TAX INFORMATION BULLETIN

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This *Tax Information Bulletin* is also available on the internet in PDF. Our website is at **www.ird.govt.nz**

It has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you prefer to get the *TIB* from our website and no longer need a paper copy, please let us know so we can take you off our mailing list. You can do this by completing the form at the back of this TIB, or by emailing us at **IRDTIB@datamail.co.nz** with your name and details.

THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

Inland Revenue produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents.

Because we are keen to produce items that accurately and fairly reflect taxation legislation, and are useful in practical situations, your input into the process—as perhaps a user of that legislation—is highly valued.

The following draft item is available for review/comment this month, having a deadline of 30 April 2004.

Ref.	**Draft type**	**Description**
ED0057	Question we've been asked	Livestock valuation—previous years' invalid elections

Please see page 26 for details on how to obtain a copy.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings, a guide to binding rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin* Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at **www.ird.govt.nz**

SUPPLIES PAID FOR IN FOREIGN CURRENCY – GST TREATMENT

PUBLIC RULING – BR PUB 04/01

Note (not part of the ruling):

This ruling is essentially the same as public ruling BR Pub 95/12, published in *Tax Information Bulletin* Vol 7, No 7 (January 1996), and public ruling BR Pub 00/04, published in *Tax Information Bulletin* Vol 12, No 6 (June 2000). BR Pub 95/12 applies when the time of supply occurred prior to 1 March 1999, BR Pub 00/04 applies when the time of supply occurred on or after 1 March 1999 until and inclusive of 29 February 2004. This ruling's period of application is from 1 March 2004 for an indefinite period.

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

Taxation Laws

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Ruling applies in respect of sections 9(1), 10(2), 14(1)(a), 77, the definition of "money" in section 2(1) and the definition of "financial services" in section 3(1).

The Arrangement to which this Ruling applies

The Arrangement is the acceptance by a registered person of payment in foreign currency for a taxable supply of goods or services made in New Zealand.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The value of the taxable supply is the amount of foreign currency converted to New Zealand currency at the exchange "buy rate" applying at the time of supply.
- The appropriate exchange rate is the "buy-rate" offered by an approved bank or an approved bureau de change at the time of supply.

The period or income year for which this Ruling applies

This Ruling will apply from 1 March 2004 for an indefinite period.

This Ruling is signed by me on the 10th day of March 2004.

Martin Smith
General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 04/01

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 04/01 ("the Ruling").

The subject matter covered in this Ruling was previously dealt with by BR Pub 95/12 published in *Tax Information Bulletin* Vol 7, No 7 (January 1996), at page 17 and BR Pub 00/04 published in *Tax Information Bulletin* Vol 12, No 6 (June 2000), at page 4. This Ruling applies for the period from 1 March 2004 for an indefinite period.

Background

Public Ruling BR Pub 95/12 dealt with the GST consequences of receiving payment in foreign currency for taxable supplies of goods and services made in New Zealand. A number of registered persons, particularly those involved in tourism, accept foreign currency as payment for supplies of goods and services. Often a registered person will offer the customer an "inhouse" exchange rate. This exchange rate is less favourable to the customer than other exchange rates. That is, the customer gets less New Zealand currency for the foreign currency than that obtainable at a bank or a bureau de change.

The registered supplier will exchange the foreign currency at a bank and receive New Zealand currency. Because the bank exchange rate is better than the exchange rate the registered person gave the customer, the registered person will make a profit on the conversion of the foreign currency. The Ruling considers the GST treatment of such a profit. In particular, the Ruling considers whether the profit is consideration for an exempt supply, or whether the profit is part of the consideration for a taxable supply.

Public Ruling BR 00/04 was essentially a re-issue of Public Ruling BR Pub 95/12.

Legislation

Section 2(1) defines "money":

"Money" includes-
(a) Bank notes and other currency, being any negotiable instruments used or circulated, or intended for use or circulation, as currency; and
(b) Postal notes and money orders; and
(c) Promissory notes and bills of exchange,-
whether of New Zealand or any other country, but does not include a collector's piece, investment article, or item of numismatic interest.

Section 3(1) defines "financial services":

For the purposes of this Act, the term "financial services" means any one or more of the following activities:
(a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise)...

Section 14(1)(a) exempts supplies of financial services from GST.

Section 9 defines the time of supply. Section 9(1) states:

Subject to this Act, for the purposes of this Act a supply of goods and services shall be deemed to take place at the earlier of the time an invoice is issued by the supplier [or the recipient] or the time any payment is received by the supplier, in respect of that supply.

Section 10 is the section providing for the value of supply. Section 10(2) states:

Subject to this section, the value of a supply of goods and services shall be such amount as, with the addition of the tax charged, is equal to the aggregate of,-
(a) To the extent that the consideration for the supply is consideration in money, the amount of the money:

Section 77 states:

For the purposes of this Act, all amounts of money shall be expressed in terms of New Zealand currency, and in any case where and to the extent that such amount is consideration in money for a supply, that amount shall be expressed in terms of New Zealand currency as at the time of that supply.

Application of the legislation

Number of supplies

When a registered person sells goods and services to a customer who pays in foreign currency, there is only one supply. That supply is the supply of goods and services.

A possible alternative view is that there are two supplies in these circumstances: the first supply being a supply of goods and services from the registered person to the customer, the second supply being an exempt supply (under section 3(1)(a) and section 14(1)(a)) of the exchange of currency, also from the registered person to the customer. However, as already stated that is not the position where a sale of goods and services occurs with the customer paying in foreign currency—there is only one supply in this situation.

The position is different if a customer, having already completed an exchange of foreign currency for New Zealand currency with a registered person, in a separate transaction then chooses to use that New Zealand currency to purchase goods and services from the same registered person.

It will be a question of fact in each case whether there are one or two supplies. In the ordinary commercial situation there can be no reconstruction of the

transaction to recharacterise two supplies as one or vice versa, nor is it appropriate to apply principles of economic equivalence to achieve similar results between one supply and two supply situations.

When a registered person accepts foreign currency in payment for supplies, there is no exempt supply of the exchange of currency. To be an exchange of currency under section 3(1)(a) one currency must be exchanged for another. Section 3(1)(a) does not cover the situation when currency is exchanged for goods and services. The fact that the registered person will later exchange the currency with a bank or bureau de change does not alter this. The transaction between the bank or bureau de change and the registered person involves an exempt supply of the exchange of currency by the bank or bureau de change to the registered person. There is no such exempt supply from the registered person to the customer paying with foreign currency.

In situations where there is only one supply, a supply of goods and services, the value of supply is important, particularly since the registered person usually makes a profit from the low exchange rate.

Value of supply

When a registered person sells goods and services to a customer, the value of supply is determined using the rules in section 10. Under section 10(2)(a), when consideration for the supply is an amount of money, the value of supply is the amount of money. "Money" is defined in section 2(1) and includes foreign currency.

Therefore, when a customer tenders foreign currency as consideration for a supply, the value of supply is the amount of foreign currency. However, section 77 requires all amounts of money tendered in consideration of a supply to be "expressed in terms of New Zealand currency as at the time of that supply".

"Expressed in terms of New Zealand currency"

Three interpretations of the phrase "all amounts of money shall be expressed in terms of New Zealand currency" are possible. It could mean that:

- The parties must state their transaction, or document it, in New Zealand currency and the supplier returns that amount for GST purposes; or
- The supplier must convert foreign currency to New Zealand currency at the current market exchange rate and return that amount for GST purposes; or
- The supplier may convert foreign currency to New Zealand currency at the rate agreed between the parties and returns that amount for GST purposes.

The first interpretation does not require any type of conversion, whereas the second and third do.

