The disputant felt he had been unjustifiably dismissed and commenced grievance proceedings, firstly with the Employment Court, seeking an injunction for reinstatement, then secondly with the Employment Tribunal seeking damages under the Employment Contracts Act 1991.

The disputant was made redundant on 23 October 1997 and commenced employment with another company on 2 March 1998. During the intervening four-month period, he sought to gain income by marketing his services to business associates and other contractors in his field of expertise. A number of agreements were signed with various contractors but no paid work was obtained. During the four-month period the disputant returned no income from self-employment.

The disputant sought to deduct legal expenses of some \$101,000 representing invoices in respect of his personal grievance actions in the Employment Tribunal, Employment Court and Court of Appeal. The Commissioner has declined the deductions on the basis that the expenses were incurred in respect of gaining income from employment rather than being incurred in deriving gross income or in the course of carrying on a business for the purpose of deriving gross income.

Decision

On the first issue, Judge Willy found that the disputant was in fact carrying on a business during the four-month period in question. His Honour weighed the activities the disputant was engaged in against the relatively short period of that activity and held that a business had nonetheless commenced. In so doing he considered the business tests set out by the Court of Appeal in the well-known *Grieve, Eggers and Stockwell* cases.

His Honour found for the Commissioner on the second issue, that, even if there was a business activity, there was insufficient nexus with the expenditure claimed and the income-earning activity. The disputant's argument turned on the "preservation of reputation" cases such as *Case N4* (1991) 13 NZTC 3030, and *A v CIR* (1985) 7 NZTC 5074. His Honour followed the Commissioner's submissions that the legal costs did not arise from the conduct of the purported business, as did the taxpayers' expenses in the cited cases, but had their genesis in a completely separate action. On this basis Judge Willy held that the disputant failed, and confirmed the Commissioner's assessments.

This was followed by an obiter discussion of the Commissioner's alternative submissions. His Honour rejected the argument that the legal fees were expenses of a capital nature, noting that "...there are cases in which the incurring of legal costs to prosecute defamation proceedings to protect an established business have been allowed..." Further, his Honour found that the next submission that the expenditure was purely a private or domestic matter (being the preservation of personal reputation) did not arise on the facts, but if it had, then it couldn't be private.

The submission that the deduction was barred by section BD2(2)(c) of the Act (obtaining income from employment) was also discussed:

"This is in my view really another way of looking at the question of whether a nexus exists between the business activity and the payments concerned. If that nexus does not exist, as I have found, then the work to which the payments attach is clearly connected with the disputant's employment contract with his former employers. To that extent it may be that the Commissioner is correct in this submission, but it can only become relevant once it has been found that the payments are too remote to comprise a business expenditure."

Finally, his Honour accepted the Commissioner's submissions that, had the issue arisen, the disputant would have failed the *Buckley and Young* apportionment test, proceeding as he did on an "all or nothing" basis.

WHETHER INCENTIVE PAYMENT IS EMOLUMENT OF SERVICE AND ASSESSIBLE

Case: CIR v Darryl Kerslake
Decision date: 3 May 2001
Act: Income Tax Act 1994
Keywords: *Errors of fact on appeal, monetary remuneration, emolument, benefit in money*

Summary

The Commissioner was successful in an appeal against the decision of Judge Willy in TRA *Case U21* (1999) 19 NZTC 9,199.

Facts

The defendant was employed by a pharmaceutical company that was winding down its New Zealand operation. The company wished to retain key employees until the operation ceased. The defendant received a retention incentive payment (“the Payment”) from his employer at the end of his service as part of a redundancy package. The Payment was offered to all employees who had been given notice of impending redundancy, and was paid out upon severance to those employees who remained with the company until they were no longer required. The Payment was calculated as 3 months gross salary and was paid in addition to a normal redundancy payment.

The company made a source deduction from all employees’ final payments but by clerical error, neglected to do so for part of the defendant’s payout. The Commissioner assessed the defendant for tax on the whole redundancy package, including the Payment. The defendant commenced challenge proceedings.

The TRA Decision

In the TRA, Judge Willy found for the disputant. He considered the case raised a “novel point” and that the circumstances of the case were unique. His Honour found that the Payment was made at the commencement of an agreement between the parties that the disputant would temporarily surrender his rights to leave the employer’s service. As such the payment was held to be akin to a restraint of trade payment and not to be an emolument. This finding varied with the evidence before the Court that showed the Payment to be an inducement rather than a restraint, and that the disputant was free to leave his employer’s service at any time. Had he done so, he

would have merely forfeited his right to the Payment.

