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**

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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 items are available for review/comment this month, having a deadline of 28 February 2006.

Ref.	Draft type	Description
QB0047	Question we've been asked	Effect of repeal of Income Tax Act 1994 on depreciation determinations issued before repeal
QB0049	Question we've been asked	GST and fees paid for the processing, monitoring and granting of resource consent, pursuant to section 36 of the Resource Management Act 1991
INS00072	Interpretation statement	Care and Management of Taxes

Please see page 38 for details on how to obtain a copy.

The following draft item is available for review/comment this month, having a deadline of 9 March 2006.

Ref.	Draft type	Description
ED 0086	Standard practice statement	Reduction of shortfall penalties for previous behaviour

Please see page 38 for details on how to obtain a copy.

STANDARD PRACTICE STATEMENT

This statement describes how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

SPS 05/12 – LOSS OFFSET ELECTIONS BETWEEN GROUP COMPANIES

Introduction

1. This Standard Practice Statement ("SPS") sets out certain practices which the Commissioner will accept for offsetting losses by election between group companies. It also sets out the consequences of specific events that can impact on a loss offset and how these should be addressed.

2. The SPS does not consider all questions relating to loss offsets within a group of companies and accordingly is not a fully comprehensive guide to section IG 2 of the Income Tax Act 2004. For instance, it does not consider what constitutes a group of companies, the question of dual residency and subvention payments.

Application

3. This Standard Practice Statement will apply to group company loss offset elections where the year of offset is the 2005-2006 or later income year and the election is made on or after the date of this Standard Practice Statement. However, it may be used as a guide in respect of earlier income years, as it reflects current Inland Revenue policy.

Summary

4. The Income Tax Act 2004 ("the Act") makes provision for the sharing of losses between companies that are in the same group of companies. Where a company has made a loss it may elect to give another group company or companies that are in profit, the benefit of the loss that it has sustained. It does this in respect of "the year of offset," ie the year in which it has a net loss (which may result from carrying forward earlier losses partly or wholly) and to which its election relates. The amount so elected is then offset against the net income of the profit company in the same year of offset. Another method of sharing a loss is for the profit company to make a "subvention payment" to the loss company. A subvention payment is a payment made by a profit company to a loss company and is offset against the profit company's net income and reduces the loss company's available net losses. The same level of benefit is obtained, but the subvention payment involves a real movement of money from one company to the other. Both methods may be used together.

5. This SPS provides for the consistent application of certain aspects of the loss offset provisions in Subpart IG of the Act where such elections are made. It discusses the requirements for giving notice, in particular whether a specific amount must be elected or whether a formula may be used, the Commissioner's practice with respect to part year losses, and what should happen when the loss company's loss or the profit company's profit is increased or reduced.

6. Briefly, the standard practice for valid elections is as follows:

    a) They may be given either manually (paper-based) or electronically;

    b) An election should refer to an amount that is identifiable as a specific dollar amount at the time the notice of election is made;

    c) For part years, there should be "adequate accounts" from both the loss company and the profit company, the standard for which requires a sufficiency of detail of the assessable income and the allowable deductions of the company, in respect of part of the income year, materially the same as the level of reporting necessary for the preparation of end-of-year accounts;

    d) Where the loss company is reassessed (having its loss reduced below the level in the election) and as a consequence is not entitled to offset the amount elected, then (i) where there is only one available profit company the Commissioner will, usually after consultation with the company's agent, simply assess or reassess the profit company in accordance with s89C(k) of the Tax Administration Act 1994, or (ii) where there is more than one profit company capable of sharing the loss the election may be altered;

    e) Where the loss company is reassessed and as a consequence has additional losses to offset, a further election can be made in respect of those additional losses if this can be done within the statutory time period for making elections or within such further time as the Commissioner may allow;

    f) Where a profit company is reassessed and as a consequence has additional profit that could be the subject of an offset, a further election can be made by the loss company in respect of the additional profit within the statutory time period or within such further time as the Commissioner may allow;

g) Where a profit company is reassessed and as a consequence has reduced profits (below the level of losses available), the election is valid up to the amount of the reduced profits; and

h) Generally, an election and any subsequent election must be made by 31 March in the year following the year of offset. A late election can be accepted at the discretion of the Commissioner.