Section 20(1) of the Australian Income Tax Assessment Act 1936 refers to income being "expressed in terms of Australian currency". Section 77 is expressed in the same terms for New Zealand currency. Section 20(1) had been accepted as embodying the decision of the Privy Council in *Payne v Deputy FCT* [1936] 2 All ER 793 (see, for example, Dixon J in *Adelaide Electric Supply Co Ltd v FCT* (1949) 78 CLR 557). In the *Payne* decision, Lord Russell said at page 796 of the judgment:

> ...the assessable income of the taxpayer must, whatever be the currency in which he derives it, all be **expressed in terms of Australian currency**; **in other words** if any portion of his assessable income is derived by him in French or Belgian currency, **it must before he can be properly assessed to Australian income tax be converted into its equivalent, at the time it was derived, in Australian currency.** In exactly the same way, any income derived by him in British currency must be converted into its equivalent in Australian currency. In short when an Australian statute tells the taxpayer to state his derived income in order that a fraction thereof (ie so many pence in the pound of derived income) may be taken as tax, this can only mean that his derived income is to be stated and dealt with in terms of Australian currency. From this it would accordingly follow that the commissioner was right in including the amount of £1,097 in the appellant's assessment. [Emphasis added.]

Lord Russell interpreted the words subsequently adopted in section 20(1) to mean that the foreign currency must be converted to the currency of the taxing country at the current market exchange rate. This is considered to be the preferred approach. That is, the phrase "expressed in terms of New Zealand currency" in section 77 requires the amount of foreign currency tendered as consideration for a supply to be converted into an amount of New Zealand currency at the exchange rate applying at the time of supply.

The above interpretation is also consistent with the use of the same phrase by the New Zealand legislature in the now repealed section KF 2(5) (definition of "effective rate of domestic income tax"). The relevant part of the former section KF 2(5) stated:

> "Effective rate of domestic income tax", in relation to a company that is not resident in New Zealand and to an accounting year of that company, means the rate ascertained in accordance with the following formula:
>
> $$\frac{a}{b}$$
>
> where-
>
> a is the total income tax (**expressed in terms of New Zealand currency** at the rate of exchange in force on the last day of that accounting year) payable by that company in the country or territory in which it is resident, in respect of the total income derived by it in that accounting year, being the total income upon which the total income tax is levied; and
>
> b is that total income (**expressed in terms of New Zealand currency** at the rate of exchange in force on the last day of that accounting year): [Emphasis added.]

This definition is an equivalent use of the phrase in section 77, and supports the interpretation that the phrase requires some type of conversion. As already outlined, the decision in *Payne* supports the interpretation of the phrase in section 77 as requiring the conversion of the foreign currency (tendered as consideration for a supply) at the exchange rate applying at the time of supply.

Exchange rate applying at the time of supply

Section 77 requires the amount of money that is consideration for a supply to be expressed in terms of New Zealand currency "as at the time of that supply".

Section 9 determines the time at which any supply takes place. Section 9(1) states the general rule, ie that a supply shall be deemed to take place at the earlier of the time an invoice is issued or the time any payment is received by the supplier. Generally, in the circumstances to which the Ruling applies, the time of supply is the time of payment. Accordingly, it is the exchange rate applying at the time of payment that is to be used to convert the foreign currency to New Zealand dollars for GST purposes and not an exchange rate applying at the date the registered person converts the foreign currency to New Zealand dollars. Nor is the rate of exchange actually obtained on the conversion of the foreign currency to be used if this differs from the exchange rate applying at the time of payment. Where an invoice is issued before a payment is made, the exchange rate applicable on the date of issue of the invoice is the correct date to be used to convert the foreign currency to New Zealand dollars for GST purposes.

The Commissioner will accept the exchange rates offered by an approved bank or an approved bureau de change.

In this connection, all registered banks in New Zealand are approved. American Express and Travelex Australasia Group, which includes Thomas Cook, are approved bureaux de change.

The value of supply is not the value of foreign currency tendered as consideration exchanged at the registered person's low exchange rate. Instead, it is the value of foreign currency tendered as consideration converted at the exchange rate determined by the approved banks and bureaux de change operating in the foreign exchange markets at the time of supply (payment). The applicable exchange rate in all cases is the "buy-rate".

Examples

Example 1

Hotel Guest wishes to exchange some foreign currency for New Zealand currency. Hotel offers him a low exchange rate, which he accepts. Hotel exchanges the foreign currency at a bank and makes a profit.

The profit is consideration for an exempt supply, being the exempt supply of an exchange of currency. Hotel has exchanged New Zealand currency for foreign currency. The consideration for the supply is the difference between the exchange rate Hotel receives from the bank, and the exchange rate Hotel gave Hotel Guest.

For example:
Approved exchange buy rate:
NZ$1=Foreign$3 or Foreign$1=NZ$0.33

Hotel exchange rate:
NZ$1=Foreign$4 or Foreign$1=NZ$0.25

Hotel Guest exchanges Foreign$300 at Hotel exchange rate, and receives NZ$75. Hotel exchanges the Foreign$300 at the bank for the approved exchange buy rate and receives NZ$100. The NZ$25 profit is consideration for an exempt supply and does not have to be returned for GST purposes.

Example 2

Hotel Guest checks out of Hotel and settles his bill using foreign currency. Again Hotel offers him a low exchange rate which he accepts. Hotel exchanges the money at a bank and makes a profit.

The profit on the currency exchange at the bank is part of the consideration for the taxable supply of goods and services by Hotel to Hotel Guest. The value of supply is the amount of foreign currency tendered in consideration for the supply. As the amount of money is foreign currency, it needs to be expressed in amounts of New Zealand currency. That change to New Zealand currency should take place at the approved exchange buy rate at the time of supply. That means the profit on the currency exchange is part of the consideration for the taxable supply Hotel makes.

For example:

Exchange rates as above. Bill of NZ$1,000. Hotel Guest tenders Foreign$4,000 to pay the bill. Hotel accepts the Foreign$4,000 in full payment of the bill, at Hotel's exchange rate. Hotel then exchanges the Foreign$4,000 at the bank for the approved exchange buy rate and receives NZ$1,333, making a profit of $333 on the currency. This profit is part of the consideration for a taxable supply and should be returned as such for GST purposes. The entire $1,333 is the consideration for the supply.

PRODUCT RULING – BR PRD 04/01

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Truck Leasing Limited trading as Esanda Fleet Partners ("Esanda").

Taxation Laws

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

This Ruling applies in respect of sections BG 1, CI 3(1), GC 15, GC 17, and Schedule 2, Part A, clause 1(c).

The Arrangement to which this Ruling applies

The Arrangement is the leasing of motor vehicles by Esanda under Multi-lease agreements to employers who provide the motor vehicles to employees for their private use. The Multi-lease agreements involve a motor vehicle lease with a term of one year, with the possibility of entering into two further terms of one year each.

Further details of the Arrangement are set out in the paragraphs below.

1. Esanda conducts a fleet leasing business. One of the options offered to customers is a motor vehicle lease with a term of one year, with the possibility of entering into two further terms of one year each ("Multi-lease").

2. The arrangement for which this ruling is sought is the lease (using the Multi-lease product) of a motor vehicle from Esanda to an employer and the provision of that motor vehicle by the employer to an employee for their private use and enjoyment. The lease from Esanda to the employer is made under the terms and conditions contained in the Master Lease Agreement and Agreement to Lease (copies of which were provided to Inland Revenue with the application dated 2 December 2003). The Master Lease Agreement states that the agreement is between the lessee and Truck Leasing Limited.

3. As part of Esanda's contractual obligations under the arrangement, it is required to advise employers of the market valuation of the vehicles.

4. The leases are operating leases rather than finance leases for income tax purposes.

5. Employers find the Multi-lease product appealing because of its flexibility. There are no penalties payable as a result of a customer choosing not to take up a further lease of the vehicle concerned. At the expiry of each 12-month period, lease obligations have been met under the Multi-lease product.

6. By comparison, Esanda imposes a significant potential penalty for early termination under its three year lease (under clause 28 of the Master Lease Agreement, Esanda can determine the amount of the penalty).

7. The flexibility provided by the Multi-lease is particularly valuable when employers are unsure of the number of employees for whom they will require vehicles or are unsure of the type of vehicle the employees may wish to have available. As a result, the employers prefer short lease terms so that they are not required to continue either renting vehicles that they do not require or pay significant penalties for early termination.

8. The leasing of the motor vehicles by Esanda to customers/lessees (being, for the purposes of this ruling, the employers) comprises the following steps:

(a) Initial lease enquiry

This is the initial contact from the potential customer inquiring about leasing vehicles from Esanda.