Judge Willy acknowledged that payments of a capital nature, such as restraints of trade, may still be assessable if they were caught within the definition of “monetary remuneration” under section BB4(b) of the Act. The Commissioner argued that such was the case as the payment was “... in respect of or in relation to the employment or service of the taxpayer”. It was held however, that only the last category of payment in the definition of “monetary remuneration” required such nexus:

“... the words must be construed within the statutory framework in which they appear. That is they can only relate to one of the categories of payment referred to in s.OB1 ... ‘other benefit in money in respect of or in relation to the employment or service of the taxpayer’”.

The Commissioner appealed the decision arguing that it erred in both fact and law.

Decision

His Honour Justice McGechan found that, on the evidence before the Authority, there was no basis for the finding that the defendant remained in employment beyond his final pay date, nor that there was a separate contract entered into, nor any form of positive obligation binding the defendant. The words used by the employer in making the offer were held to be determinative of the nature of the payment—it was to “encourage” staff to remain with the company.

“When that is combined with the label used for the payment – Retention ‘Incentive’ – there is little room for any finding that this was an arrangement which imposed obligatory continued service upon the Taxpayer.”

Earlier, his Honour noted his jurisdiction in such matters:

“This Court is as well equipped to make factual findings, including the drawing of inferences, as the Authority. To the extent findings of fact were not open on the evidence, or inferences drawn are not supportable, this Court can and should intervene.”

Having so found, his Honour held that the decision could not stand. The payment was clearly an emolument of service in line with everyday meaning of the term:

“I consider this would be the case even if the word ‘emolument’ stood in isolation. It is even more so given the added words “emolument (of whatever kind)”. The concept of ‘emolument’ is intended to be approached on the broadest possible basis. The present facts are readily included.”

His Honour also corrected a misstatement of law by the Authority regarding the nexus with employment. He noted that the words “in respect of” in the OB1 definition of “monetary remuneration” do not relate only to the words “other benefit in money”, they relate to all items listed previously in the definition. His Honour further stated that the payment was also a “benefit in money” and that whatever category it fell into, it was clearly related to the employment or service of the defendant.

Based on his findings of fact, his Honour held that the restraint of trade cases did not assist the defendant as it was not paid to stop the defendant working for another, but to remain working for the company.

The Commissioner’s assessment was confirmed.

WHETHER LOSS INCURRED ON THE SALE OF SHARES WAS DEDUCTIBLE

Case: TRA Number 001/00. Decision Number 3/2001

Decision date: 10 April 2001

Act: Income Tax Act 1976

Keywords: *Section 65(2)(e)*

6. 120,000 from the Development Finance Corporation.

Decision

In respect of the 500,000 shares given to the disputant as an inducement for leaving his law practice, Judge Barber held that they did not come within section 65(2)(e). His Honour stated:

“Whatever the objector may have brain-washed himself into now believing, it is not credible that a man of his integrity and prominence would accept the inducement shares for no monetary consideration on a short term basis. Indeed, it is commercially disturbing to me that such a proposition has been so earnestly advanced for the objector.”

However, in respect of 470,332 shares acquired up to January 1987, Judge Barber accepted that the disputant acquired the shares with a purpose of resale. His Honour said:

“That was his evidence on oath and, all in all, other evidence is neutral on the point. I do not think that the objector is an untruthful witness although, as already indicated, I think he has brainwashed himself on some aspects and, with a lapse of time, become a little hazy on some key matters. However, bearing in mind that the onus of proof is on the objector to the standard of the balance of probabilities, I am just able to accept his evidence that the shares acquired [the 470,332 shares] ... were broadly for his original purpose of resale...”

In respect of his interest in his farming partnership Judge Barber said:

“I am just able to accept his evidence that he then intended to sell the shares as soon as he felt appropriate in the short-term.”

Overall Judge Barber held that 470,332 shares were acquired on revenue account and 644,000 shares on capital account. However, the majority of the loss relates to the shares on revenue account.

Summary

Both the Commissioner and the disputant were partially successful (the disputant was allowed to deduct 53% of the loss claimed).

Facts

The disputant purchased approximately fifteen parcels of shares between 1985 and 1989 in a company that he founded and was the managing director of. In 1991 he sold all the shares to his family trust with a loss on the sale of \$494,469.40.

A total of 1,114,342 shares were involved. The disputant acquired the majority of the shares as follows:

1. 100,000 shares at the time of the company’s public float.
2. 90,000 shares from the disputant’s family trust.
3. 59,400 shares from a sharebroker.
4. 512,998 shares in consideration for the company acquiring a farming partnership of which the disputant was a member (300,000 of these shares were not at issue in this case).
5. 500,000 shares as an inducement to leave the disputant’s law practice and give his available time to the company.

PROPERTIES APPLIED FOR NON-TAXABLE PURPOSE

Case: CIR v Carswell Investments Co Ltd
Decision date: 3 May 2001
Act: Goods and Services Tax Act 1985
Keywords: *Section 21(1), adjustments*

Summary

The Commissioner was successful in his appeal from the Taxation Review Authority.