7. The legislation is in section IG 2 of the Income Tax Act 2004. The section states the circumstances in which losses may be offset.

Background

8. Inland Revenue has hitherto had no published practice on loss offset elections. This SPS is necessary to ensure that consistent decisions are made when loss offset elections are received by Inland Revenue.

9. A Standard Practice Statement sets out what the Commissioner considers should be the *standard or normal practice* in the situations that it covers.

Standard Practice

Prerequisites

10. Before a loss offset can proceed the following factors must be present.

Net loss company

11. There must be a company with a net loss for an income year or a net loss carried forward. The loss company must also have 49% continuity of ownership from the time the loss is incurred until the loss is offset.

12. The loss company must be incorporated in New Zealand or be carrying on business in New Zealand through a fixed establishment in New Zealand.

13. The loss company must not be a dual resident company ie the company, though resident in New Zealand, must not:

- be treated under a double tax agreement as not being resident in New Zealand for the purposes of the double tax agreement; or
- be liable for income tax in another country by reason of domicile, residence or place of incorporation; section IG 2(11).

Profit company or companies

14. There must be one or more profit companies in the same group of companies as the loss company. All companies involved must be in the same group of companies for the whole continuity period.

Whether or not two companies form a group of companies is outside the scope of this SPS.

Amount of loss

15. The amount of loss to be offset cannot exceed the taxable income of the elected profit company or the total taxable income of all the elected profit companies (section IG 2(2)(f)) and neither may the amount of loss to be offset exceed the net loss of the loss company (section IG 2(2)(b)).

A specific amount

16. An election should refer to an amount that is capable of identification as a specific dollar amount. The amount must be fixed by the election in a manner which binds the electing company, but need not be quantified in the notice of election. That is, a formula may be used where it could be known at the time of the election what the result of applying that formula would be. For example, the election might provide that the loss to be offset is to be such amount as would reduce the profit company's taxable income to nil.

Example 1

In a group consisting of two companies, it is found, once its accounts have been prepared, that Company A has a tax loss of $10,000. It is anticipated that Company B will be in profit and that the amount of the taxable profit will be about $2,000, ie less than the amount of Company A's loss. Company B's accounts, however, have still to be prepared as the accountants are waiting on further information from their clients. That information will be arriving in a few days. There is still time to file an election and the question is whether Company A can now elect to offset some of its loss up to the amount of the profit company's profit by using a formula, which formula will simply be that the amount to be offset will be the amount of Company B's profit.

The answer is that this is permissible because:

- the notice will be given in time;
- the amount will be subsequently identified as a specific dollar amount;
- it does not matter that (even if the accounting firm could commit staff to the finalisation of the accounts) the profit cannot be ascertained with finality at the time of the notice;
- the information will be in the accountants' hands shortly and so the profit will be identifiable at a time close to the notice. It could even be said that the profit is presently identifiable if the information is somewhere within Company B; and
- the amount to be offset is already fixed in that it is controlled by the formula.

The election

17. An election to offset the loss must be made by the loss company in writing. The loss company can give notice of the election by:
    - completing the appropriate boxes in a return; or
    - completing the appropriate boxes in an e-filed return; or
    - sending either manually or electronically a notice of election in writing (either with the return or separately).

18. The details to be provided by completing the appropriate boxes in the income tax return for companies are as follows:
    - where it is a loss company's return that is being prepared, the IRD numbers of the profit companies and the amounts being offset to each of them, and
    - where it is a profit company's return that is being prepared, the IRD numbers of the loss company or companies that are offsetting losses to it and the amount being offset from the loss company or, if there is more than one loss company, the amount being offset from each of them. If a loss company makes more than one valid election to the same profit company it may simply enter the total amount and record it in the return as one transaction.

19. A written Notice of Election can be filed outside the loss company return. There is not a prescribed form to be used but the Notice must be signed by an officer or an agent of the company, although where it is filed electronically by a recognised tax agent it will be assumed that the agent has authority to make the election on the loss company's behalf. In this case, where a more formal Notice is filed, it would be helpful if separate copies were provided for each of the returns of the companies affected by the election. The Notice should contain the information required above at paragraph 18, ie:
    - the total amount of the loss or losses to be offset,
    - the name and IRD number of the loss company that is offsetting losses and the amount being offset from the loss company or, if there is more than one loss company, their names and numbers and the amount being offset from each of them, and
    - the names and IRD numbers of the profit company or companies and the amount being offset to each of them and from which company or companies.