(b) Marketing response

This involves the initial meeting and consideration of promotional material.

(c) Lease proposal

Esanda provides the customer with a "Lease Proposal". This is not a contractual document. It is a strategic/informative document that sets out the general basis for the services that Esanda can provide to customers, as lessees.

(d) Credit application

The lessee's credit application is completed and assessed.

(e) Motor Vehicle Leasing Terms and Conditions

When a lessee commences dealings with Esanda, Esanda then provides the lessee with the Motor Vehicle Leasing Terms and Conditions. This is the Master Lease Agreement ("MLA"), which sets out the general terms and conditions for motor vehicles to be subsequently leased from Esanda. There is no specific reference to actual vehicles in the MLA.

(f) Vehicle Order

The lessee then completes a "Vehicle Order" which details their precise requirements, for example, the vehicle, term, kilometres, and relevant monthly lease rental etc. The Vehicle Order also incorporates the conditions in the MLA.

The Vehicle Order is completed prior to the commencement of each new lease and reflects the details for that lease only.

(g) Acceptance

Esanda then confirms acceptance with the lessee.

(h) Agreement to Lease

Esanda and the lessee then enter into an "Agreement to Lease". The terms and conditions set out in the MLA are incorporated into this lease agreement. In a contractual sense, the lease of each vehicle is clearly created by the offer and acceptance of each specific Agreement to Lease. The actual motor vehicle is then delivered to the lessee.

Under each and every Agreement to Lease entered into between Esanda and a particular lessee, the following will apply:

- The term of the lease is 12 months.
- There will be no provision for automatic renewal of the term of the lease.
- There will be no option conferred on the lessee to renew, extend or vary the term of the lease.
- There will be no provision for an incentive to the lessee if it takes up a further lease of the vehicle.
- There will be no penalty on the lessee if it does not take up a further lease of the vehicle.

(i) Procedure at the end of the lease

As standard practice, Esanda advises the lessee of the status of the lease at least three months prior to the expiration of the 12-month lease term. Esanda is then able to determine whether the lessee wishes to lease the vehicle for a further lease term of 12 months. If not, the vehicle is returned to Esanda upon expiry of the lease. If the lessee wishes to retain the vehicle, a new lease is entered into for a further 12-month period. This new 12-month lease is assigned a separate and distinct number or record in Esanda's computer system, which is used to manage vehicles leased using its Multi-lease product. In all cases, the old record for the previous 12-month lease is noted as having terminated. In addition, a new Agreement to Lease is executed for the further 12-month lease. Again, the general conditions set out in the MLA are incorporated into that new Agreement to Lease.

The rental rates for the second and third periods are lower than the first. The rates reduce as the depreciated value of the vehicle reduces. If the customer does not renew, it does not get the benefit of reduced rates. However, there is no obligation on Esanda to provide vehicles for subsequent 12-month leases and no obligation on customers to enter into a subsequent 12-month lease.

(j) Valuation of vehicles

As noted above, Esanda is required to advise lessees of the market value of the vehicle at the commencement of each 12-month lease period. The market value assessment takes into account the type of car and its condition and mileage. Esanda advises employers/lessees of the market valuation of the vehicles, and also provides market value forecasts for subsequent periods for indicative purposes only. Market values are routinely reviewed prior to the commencement of subsequent leases to ensure that the forecasts are accurate.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) The motor vehicles leased by the employers under this Arrangement are leased for the private use or enjoyment of the employees or made available for the private use or enjoyment of the employees.

b) No contract, agreement, plan, or understanding (whether enforceable or unenforceable), or any other documentation that concerns or otherwise affects the terms of the leases entered into under the Arrangement, is entered into between Esanda and the Lessee in relation to the Arrangement, other than the MLA, the Agreement to Lease and the Vehicle Order.

c) Any rental rate for the Lessee for a subsequent lease period is the same rental rate that would be offered to any other customer for that particular vehicle and lease period (taking into account the customer credit rating, customer fleet size, kilometre allowances, and general service components of the lease including vehicle maintenance) irrespective of whether a previous lease for that vehicle was entered into by that Lessee.

d) There is no contract, agreement, arrangement, plan, undertaking or understanding (whether formal or informal, and whether intended to be legally enforceable or not) at the time of entering into any lease under this Arrangement:

- that any party will, or will if requested, renew, extend or vary the Lease Term;
- that the parties will enter into a further lease in respect of the vehicle; or
- that there will be penalties for choosing not to enter into a further lease in respect of the vehicle.

e) All calculations, factors, and/or projections which are taken into account in formulating the rental rates applying to each lease are not in any way based on a lease of the relevant motor vehicle for more than the relevant lease period.

f) No Lessee is associated with Esanda within the meaning of section OD 7.

g) The Lease is not a "finance lease" as defined in section OB 1.

How the Taxation Laws apply to the Arrangement

Subject in all respects to any condition stated above, the Taxation Laws apply to the Arrangement as follows:

- The market value of a motor vehicle under this Arrangement, for the purposes of calculating the fringe benefit value of that vehicle under section CI 3(1) and Schedule 2, Part A clause 1(c), is determined on the date on which each new 12-month lease commences.
- Sections GC 15 and GC 17 do not apply to the Arrangement.
- Section BG l does not apply to negate or vary the conclusions above.

The period or income year for which this Ruling applies

This Ruling will apply for the period 4 May 2004 to 3 May 2007.

This Ruling is signed by me on the 5th day of February 2004.

Martin Smith
General Manager (Adjudication & Rulings)

NEW LEGISLATION

FRINGE BENEFIT TAX – PRESCRIBED RATE OF INTEREST ON LOW-INTEREST, EMPLOYMENT-RELATED LOANS

The prescribed rate of interest used to calculate fringe benefit tax on low-interest employment-related loans has increased from 7.08% to 7.30% for the quarter beginning 1 April 2004.

The rate is reviewed regularly to ensure it is in line with the Reserve Bank's survey of first mortgage interest rates. It was last changed with effect from the quarter beginning 1 October 2004.

The new rate was approved by Order in Council on 23 February 2004.

Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations 2004

STUDENT LOAN SCHEME – REPAYMENT AND INTEREST WRITE-OFF THRESHOLDS & INTEREST RATES FOR 2004–05

The student loan scheme repayment threshold, which sets the income level at which compulsory repayments begin, will increase from its current level of $15,964 to $16,172 for the 2004–05 income year.

The student loan scheme interest write-off threshold, which sets the level of income that part-time or part-year students may have and still be entitled to a full interest write-off, will increase from its current level of $25,909 to $26,140 for the 2004–05 income year.

The student loan scheme repayment and interest write-off thresholds are based on the amount of the domestic purposes benefit payable to a person with two or more children. The repayment threshold is aligned to the gross amount of the benefit, rounded up so that it is divisible into whole dollars on a weekly basis, and the interest write-off threshold is aligned to the amount of other income at which the benefit is fully abated. These thresholds are reviewed annually in December each year and are set on the basis of the amount that it is projected will be payable from 1 April of the following year.

The total student loan scheme interest rate for the 2004–05 income year will remain at 7.0%.

The total interest rate has two components – the base interest rate and the interest adjustment rate. These are 4.2% and 2.8% respectively for the 2003–04 income year. From 1 April 2004 the base interest rate will increase to 5.5% and the interest adjustment rate will decrease to 1.5%.

Student Loan Scheme (Repayment Threshold) Regulations 2003

Student Loan Scheme (Income Amount for Full Interest Write-off) Regulations 2003

Student Loan Scheme (Interest Rates) Regulations 2004

TAXATION (DISASTER RELIEF) ACT 2004

Introduction

Inland Revenue has been given more flexibility in dealing with taxpayers who were adversely affected by the February 2004 floods and by those who will be adversely affected by similar events in the future. The changes:

- relax the rules about accepting provisional tax estimates
- extend the criteria under which use-of-money interest may be remitted, and
- allow for applications for remittance of late payment and late filing penalties and use-of-money interest to be verbal.

Background

The February 2004 floods were a very significant event. Before the amendments were made, tax law generally lacked the flexibility required to cope with an event of this magnitude.