Facts

Carswell Investments Co Limited (“Carswell”) is a property development company. Its main activity during the relevant period (April 1995 to March 1998) was the acquisition of vacant sections onto which existing houses were relocated. This case concerned twenty properties that were let as rental accommodation pending their sale.

The Commissioner and the taxpayer agreed that the principal purpose for which the properties were held was a taxable one (property development) but the Commissioner considered that the letting of houses (an exempt supply (section 14(c))) brought section 21(1) of the Goods and Services Tax Act 1985 into play. Section 21(1) (since amended) is entitled “Adjustments”.

In the TRA Judge Willy, though recognising he was bound by the earlier High Court decision of Giles J in *CIR v Morris* (1997) 18 NZTC 13,385, distinguished this case from *Morris* on its facts. *Morris* was an appeal from a TRA decision of Judge Barber (*Case S81*). Judge Willy made it clear that he preferred an alternative approach taken by Judge Barber in *Case S81* stating “if I was free to I would have applied the reasoning of Judge Barber.”

However, Judge Willy described the facts of this case as “a far cry from the facts of the *Morris* case.” His Honour held that the properties were let to facilitate their security while they were marketed for sale, rather than to derive rents from them.

Decision

Panckhurst J, found for the Commissioner. His Honour endorsed the reasoning of Giles J in *Morris* and held that it applied in this case.

He noted that there was a distinction in section 21(1) between “principal purpose” and “a purpose”. He also noted that Giles J had also recognised the difference between motive and purpose. However, Panckhurst J considered that this distinction might not be that helpful in cases like this. Panckhurst J also accepted Giles J’s reasoning that the test for purpose is objective and that the search is for a new purpose, which is separate and distinct from the principal purpose.

Panckhurst J also noted that an appeal from the TRA is by way of rehearing and therefore that the High Court is required to reconsider the essential issues and reach its own conclusion. His Honour also noted that this was not “a case where issues of credibility loomed large and where therefore the trial Judge enjoyed a marked advantage.”

In respect of the TRA decision Panckhurst J stated:

“With respect I am of the clear view that the Authority in this case erred in reaching the conclusion that there was no subsequent purpose, non-taxable in nature, to attract the operation of s21(1).

“The key finding that the properties were let to facilitate their security while they were marketed for sale, not to derive rents from them, is simply at odds with the objective facts of this case. It is inescapable that Carswell was involved in substantial domestic rental activity. Income of about \$377,000 was generated over the three relevant financial years, an agreed fact which incidentally was not acknowledged let alone faced up to in the decision under appeal. I do not suggest that security was not part of the motivation for Carswell in letting the properties, but to seize upon it as the company’s purpose, to the exclusion of the rental income activity, was in my view unreal.”

Panckhurst J also considered the duration of the tenancies:

“Eight of the twenty properties were let throughout the entire three year period. The average time for which the properties were let was about twenty-three months... Again the judgment does not confront this aspect of the evidence.”

Panckhurst J held that there was a subsequent purpose in this case and that section 21(1) applied.

REGULAR FEATURES

DUE DATES REMINDER

June 2001

- 5 **Employer deductions and Employer monthly schedule**
Large employers (\$100,000 or more PAYE and SSCWT deductions per annum)
- *Employer deductions (IR 345) or (IR 346) form and payment due*
 - *Employer monthly schedule (IR 348) due*
- 20 **Employer deductions**
Large employers (\$100,000 or more PAYE and SSCWT deductions per annum)
- *Employer deductions (IR 345) or (IR 346) form and payment due*
- Employer deductions and Employer monthly schedule**
Small employers (less than \$100,000 PAYE and SSCWT deductions per annum)
- *Employer deductions (IR 345) or (IR 346) form and payment due*
 - *Employer monthly schedule (IR 348) due*
- 29 **GST return and payment due**

July 2001

- 5 **Employer deductions and Employer monthly schedule**
Large employers (\$100,000 or more PAYE and SSCWT deductions per annum)
- *Employer deductions (IR 345) or (IR 346) form and payment due*
 - *Employer monthly schedule (IR 348) due*
- 9 **Provisional tax instalments due for people and organisations with a March balance date**
- 20 **Employer deductions**
Large employers (\$100,000 or more PAYE and SSCWT deductions per annum)
- *Employer deductions (IR 345) or (IR 346) form and payment due*
- Employer deductions and Employer monthly schedule**
Small employers (less than \$100,000 PAYE and SSCWT deductions per annum)
- *Employer deductions (IR 345) or (IR 346) form and payment due*
 - *Employer monthly schedule (IR 348) due*
- FBT return and payment due**
- 31 **GST return and payment due**

These dates are taken from Inland Revenue's Smart business tax due date calendar 2001–2002