Late elections and extensions of time for filing them

20. An election must generally be made by 31 March in the year following the year of offset (that is, in the year to 31 March in respect of which the offset is elected). A late election can however be accepted at the Commissioner's discretion; section IG 2(3). The purpose of the loss offset provisions is to allow those companies that incur losses to utilise those losses even where different entities are involved, so that there is similarity in the tax treatment of a group of companies, each carrying on separate enterprises, as against a single company that carries on the same enterprises in separate divisions. A case need not be exceptional for the discretion to be exercised favourably. In exercising this discretion the following factors will be considered:
    - the timing of the late application/election to offset a loss: generally, the longer the delay, the potential risk to the Revenue in terms of subsequent audit. Also the effect of a loss offset means that the loss company's assessment must be increased to reflect the reduced loss remaining and this can only be done within four years from the end of the income year in which its return is filed, or within such further time where the company waives the time bar under section 108B of the Tax Administration Act 1994;
    - the reason for the delay and its correlation to the length of the delay;
    - the circumstances which have changed after the election date;
    - the circumstances surrounding the failure to provide a notice within time;
    - whether the circumstances were beyond the applicant company's control;
    - any public interest considerations, to ensure the integrity of the tax system is protected. This would mean that the profit and loss company would be treated fairly in that any decision to allow or not allow an extension of time would be in accord with the way other companies in a like position would be treated;
    - prejudice to any party (the Commissioner, the loss company and the profit company) from the exercise or non-exercise of the discretion;
    - whether there have been reassessments made by the Commissioner, giving rise to possible further elections; and
    - any other matters relevant to the merits of the application.

Example 2

A reason for the delay could be that the Commissioner has made an adjustment increasing a profit company's income as a result of an avoidance scheme, evasion or fraud. This factor would weigh against the favourable exercise of the discretion where the profit company then (later than the correct date) seeks to access losses elsewhere from within the group. It could be said that the delay in requesting the compensating election is directly attributable to the actions of the loss company or parties with which it is associated. In cases of illegality the Commissioner will not readily assist the taxpayer to utilise losses.

Example 3

A late election is filed on 10 April after 31 March of the year following the year of offset. It is accompanied by a request for an extension of time of ten days. The reasons given for requesting the extension are that although the loss company's return had been prepared and filed sometime previously, there were numerous profit companies in the group the preparation of whose returns was time consuming. Their returns were filed on time (some actually on 31 March) but due to pressure of work the question of offsetting the loss company's losses was overlooked. Early in April this omission came to the agent's attention and a decision was made about how the offset should be made. The election was then filed without delay. Inland Revenue considered the request and granted it.

Further elections

21. Once a loss company has made an election it cannot withdraw that election or change any part of that election. It is final and irrevocable (see the concluding words of section IG 2(2)). However, further elections can be made in some cases – a loss company is not limited to a single election in respect of only one profit company.

Part year losses

22. It is possible to offset a part year loss (section IG 2(4)). This requires:

- the loss company and profit companies to have continuity of shareholding for the relevant period, ie the period that the loss to be offset is attributable to;
- the provision of adequate accounts for the loss company that are fairly and reasonably attributable to the relevant period;
- the provision of adequate accounts for all profit companies that again are fairly and reasonably attributable to the relevant period;
- that these accounts contain sufficient information to show they are accurate for the relevant period. The standard for "adequate accounts" requires a sufficiency of detail of the assessable income and the allowable deductions of a company, in respect of part of the income year that is materially the same as the level of reporting necessary for the preparation of end-of-year accounts adjusted for tax purposes. The Commissioner's view is that this requires accounts prepared in accordance with generally accepted accounting practice adjusted for the purposes of income tax legislation, eg to reflect assessable income or deductible expense, at the level required under the Financial Reporting Act 1994. (This does not require the preparation of notes to the accounts and disclosure statements.) The part-year accounts will of necessity be different from full-year accounts due to different ratios, denominators, etc.; and
- a valid election.