Key features

The relief measures apply when there is a "qualifying event":

- the February 2004 floods, or
- a naturally occurring event in respect of which a state of emergency is declared under Part 4 of the Civil Defence Emergency Management Act 2002 and which the Governor-General by Order in Council declares to be a qualifying event.

The relief is not limited to the area in respect of which the emergency is declared. As long as there is a "qualifying event" all significantly affected taxpayers, regardless of where they are located, qualify.

Provisional tax estimates

Section MB 3 of the Income Tax Act has been amended and a new subsection MB 3B has been added. A definition of "qualifying event" has been added to section OB 1.

The amendments allow the Commissioner to accept an estimate or revised estimate of residual income tax payable by the taxpayer if the Commissioner is satisfied that:

- the taxpayer is significantly affected by a qualifying event, and
- as a consequence of a qualifying event, the taxpayer is unable to deliver an estimate or a revised estimate of residual income tax by the date required (estimates cannot be made after the third provisional tax instalment date), or
- the effect on the taxpayer of the qualifying event makes it equitable for the taxpayer to make an estimate or revised estimate, and
- the taxpayer makes the estimate or revised estimate as soon as practicable.

This measure is intended to afford immediate relief to taxpayers affected by the February 2004 floods in the central North Island, and to those affected by similar events in the future. Because no criteria are provided as to how the estimate is to be made, the Commissioner can specify them.

Remission of penalties and use-of-money interest

A new section 183ABA has been inserted into the Tax Administration Act 1994. It authorises the Commissioner to remit late filing penalties, non-electronic filing penalties, late payment penalties and use-of-money interest if they are charged to taxpayers who are significantly affected by a qualifying event. Because section 183H of the Tax Administration Act does not apply to this section, applications for these remissions do not need to be made in writing; they can be made verbally.

Application date

The provisions relating to Orders in Council specifying qualifying events apply from the date of enactment, 17 March 2004. The remaining amendments apply from 1 February 2004.

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.

NOVEL REASON FOR FINDING CFRT IS CHARITABLE AFTER ALL

Case:	(Latimer & Ors for the) Crown Forestry Rental Trust v CIR
Decision date:	25 February 2004 (London time)
Act:	Income Tax Act 1976
Keywords:	Charities, Crown

Summary

The Privy Council reverses judgments of High Court and Court of Appeal.

Facts

On 20 July 1989 the Crown, the New Zealand Maori Council, and the Federation of Maori Authorities Inc executed an agreement to provide for the terms and conditions upon which the Crown would sell existing tree crops on Crown forestry land to commercial purchasers together with a licence to use the land on an ongoing basis. The rent payable by each purchaser was to be put in a fund administered by a rental trust. The interest earned by the investment of the rent was to be made available to assist Maori making claims involving land before the Waitangi Tribunal.

The Crown Forestry Rental Trust ("the Trust") was established in 1989. Under clause 2.1 of its Trust Deed it is stated as being established to:

a) Receive the Rental Proceeds from the Licences;

b) Make the interest, earned from investment of those Rental Proceeds, available to assist Maori in the preparation, presentation and negotiation of claims before the Waitangi Tribunal which involve, or could involve, Licensed Land.

Lower court judgments

In the High Court and the Court of Appeal the CIR succeeded, albeit on different grounds in each Court. The High Court Judge, O'Regan J, ruled in favour of the Commissioner on the ground that the Trust was not "established for charitable purposes" because it had two purposes, assisting Maori claimants and acting as stakeholder, the latter being a separate stand-alone purpose which was not charitable (*Latimer v Commissioner of Inland Revenue* [2002] 1 NZLR 535). That concluded the matter in favour of the Crown but the Judge went on to consider the remaining issue on which he had heard argument and held that the purpose of assisting Maori claimants was charitable.

The Judge briefly addressed the significance of the Crown's right to any ultimate surplus, and observed that it was not relevant to the issue before him, being essentially a declaration of the trust which would have arisen in any case even if it were not included expressly in the trust deed. (Their Lordships considered that in saying that the trust was not relevant to the issue before him, the Judge may have overlooked or underestimated the significance of the trustees' power to refrain from distributing the whole of the income.)

The trustees appealed to the Court of Appeal and the Commissioner cross-appealed on the issue whether the provision of assistance to Maori claimants was a charitable purpose.

The judgment of the Court was delivered by Blanchard J (*Latimer v CIR* [2002] 3 NZLR 195). The Commissioner's argument that the existence of the ultimate trust in favour of the Crown deprived the Trust of charitable status was ultimately decisive in the Court of Appeal with the consequence that the judgment for the Commissioner in the High Court was confirmed. The Court dismissed both the trustees' appeal and the Commissioner's cross-appeal.

It confirmed the Judge's ruling that Trust's primary purpose of assisting Maori claimants was charitable, but held that the ultimate trust carrying surplus income to the Crown was fatal to the trustees' case. The Court of

Appeal held (i) that what was important was the terms of the trust deed, not the parties' expectations; (ii) that in any case there was no evidence of an expectation that the return of surplus income to the Crown would be minimal nor was the possibility so minor as to be dismissed as ancillary; and (iii) that the return of surplus, if it took place, would not be given to the Crown for a charitable purpose.

Decision

Their Lordships agreed with the Court of Appeal that, in order to qualify for exemption under section 61(25), the trust did not need to be established for charitable purposes; it is sufficient that the trust funds are applicable for exclusively charitable purposes.

Where a trust authorises the trustees to apply the trust income for a number of different purposes, the trust is not a valid charitable trust unless every purpose is wholly charitable. Where the trustees are authorized to apply trust money for a range of charitable and non-charitable purposes it cannot be said with certainty of any particular sum that it will be applied to charitable purposes: it may be applied to non-charitable purposes. So had the trust deed required the whole of the net income (after expenses) to be used for assisting Maori claims, the Trust would have qualified for exemption under section 61(25).

But the Trustees are not obliged to apply the whole of the trust income as it arises. They may carry it forward and apply it in future years; and insofar as it is not wholly expended when the Trust comes to an end any remaining balance is to be returned to the Crown. It follows that it cannot be said of any sum of income in the hands of the Trustees that it will be applied for charitable purposes; it may be retained and ultimately become payable to the Crown.

The ultimate trust in favour of the Crown is a substantial trust in its own right, and unless the Crown is a charity or holds on charitable trusts or the trust in its favour can be dismissed as merely ancillary or incidental to the primary trust to assist the Maori claimants its existence makes it impossible to contend that the trust income is applicable to exclusively charitable purposes. If the ultimate beneficiary were a natural person then the CIR's case would be beyond question.

In their Lordships' opinion there is a real distinction between a gift by a third party to the Crown, which can sensibly be made subject to an implied limitation in favour of charity; and a gift by the Crown for charitable purposes which do not exhaust the fund, with the result that, so far as not applied in favour of charity, the fund remains at the free disposal of the Crown. In the former case the Crown takes as donee; in the latter it resumes possession of its own. In the present case the Crown is the designated beneficiary under the ultimate trust, not because it is the object of the settlor's bounty, but because it is the settlor.

In their Lordship's view, the fact that the beneficiary of the ultimate trust, the Crown, is a tax-exempt entity, is decisive. Their Lordships did not accept the Trustees' contention that the Crown is itself a charity, or that it holds all its funds to be applied exclusively for charitable purposes. If either were true there would be no need to exempt the Crown from income tax. However, insofar as the forest rentals are not otherwise applicable, they remain beneficially the property of the Crown. The income of the Trust consists of the income derived by the Trustees by investing the forest rentals. Insofar as such income is needed for the purpose of assisting Maoris to prosecute their claims, it is to be devoted to charitable purposes and so exempt from tax; and insofar as it is not applied for such purposes it remains beneficially the tax-exempt income of the Crown. In their Lordships' opinion it never comes within the scope of the tax at all.

APPLICATION FOR DISCOVERY REFUSED

Case:	TRA decision 008/04
Decision date:	17 February 2004
Act:	Tax Administration Act 1994
Keywords:	Discovery

Summary

Judge Barber refused the objectors' discovery application largely on the grounds that the documents that were requested were irrelevant.

Facts

This interlocutory decision relates to certain participants of the JG Russell tax avoidance template. The template operated by grouping profitable companies with companies with tax losses so as to relieve the profitable companies of their income tax obligations. The scheme has been described by the Court of Appeal as a "blatant tax avoidance scheme" (*Miller v CIR; Managed Fashions Limited v CIR* (1998) 18 NZTC 13,961).

Russell template cases are heard on an ongoing basis, with interlocutory decisions issued at various intervals. Evidence is rolled over from one hearing to the next and later judgments sometimes incorporate earlier ones.

This decision follows on from the decision issued by Judge Barber on 13 August 2003 (now reported as *Case W24* (2003) 21 NZTC 11,246), a decision on 8 January 2004, and five decisions issued on 16 January 2004.

This decision related to a specific request for the discovery of documents relating to the *Kemp* litigation (*Kemp & Ors v CIR* (1999) 19 NZTC 15,110). The Commissioner submitted that the documents were not

relevant (the *Kemp* litigation occurred after the assessments were made in these cases and involved different taxpayers) while the objectors submitted that the documents might show evidence of fraud or "vendetta".

The documents were listed in a draft discovery list attached to an affidavit of one of the Commissioner's witnesses. That witness had also referred to the documents under cross-examination.

Decision

Judge Barber described the documents and how they came into existence, along with some background to the *Kemp* litigation. His Honour noted the objectors' submission that the "fraud exception" might exist: that is, documents could not be privileged if they were brought into existence for the committing of an illegal or wrongful act. The Commissioner submitted that the documents were not relevant.

Judge Barber held (at paragraph [19]):

> I have already indicated to the parties that there seems to be only one reason why anyone might consider the Kemp documents to in any way relate to the remaining justiciable issues in this case, namely that they relate to the J G Russell tax avoidance template scheme. However, they relate to that scheme with regard to taxpayers who are not any of the present objectors. Accordingly, they could not be relevant to the correctness of the assessment against any of the present objectors.

Judge Barber held that there was not a "sufficient nexus to the justiciable issues in the present case" and rejected the submission from the objectors that the settlements were "part and parcel of the vendetta". His Honour noted (in relation to the settlements) that "[e]ven if there was vendetta conduct, it would hardly be such an abuse of process as to somehow invalidate the assessments in respect of which the settlement negotiations took place."

Judge Barber refused to inspect the documents and ruled that they were inadmissable.

CHILD SUPPORT JUDICIAL REVIEW UNSUCCESSFUL

Case: Sonny Shaw v CIR

Decision date: 16 February 2004

Act: Child Support Act 1991

Keywords: Child support

Summary

The Commissioner's conduct was vindicated and the plaintiff's application was unsuccessful.

Facts

Background

Essentially this case was brought by the plaintiff as an attempt to reduce the amount claimed by the Commissioner to be owing as a result of his child support obligations.

The plaintiff separated from his wife in 1987. There were four children. No support was provided to his wife between 1992 and 1997 and by 1997 he had accumulated a child support debt of some $37,000. When the Commissioner commenced enforcement proceedings, the plaintiff objected in accordance with the Child Support Act 1991. Those proceedings have been exhausted.

The plaintiff has paid his core child support debt, but 10% penalties of approximately $80,000 are still owing.

Claims

This case was a "judicial review" type case, with various claims being made by the plaintiff. These included a claim for $28,402.01 (representing money taken by the Commissioner from his bank accounts for child support debt), orders that the Commissioner was in breach of agreements made with the plaintiff, orders relating to abuse of process and breach of contract, and costs and interest.

Further facts

The plaintiff disputed his child support assessments in District Court hearings between 1997 and 2000. On 20 July 2000 Judge O'Donovan held that the sum owned by the plaintiff at that time totalled $79,678.41 ($21,408.18 core child support and the remainder penalties). The plaintiff was prepared to pay $17,140.00. The Judge indicated that he might be prepared to accept an amount around $20,000 (the Commissioner sought the full amount) but this was not acceptable to the plaintiff.

When the application resumed on 25 July 2000 the Judge ordered the plaintiff to pay $18,689 immediately and also sentenced him to eight months periodic detention. The penalties and remaining core tax remained owing.

The plaintiff appealed that decision, but was unsuccessful. The plaintiff alleged that a settlement agreement was reached with the Commissioner after the appeal hearing. Various other hearings took place in the District Court, High Court, and Court of Appeal between 2000 and 2003 (the plaintiff was generally unsuccessful).

This proceeding was commenced on 26 July 2002 and alleged that at various times the Commissioner had agreed to compromise the amount owed by the plaintiff and had then resiled from the agreements. The Commissioner applied to have the claim struck out. It was not struck out, but the plaintiff was ordered to file an amended statement of claim that complied with the High Court rules. The amended claim was also not clear so with the assistance of the parties Laurenson J made a note of what issues were to be determined.

Decision

At the beginning of the decision Laurenson J made a finding of fact that in two instances the plaintiff was not telling the truth. Based on this and other matters, findings of credibility were made against the plaintiff.

Before determining the issues Laurenson J set out the amount of child support and penalties the plaintiff owed at the hearing before Judge O'Donovan in 2000 and considered three minor issues in relation to sums that could possibly be set off from that amount. His Honour also noted that it was unfortunate that the plaintiff did not seek legal advice when it was suggested by Judge O'Donovan, which left him in the position of having to pay some $120,000 of penalties, saying that "[t]o a very large extent he is the author of his own misfortune."

First issue – whether an agreement had been reached in 1998

There had been a meeting in March 1998 between the plaintiff and two officers of the Commissioner where the plaintiff's child support situation had been discussed. Laurenson J found that the evidence did not show an agreement to settle his child support obligations, as alleged by the plaintiff. It had only been agreed that certain matters would be investigated that could lead to an arrangement regarding the plaintiff's arrears.

Two officers of the Commissioner had also visited the plaintiff's mother because of concerns relating to possible legal action against a family trust which apparently owed money to the plaintiff. They were concerned that she appeared to be an elderly person who could be about to be on the end of a legal action in relation to a matter she knew nothing about. The plaintiff alleged that during the visit the officers told his mother not to pay certain funds out of the family trust.

Laurenson J found that there was no pressure brought to bear on the plaintiff's mother to prevent her disbursing monies from the trust to the plaintiff and that shortly after the visit she instructed her own solicitor (as suggested by the officers). The visit was undertaken in good faith.

Second and third issues– whether agreements were made in 2000

A letter had been written to the plaintiff on 28 July 2000 saying that the Commissioner was prepared to accept "a lump sum payment of outstanding assessment plus 10% penalties in full and final settlement of your child support arrears." There was no statutory basis to make that offer. The plaintiff also alleged that a similar offer had been made by Crown Counsel after one of the High Court hearings (on 7 November 2000).

The Commissioner submitted that the second offer had not been made and during a meeting the next day (8 November 2000) the plaintiff was informed that the Commissioner did not have authority to make the first offer, and that the full amount had to be paid. About a week later, on 13 November 2000, the plaintiff forwarded a cheque to the Commissioner for $21,082.11, purportedly in acceptance of the first offer. The cheque was banked on 14 November 2000.

The Commissioner wrote to the plaintiff on 17 November 2000 saying that the settlement offer was not acceptable. The plaintiff replied stating that the cheque should not have banked if the offer was not accepted, stating that the phrase "this cheque is only to be banked if accepted as full and final settlement …" had been written on the reverse of the cheque.

Laurenson J, however, found that there had never been such endorsement (the cheque was located) and that the plaintiff's evidence that the offer from Crown Counsel had been tape-recorded was "entirely unconvincing".

Laurenson J held that there had been an offer in the letter of 28 July 2000, but that the officer who wrote the letter did not have the statutory authority to make it. If there had been an agreement, the Court would not uphold it if it was made without lawful authority: *Kemp & Ors v CIR* (1999) 19 NZTC 15,110. In any event, the offer was not properly accepted and the cheque was at best a counter-offer, and more importantly, the original offer had been withdrawn before acceptance.