23. Where a company has a loss of continuity part way through a month and its accounting system balances and reports at the end of the month, subject to backing out significant transactions pre or post the loss of continuity, Inland Revenue will accept the use of the end of month balance sheet numbers for determining provision balances. Inland Revenue will accept pro-rata allocation of the month's income and expenditure to determine the pre and post continuity change profit or loss.

24. In some cases it may be difficult to prepare part year accounts to the level of detail set out above, particularly in circumstances where there has been a significant lapse of time from the part year. In these circumstances, taxpayers may discuss their individual positions with Inland Revenue and depending on the facts agree to a different approach being taken.

Reassessments

25. In some cases Inland Revenue may reassess a profit or loss company resulting in increased or reduced profits or losses respectively. As a consequence there may be a need for further or fresh elections or the original election may be altered. There are four situations that may be brought about by reassessments. These are:

- The available loss is reduced below the amount originally elected to be offset.
- The available loss is increased.
- The profit company has additional profit that could be the subject of an offset.
- The profit company has reduced profits below the level of the amount of the loss offset.

Reduced loss

26. Where the loss company is reassessed (having its loss reduced below the level in the election) and as a consequence is not entitled to offset the amount elected then:

    (i) where there is only one profit company then the Commissioner will, usually after consultation with the company or its agent, simply assess or reassess the profit company in accordance with sections 89C(k) and 113 of the Tax Administration Act 1994. No further election is necessary as the assessment of the profit company will reflect the reduced loss available to be offset; and

    (ii) where there is more than one profit company the election may be altered in accordance with subsection (7).

27. Where there is more than one profit company the loss company may elect how that reduced loss is to be allocated to the profit companies pursuant to section IG 2(7)(c). If the loss company does not make this subsequent election within six months or within such further time as the Commissioner may allow, the reduced loss is allocated proportionately to the profit companies.

Increased loss

28. Where the loss company is reassessed and as a consequence has additional losses to offset, a further election can be made in respect of those additional losses. The first election cannot be altered at all. The further election must meet all the criteria set out above for an election, for example it must be on time, state the specific amount to be offset, and name the profit company or companies.

Increased profit

29. Where a profit company is reassessed and as a consequence has additional profits that could be the subject of an offset, a further election can be made by the loss company in respect of the additional profits within the statutory time period (set out in subsection IG 2(3)). This election must meet all the criteria set out above.

Reduced profit

30. Where a profit company is reassessed and as a consequence has reduced profits (below the level of the loss offset), the election remains valid up to the reduced amount of the profit. The "unused" offset loss remains to the credit of the loss company.

31. Accordingly a fresh notice of election need not be filed.

Late filing

32. These elections that are necessitated by reassessments should be made within the time allowed (subsection (3)), ie by the 31 March in the year following the year of offset or within six months of the date upon which notice is given to the loss company of the determination of the reduced amount of the net loss.

33. A late election can be accepted at the Commissioner's discretion. In exercising this discretion, the factors set out above at paragraph 20 will be considered, ie the merits of the application, the circumstances surrounding the failure to elect within time (including the fact that the reassessment may have occurred after the time for making elections had expired), the explanation for the delay, the length of the delay, compliance costs and fairness as between the taxpayer and the treatment of other taxpayers in a like position, are factors that will be taken into account. Late offset elections filed after a reassessment (whether as a result of a voluntary disclosure or not) would be allowed in most cases. However if, for example, there is an issue of evasion or tax avoidance then that factor would be taken into account in deciding whether to exercise the discretion to allow the late election.

Requests to amend assessments

34. After an election has been made there may be changes to the assessments of the loss company or profit company which impact on the loss offset resulting in the situations covered in the immediately preceding paragraphs. Where there are any consequential impacts on the loss offset election and a further election needs to be made or the election needs to be revised, the taxpayer companies may need to consider whether section 113 of the Tax Administration Act 1994 (including Inland Revenue's practice in respect of section 113) allows those changes to be implemented. In this regard SPS INV-510 *Requests to amend assessments (published in Tax Information Bulletin* Vol 14, No 8 (August 2002)), which sets out the circumstances when the Commissioner may amend assessments to ensure correctness, is relevant in considering whether the election should be approved.