Fourth issue – whether there had been misfeasance in public office

Laurenson J set out the elements of the tort of misfeasance in public office and held that the plaintiff's claims were unsuccessful.

Conclusion

Laurenson J concluded that he was "satisfied that over the years the plaintiff sought to avoid payment of his child support arrears, including penalties. He had an earning capacity which enabled him to meet those arrears. Instead he chose to argue over details which finally proved to be of little consequence and, at the same time, accumulate assets in his family trust and indulge his own pursuits."

TRANSFER APPLICATION ALLOWED

Case:	Deepsea Seafoods (No. 1) Ltd & Ors v CIR
Decision date:	23 December 2003
Act:	Tax Administration Act 1994
Keywords:	Transfer from the Taxation Review Authority to the High Court

Summary

The Commissioner's application was successful. The High Court ordered that the challenges be transferred from the Taxation Review Authority to the High Court and to be consolidated with related judicial review proceedings.

Facts

This decision relates to an application by the Commissioner to transfer nine proceedings from the Taxation Review Authority ("TRA") to the High Court, and to consolidate them with each other and with two existing High Court judicial review proceedings. The respondents (apart from one) opposed the application and sought to dismiss it on the ground that a separate application should have been filed for each individual respondent as opposed to a joint one.

All nine respondents (two natural persons, the corporate trustees of their family trusts, and five companies) filed tax returns claiming various deductions. In 1999 the Commissioner issued a number of notices under section 17 of the Tax Administration Act 1994 seeking information relating to the deductions. The notices were not complied with and two of the respondents issued judicial review proceedings challenging their validity. It was claimed that the Commissioner was not treating the respondents impartially.

In January 2003 the Commissioner issued NOPAs in relation to the respondents' 1997 and 1998 income years, disallowing the majority of the deductions claimed. This was on the basis that the Commissioner had not been provided with information to verify them. Assessments were issued prior to the time-bar.

The respondents filed challenges to the assessments in the TRA. The Commissioner applied to have the challenges transferred to the High Court and consolidated with the judicial review proceedings.

The respondents argued that the Commissioner had to make nine separate transfer applications and could not make a joint one as he had purported to do. It was also argued that the joint application breached the individual respondents' rights to secrecy.

Decision

Fisher J accepted that an originating application was the appropriate form in which to bring the application before the High Court: *CIR v McIlraith* (2003) 21 NZTC 18,112.

First issue – whether the Commissioner could apply to have all nine disputes transferred in the one application

In respect of the first issue Fisher J agreed that usually the tax affairs of a taxpayer should be kept separate from other taxpayers, but it did not follow that a joint originating application would never be appropriate. The parties to the application should be determined by R 74 of the High Court rules, which deals with joinder of defendants. Fisher J held that there was sufficient interconnection between the respondents' challenges to justify joining them in terms of R 74 (discussed further below).

In relation to the respondents' confidentially concerns Fisher J agreed with the respondents' counsel that in most situations the tax affairs of each taxpayer would be addressed separately if there would be a risk of prejudice to their privacy interests. However, in this case, notwithstanding the respondents' arguments to the contrary, the Judge found that the respondents were closely related.

Fisher J noted that the evidence before him indicated that the respondents were closely related to each other, with considerable commonality between their shareholders and directors (in respect of the company respondents). It was noted that some of the company respondents were owned by the corporate trustee respondents, and that the two natural person respondents had been directors of some of the company respondents at the relevant time. The judicial review proceedings referred to all nine of the respondents, and the same accountant and solicitor have acted for all of the respondents.

Fisher J held that there "is no foundation in any of that evidence for the suggestion that a combined procedural approach to the tax affairs of the nine respondents could prejudice their privacy interests." Fisher J set aside the respondents' protests to jurisdiction and formally granted the Commissioner leave to proceed with the originating application.

Second issue – whether the proceedings should be transferred

In respect of the second issue Fisher J noted that section 138N of the Tax Administration Act 1994 (under which the Commissioner brought his application) had been considered by a number of earlier decisions. His Honour set out the principles from those decisions and applied them to the facts before him.

His Honour noted that he did not consider the issues in dispute to be particularly complex. However, the history of the litigation suggested that it would be useful for the parties to have access to High Court case management and interlocutory procedures. His Honour also considered that there was sufficient overlap between the challenge and review proceedings, and that it would be "more efficient to deal with all matters at once." It was accepted that costs are lower in the TRA, but this was not considered to be crucial. The respondents who were parties to the review proceedings had already put their tax affairs in the public domain and, in any event, the High Court had the power to protect confidentially. Overall Fisher J considered that the Commissioner's application should be granted.

Fisher J ordered that the nine respondents' challenges be consolidated, and that they also be consolidated with the review proceedings.

ARE NATURAL PERSONS TAXABLE?

Case: D Keighley v CIR (Appeal)

Decision date: Interim 10 October 2003
Supplementary 28 November 2003

Act: Income Tax Act 1994

Keywords: Person, jurisdiction to tax, "juristic person"

Summary

The taxpayer claimed immunity from taxation on a number of grounds, the main argument being that the taxing statutes do not adequately define "person" to include natural persons. The appeal was dismissed.

Facts

This was an appeal from a decision of the District Court at Tauranga on 4 February 2003. On that occasion the Commissioner's application to strike out the defence filed by the taxpayer was granted. The taxpayer then filed a motion on appeal that covered no less than 10 grounds alleging that the District Court Judge was in error.

Decision

The interim decision given orally on 10 October 2003 was brief. His Honour Justice Baragwanath commented on the arguments raised in the Notice of Appeal.

> "I find it unnecessary to recite them in this judgment because each of them is legally untenable. They include for example an argument that the tax legislation has no application to [the Appellant] which is not an argument admissible in a court of law. There was an attempt to distinguish between him as flesh and blood individual from what he calls ' juristic persons'; whereas of course the tax law applies both to individuals and to legal constructs such as companies to which the law ascribes legal effect."

Nonetheless His Honour was concerned, because of an argument raised at the last moment, as to whether any action of the courts or the Commissioner might have resulted in a denial of natural justice. His Honour referred to the dictum of Megarry J in *John v Rees* [1969] 2 All ER 274,at 309 in this respect. He granted leave to the Commissioner to file further affidavits and submissions. The Appellant was granted a right of reply.

Having received the Commissioner's further evidence and submissions and the Appellants response, His Honour issued a supplementary decision which dealt with the final issue. This was done on the papers. In so doing His Honour observed:

> "Mr Keighley has however elected not to accept the opportunity offered. Instead he has today filed a ten page document that simply does not address the only relevant question…"

The appeal was dismissed. The issue of costs was reserved for memoranda. Upon receipt of these the Court awarded costs to the Commissioner on the basis that the proceedings were unnecessarily protracted by the taxpayer.

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

PROMOTER PENALTIES – IR-SPS INV 290

Introduction

1. This Standard Practice Statement sets out the Commissioner's practice for applying promoter penalties to promoters of arrangements involving abusive tax positions.

Application

2. This Standard Practice Statement applies from 1 April 2004 to arrangements entered into on and after 26 March 2003.

3. This Standard Practice Statement must be read in conjunction with the Standard Practice Statements setting out the Commissioner's practice on imposing and reducing shortfall penalties and taking prosecutions.

Background

4. The discussion document *Taxpayer compliance, standards and penalties: a review* (August 2001) identified a number of concerns with the application of the shortfall penalties legislation to investors in tax avoidance arrangements. One concern was that in many cases investors in such arrangements are not aware of the tax effects of their investment. Another concern was that the abusive tax position shortfall penalty, which is intended to be applied to taxpayers who are not complying, was, in some cases, being applied to taxpayers who thought that they were complying but were, in fact, misled by the promoters.

5. Where a taxpayer is a party to an arrangement that results in the taxpayer taking an abusive tax position, a shortfall penalty is imposed on the taxpayer. Although the compliance and penalties legislation penalised promoters in their capacity as taxpayers, the legislation imposed no civil sanctions on promoters in their capacity as promoters of arrangements. The compliance and penalties legislation therefore provided no extra incentive for promoters to ensure that the tax effects they claim for their arrangements were correct. Furthermore, offer documents and securities law in some cases restrict taxpayers from taking legal action against the promoter.

6. The review considered two principal options, namely increasing the taxpayer's penalty or imposing a new penalty on promoters. The government considered that promoters of such arrangements should be held clearly accountable for their actions. The promoter is usually the party with the greater knowledge of the arrangement's tax effects. Often, the true tax impact of an arrangement may be determined by features that the promoter is aware of but the investor is not. These undisclosed features may place the investor at risk of significant penalties.

7. The following amendments to the Tax Administration Act 1994 give effect to the recommendations outlined in the discussion document *Taxpayer compliance, standards and penalties: a review* including that a promoter may be liable to a penalty in their capacity as promoter.

8. In addition to the following amendments, the legislation provides that in certain circumstances the previous behaviour of a taxpayer may entitle the taxpayer to a reduction of any shortfall penalties.

Legislation

Tax Administration Act 1994

3(1) DEFINITIONS
"Arrangement" —
(a) Means a contract, agreement, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect:
(b) For the purpose of Part 5A, includes facts that the Commissioner considers are material or relevant as background or context to a private or a product ruling.

141D ABUSIVE TAX POSITION
141D(3B) The penalty payable for taking an abusive tax position is reduced to 20% of the resulting tax shortfall if—
(a) The taxpayer is a party to an arrangement to which section 141EB applies and becomes liable to a shortfall penalty for an abusive tax position as a result of that arrangement, irrespective of whether a promoter penalty has been imposed in respect of the arrangement; and

(b) The sum of the tax shortfall from the arrangement for the taxpayer and the tax shortfalls from the arrangement for persons with whom the taxpayer is associated under section OD 7 of the Income Tax Act 1994 is less than $50,000; and
(c) The taxpayer has independent advice stating that the taxpayer's tax position is not an abusive tax position.

141EB PROMOTER PENALTIES
141EB(1) The promoter of an arrangement is liable to a promoter penalty if—
(a) A taxpayer becomes a party to the arrangement and a shortfall penalty for an abusive tax position is imposed on the taxpayer as a result of the arrangement; and
(b) The arrangement is offered, sold, issued or promoted to 10 or more persons in an income year.

141EB(2) For the purpose of subsection (1)(b), an arrangement is treated as being offered, sold, issued or promoted to 10 or more persons if 10 or more persons claim tax-related benefits as a result of the arrangement.

141EB(3) An arrangement is treated as being offered, sold, issued or promoted to all shareholders of a loss attributing qualifying company and partners of a partnership if the arrangement is offered, sold, issued or promoted to the loss attributing qualifying company or partnership respectively.

141EB(4) The amount of the promoter penalty is the greater of nil and the sum of tax shortfalls resulting from taking an abusive tax position on the arrangement, for which the promoter would have been liable if the promoter had—
(a) Been a party to the arrangement in the place of each party to the arrangement to whom the arrangement was offered, sold, issued or promoted; and
(b) Taken the tax position that the arrangement produced for the promoter the taxation-related benefits that were intended by the parties to the arrangement; and
(c) Had the taxation-related characteristics that would, under the tax position referred to in paragraph (b), produce for the promoter the maximum taxation-related benefits from the arrangement.

141EB(5) A promoter who satisfies paragraph (a) of the definition of **promoter** in section 141EC is liable for the promoter penalty associated with the arrangement—
(a) Jointly and severally with the other such promoters of the arrangement, for the whole promoter penalty:
(b) Jointly and severally with each promoter of the arrangement who is liable for part of the promoter penalty under subsection (6), for the part of the promoter penalty for which the other promoter is liable.

141EB(6) A promoter who does not satisfy paragraph (a) of the definition of **promoter** in section 141EC is jointly and severally liable, with the other promoters of the arrangement, for the portion of the promoter penalty that is associated with the arrangement entered into by taxpayers to whom the promoter offered, sold, issued or promoted the arrangement.

141EC DEFINITION OF PROMOTER
141EC(1) In section 141EB, **promoter** of an arrangement means—
(a) A person who is a party to, or is significantly involved in formulating, a plan or programme from which an arrangement is offered; or
(b) A person who is aware of material and relevant aspects of the arrangement and who sells, issues or promotes the selling or issuing of, the arrangement, whether or not for remuneration.

141EC(2) For the purpose of subsection (1), **promoter** does not include a person whose involvement with the arrangement is limited to providing legal, accounting, clerical or secretarial services to a promoter.

In this Standard Practice Statement, all legislative references are to the Tax Administration Act 1994 unless otherwise stated.

Discussion

The promoter

9. New sections 141EB and 141EC have been inserted to provide for the imposition of a civil penalty on promoters, in cases where investment in an arrangement leads to any investor having a shortfall penalty for an abusive tax position imposed.

10. If an arrangement is offered, sold, issued or promoted to ten or more people in an income year and it involves an abusive tax position, the promoter will be liable for a promoter penalty. The penalty will be the sum of the tax shortfalls resulting from the arrangement. The penalty is aimed at reducing the number of such investments by holding the people responsible for the design and sale of tax arrangements directly accountable for their actions.

11. Under section 141EB(4)(c) the penalty is based on the maximum taxation-related benefits that the arrangement would produce. This means, for example, that if the arrangement was based around income tax, the tax rate used to calculate the promoter penalty would be 39 cents in the dollar as that rate produces the maximum tax-related benefit, or if the arrangement involves a GST transaction the rate used to determine the promoter penalty would be 12.5%.

Independent advice – reduction of investor's shortfall penalty

12. Although not intended to impose a significant burden on an investor, there is an obligation on investors (and their advisors) to consider the tax issues involved with an arrangement before an investor can qualify for a reduction of the abusive tax position penalty from 100% to 20%.

13. The Tax Administration Act 1994 requires investors to have had the advantage of independent advice that the tax position resulting from the investment is not an abusive tax position.

Definitions

14. "Arrangement" - for the purposes of the promoter penalty, "arrangement" means a contract, agreement, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.

15. "Promoter" - the definition of "promoter" in section 141EC includes:

- a person who is a party to, or is **significantly** involved in formulating, a plan or programme from which an arrangement is offered; or
- a person who is **aware of material and relevant aspects of the arrangement** and who sells, issues, or promotes the selling or issuing of, the arrangement, whether or not for remuneration.

16. "Promoted" – is not defined, however, from the definitions of "promoter" contained in the Tax Administration Act 1994 and the Securities Act 1978, promoted would generally include the selling or issuing, or arranging the selling or issuing, of the arrangement.

17. "Offered" – is not defined in the Inland Revenue Acts, however, the definition of "offer" in the Securities Act 1978 includes an invitation, and any proposal or invitation to make an offer (for example advertisements). Case law[1] has given this a broader definition than "offer" as used in contract law.

18. "Issued" – is not defined in the Tax Administration Act 1994. Generally it will take on the same meaning as under Securities law.

19. "Tax-related benefits as a result of the arrangement" – is not defined, however such benefits could include tax deductions, tax losses, input tax credits, and deferred output tax. Benefits may arise from timing advantages or claiming deductions of a private or capital nature.

Standard Practice

20. This Standard Practice details the following:

- the criteria
- promoter
- offered, sold, issued or promoted
- calculating the penalty
- multiple promoters
- imposition of a promoter penalty
- disputable decision
- independent advice – reduction of investor's penalty
- previous behaviour – reduction of penalties.

The criteria

21. A promoter is liable for a promoter penalty when the following criteria are met:

- there is a promoter as defined
- there is an arrangement as defined
- a taxpayer becomes a party to the arrangement
- a shortfall penalty for an abusive tax position is imposed on a participant as a result of the arrangement
- the arrangement is offered, sold, issued or promoted to 10 or more persons in an income year.

Promoter

22. A promoter of an arrangement includes a person (individual or non-individual) who is a party to or who is significantly involved in formulating a plan or programme. Whether or not a person is a party or significantly involved is largely a matter of fact. It is necessary to consider a number of factors including:

- the flow of money/profits
- input into the design of the arrangement
- level of knowledge
- documents
- advertising/promotional material.