35. It will be the Commissioner's practice having approved a further election where the loss company's loss or the profit company's profit is increased or reduced, to implement it, ie once a further election has been approved then the resulting amendments to assessments will also be made. Generally an amended assessment will not be agreed where the taxpayer has previously had the opportunity to offset known losses, and has failed, for whatever reason, to do so.

This Standard Practice Statement is signed on 16th December 2005.

Graham Tubb
National Manager, Technical Standards

LEGISLATION

36. Section IG 2 of the Income Tax Act 2004 is as follows:

IG 2 Net loss offset between group companies

(1) [Continuity of ownership requirements] For the purposes of this section, continuity of ownership is treated as being maintained in respect of any company and any period where there is a group of persons—

(a) the aggregate of whose minimum voting interests in the company is equal to or greater than 49%; and

(b) in any case where at any time during the period a market value circumstance exists in respect of the company, the aggregate of whose minimum market value interests in the company is equal to or greater than 49%—

and, for the purposes of this paragraph, the minimum voting interest or the minimum market value interest of any person in the company in the period is equal to the lowest voting interest or market value interest (as the case may be) in the company which that person has during the period.

(2) [Requirements for deduction where loss company elects to offset losses or receive payments from profit company] Subject to the succeeding subsections of this section, where in respect of any income year (in this subsection referred to as the **year of offset**)—

(a) a company (in this subsection referred to as the **loss company**) has—

(i) a net loss for the year of offset that does not consist of a mining outgoing excess and is not prevented by section IE 1(2B) or (2C) from being carried forward under sections IE 1 and IF 1:

(ii) carried forward under sections IE 1 and IF 1 such a net loss of the loss company which arose in a preceding income year (in this subsection referred to as the **preceding loss year**) to the year of offset; and

(b) the loss company either—

(i) elects by notice in accordance with subsection (3) that the whole or part of the net loss be offset against the net income for the year of offset of another company; or

(ii) receives a payment from another company under an agreement providing for the other company to bear or share in the net loss—

that other company being in this subsection referred to as the profit company; and

(c) the **profit company** is in the same group of companies as the loss company for—

(i) the year of offset of the loss company; and

(ii) in any case where the year of offset of the profit company ends on a date later than the last day of the year of offset of the loss company, the year of offset of the profit company; and

(iii) in the case of a net loss or part of a net loss of the loss company, for any preceding loss year that was the 1981–82 income year or any subsequent year, the preceding loss year of the loss company; and

(iv) in the case of a net loss or part of a net loss of the loss company, for any preceding loss year that was the 1991–92 income year or any subsequent year, all income years of the loss company (if any) falling between the preceding loss year of the loss company and the year of offset of the loss company; and

(d) the loss company is at all times in—

(i) the year of offset of the loss company; and

(ii) in the case of a net loss or part of a net loss of the loss company, for any preceding loss year,—

(A) the preceding loss year of the loss company; and

(B) in any case where the preceding loss year is the 1991–92 income year or a later income year, all income years of the loss company (if any) falling between the preceding loss year of the loss company and the year of offset of the loss company—

not a dual resident company and is at all times in those years either—

(iii) incorporated in New Zealand; or

(iv) carrying on business in New Zealand through a fixed establishment in New Zealand; and

(e) continuity of ownership is maintained in respect of the loss company for—

(i) the year of offset of the loss company; and

(ii) in any case where the year of offset of the profit company ends on a date later than the last day of the year of offset of the loss company, the year of offset of the profit company; and

(f) the amount so elected to be offset or payment so received does not exceed the amount that would, were that offset not allowed or that payment not made, be the taxable income (after offsetting any net loss which is available to the profit company under this section or other than under this section) of the profit company for the year of offset; and

(g) in the case of any payment made by the profit company,—

(i) the payment does not exceed the amount of the net loss; and

(ii) the payment is made not later than the 31 March that, in relation to the loss company and the year of offset, is the latest date to which the time for the furnishing of the return for that income year may be extended under section 37(5) of the

Tax Administration Act 1994 or is made within such further time as the Commissioner may allow; and