[1] Robert Jones Investments Limited v Gardner & Anor (1993) 6 NZCLC 68,514; Orr v Martin (1991) 5 NZCLC 67,383; Dingwall & Paulger (in Rec) Steel & Ors v New Zealand Guardian Trust Company Limited (1990) 5 NZCLC 66,780

23. Generally this will require knowledge of the key features of the arrangement, or contractual or similar involvement. However it may also apply to directors of companies, or key professional advisors (whose roles are not limited to providing legal, accounting, clerical or secretarial services to promoters), involved in formulating a plan or programme from which an arrangement is offered.

Example 1[2]

An accountant in private practice works closely with an entrepreneur to design a scheme and prepare offer documents. The entrepreneur offers an arrangement to at least 10 people who claim tax-related benefits. The knowledge and role of the accountant would indicate that they were significantly involved in formulating a plan. Accordingly they would be considered to be a promoter for the purposes of the promoter penalty provisions. Other factors to consider may be whether the financial advisor is paid for their services or receive a share of the proceeds.

24. The person's involvement needs to be other than in a professional or administrative capacity on behalf of another person who is a promoter.

25. A promoter also includes a person who is aware of material and relevant aspects of the arrangement and who sells, issues, or promotes the selling or issuing of, the arrangement, whether or not for remuneration. This is also a question of fact and would involve looking at the relevant factors set out above. This would for instance, include persons aware of material and relevant aspects of a scheme who actively market the scheme to their clients, for example financial advisors.

Example 2

Following on from Example 1, a financial advisor, who was not involved in formulating the plan, offers an arrangement to their clients. The financial advisor, who is aware of material and relevant aspects of the arrangement, is considered to be a promoter for the purposes of the promoter penalty provisions. Whether or not the financial advisor received remuneration is not relevant.

Offered, sold, issued or promoted

26. One of the criteria for liability for the promoter penalty is that the arrangement has been offered, sold, issued or promoted to 10 or more persons in an income year.

[2] Please note, the examples in this Standard Practice Statement are intended to illustrate how the Commissioner may apply the practice set out in this Standard Practice Statement – they do not set practice in themselves.

27. This criterion is deemed to be met when 10 or more persons claim tax-related benefits as a result of the arrangement. Such benefits could include tax deductions, tax losses, input tax credits, and deferred output tax.

Example 3

If an investigation identifies 10 taxpayers who each claimed, as a result of a particular tax avoidance arrangement, a deduction for a share of partnership losses, then the arrangement is deemed to be offered, sold, issued or promoted to 10 or more persons in an income year.

28. When determining whether an arrangement has been offered, sold, issued or promoted to 10 or more persons, each shareholder of a loss attributing qualifying company (LAQC) and each partner of a partnership is counted, if the arrangement is offered, sold, issued or promoted to the loss attributing qualifying company or the partnership.

Example 4

An arrangement is offered to a LAQC with 3 shareholders, and another company with 6 shareholders. That will count as an offer to 4 persons – 3 through the LAQC and 1 for the other company.

29. It is the Commissioner's view that whether in fact an arrangement has been offered to 10 or more persons is measured by reference to such things as attendance at promotional events, records of correspondence held by the promoter and other objective means. Imposition of the promoter penalty is not limited to circumstances in which 10 or more persons claim tax-related benefits.

30. Arrangements advertised in the general media will be considered to be offered to 10 or more persons – regardless of how many invest in the arrangement.

31. In general, the Commissioner will apply principles derived from the Securities Act 1978 when considering whether an arrangement has been offered or promoted.

Calculating the promoter penalty

32. The penalty on the promoter is determined by reference to the total tax shortfalls resulting from the arrangement. This ensures that the promoter faces a penalty that reflects the total tax impact of the arrangement and is calculated from the maximum taxation-related benefits (shortfalls) that each investor in the arrangement would have obtained. Add those taxation-related benefits together to calculate the penalty on the promoter.

33. If the arrangement was based around income tax, the tax rate used to calculate the promoter penalty is 39 cents in the dollar, as that rate produces the maximum tax-related benefit.

34. If the arrangement involves a GST transaction, the rate used to determine the promoter penalty would be 12.5%.

Example 5

A promoter sells an arrangement to 11 investors designed to give them a deduction of $30,000 each. Using the maximum income tax rate of 39%, the sum of these maximum taxation-benefits is 11 x $11,700 which totals $128,700. Accordingly, the amount of the promoter penalty is $128,700.

Multiple promoters

35. There may be more than one promoter associated with an arrangement, and the promoters may have differing levels of involvement with the arrangement. In order to determine the extent of the liability of each promoter it is necessary to determine whether each promoter of an arrangement is:

    (a) a party to or significantly involved in formulating a plan or programme from which an arrangement is offered; or

    (b) aware of material and relevant aspects of the arrangement and who sells, issues, or promotes the selling or issuing of, the arrangement, whether or not for remuneration.

    The extent of the promoter's liability will depend on which of these two categories applies to the promoter.

36. Each promoter that is a party to or significantly involved in formulating a plan or programme from which an arrangement is offered is jointly and severally liable with the other promoters for the whole promoter penalty.

37. Where there is more than one promoter, each promoter who is not a party to or significantly involved in formulating a plan or programme from which an arrangement is offered, but is:

    (a) aware of material and relevant aspects of the arrangement; and

    (b) sells, issues or promotes the selling or issuing of the arrangement,

    is jointly and severally liable, with the other promoters, for the portion of the promoter penalty associated with the arrangement entered into by taxpayers to whom the promoter offered, sold, issued or promoted the arrangement.

Imposition of a promoter penalty

38. Promoter penalties are imposed in addition to shortfall penalties. The promoter penalty is imposed in tandem with the shortfall penalty where the promoter is subject to a shortfall (as an investor in the arrangement), but if further shortfalls are detected, further penalties will be imposed.

39. Investors remain liable for shortfall penalties when a promoter penalty is imposed on a promoter.

40. Other than where an exclusion applies under section 89C of the Tax Administration Act 1994, the Commissioner will first propose any promoter penalty in a NOPA (Notice of Proposed Adjustment).

Disputable decision

41. The imposition of a promoter penalty is a disputable decision and, as such, can be disputed in accordance with the disputes procedures provisions in Part IVA of the Tax Administration Act 1994.

Independent advice – reduction of investor's shortfall penalty

42. The abusive tax shortfall penalty on the investor will be imposed at 20% rather than 100% where:

    - the tax shortfalls of the investor and any associated person are less than $50,000; and
    - the investor has independent advice stating that the investor's tax position is not an abusive tax position.

43. The advice must state more than just facts—it must express an opinion and must state that the investor's tax position is not an abusive tax position. Statements by the promoter will not be sufficient.

44. Generally, advice will be independent when:

    - an investor receives the advice, for example in promotional material or a legal opinion
    - an investor, or a promoter on behalf of investors, paid for professional advice that the arrangement is not an abusive tax position
    - the advice expressly states that it was prepared on the basis that it would be given to the investors
    - the advisor is independent of the promoter; and
    - the advisor is not a promoter.

45. The advice must be genuinely identifiable as coming from someone independent of both the taxpayer and the promoter. When determining whether advice is independent, the Commissioner will consider:

    - any relationship between an investor and an advisor
    - any relationship between a promoter and an advisor; and/or
    - the information available to an investor regarding any relationship between a promoter and an advisor.

Previous behaviour – reduction of penalties

46. A taxpayer (ie an investor including a promoter who is also an investor) may be eligible to have their abusive tax position shortfall penalty reduced for previous behaviour in certain circumstances. If it is, then such a reduction will be available in addition to any other applicable reduction.

47. Note that the promoter penalty cannot be reduced under section 141FB which reduces shortfall penalties on the grounds of previous behaviour.

This Standard Practice Statement was signed by me on 15th March 2004.

Margaret Cotton
National Manager
Technical Standards

REGULAR FEATURES

DUE DATES REMINDER

April 2004

7 End-of-year income tax

- *2003 end-of-year income tax due for clients of agents with a March balance date*

20 Employer deductions

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

30 GST return and payment due

May 2004

20 Employer deductions

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

31 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2004–2005*
The calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSWT deduction per annum

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

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	Draft question we've been asked	*Comment deadline*
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