(iii) the payment would not (otherwise than under this subsection) be taken into account in calculating the taxable income of either the loss company or the profit company; and

(iv) the loss company gives notice of the payment to the Commissioner in accordance with subsection (3),—

the amount so elected to be offset or the payment (as the case may be) must—

(h) be offset against net income of the profit company in the year of offset; and

(i) to the extent so offset, give rise to a reduction in the available net losses of the loss company (in the same order in which the losses arose); and

(j) in the case of any payment made by the profit company, to the extent so offset, not be treated as a dividend paid by the profit company to the loss company,—

and any election made in accordance with this subsection is irrevocable.

(3) [Notice of election to offset losses] Every notice under subsection (2) must be given to the Commissioner not later than the 31 March that, in relation to the loss company and the year of offset, is the latest date to which the time for the furnishing of the return of its income for the year of offset may be extended under section 37(5) of the Tax Administration Act 1994 or within such further time as the Commissioner may allow.

(4) [Deduction for part-year losses] Notwithstanding subsection (2), where and to the extent that—

(a) an offset under that subsection would not, but for the application of this subsection, be available to a company (in this subsection referred to as the **profit company**) in an income year (in this subsection referred to as the **year of offset**) in respect of all or part of a net loss of another company (in this subsection referred to as the **loss company**) for that income year because the requirements of either or both of subsection (2)(c)(i) and (ii) and (e) are not met; and

(b) an offset under the relevant subsection would be available if regard were had, for the purposes of applying subsection (2)(c) and (e) to a period (in this subsection referred to as the **loss company commonality period**) which is part only of the year of offset of the loss company; and

(c) adequate accounts have been prepared by the loss company and furnished to the Commissioner which detail sufficiently that part of the net loss (in this subsection referred to as the **part-year loss**, and that net loss to be calculated after taking into account any amount that has been offset under this section against the net income of any company other than the profit company) as is reasonably and fairly attributable to the loss company commonality period; and

(d) adequate accounts have been prepared by the profit company and furnished to the Commissioner which detail sufficiently that part of the amount (in this subsection referred to as the **part-year profit**) that would be the profit company's taxable income if this subsection did not apply to that net loss for the whole of the year of offset of the profit company as is reasonably and fairly attributable to,—

(i) in any case where the year of offset of the profit company is co-extensive with the year of offset of the loss company, the loss company commonality period (in this subsection in respect of that case referred to as the **profit company commonality period**); and

(ii) in any other case, that part of the year of offset of the profit company (in this subsection in respect of that case referred to as the **profit company commonality period**)—

(A) which includes (but is not limited to) all or part of the loss company commonality period; and

(B) in which the profit company and the loss company are at all times members of the same group of companies; and

(C) in which continuity of ownership has been maintained in respect of the loss company,—

the loss company may, in any notice given to the Commissioner, in accordance with subsection (3) in respect of the net loss, the profit company, the loss company, and the year of offset, elect that regard must be had in applying subsection (2) in respect of the net loss, the profit company, the loss company, and the year of offset only to the loss company commonality period and, where that election is made, subsection (2) applies for the purpose of determining the amount able to be offset against the net income of the profit company in respect of the net loss and the year of offset as if—

(e) the year of offset of the loss company were co-extensive with the loss company commonality period and the net loss of the loss company for that deemed year were equal to the part-year loss; and

(f) the year of offset of the profit company were co-extensive with the profit company commonality period and the taxable income of the profit company for that deemed year were equal to the part-year profit.

(5) [Special rules for carrying forward part-year losses] Notwithstanding subsection (2), where and to the extent that—

(a) an offset under that subsection would not, but for the application of this subsection, be available to a company (in this subsection referred to as the **profit company**) in an income year (in this subsection referred to as the

year of offset) in respect of all or part of a net loss of another company (in this subsection referred to as the loss company) for a preceding income year (in this subsection referred to as the **preceding loss year**) because the requirements of any 1 or more of—

(i) paragraph (c)(i); or

(ii) paragraph (c)(ii); or

(iii) in the case where the preceding loss year is the 1991–92 income year or a subsequent income year, paragraph (c)(iii); or

(iv) paragraph (e)—

of subsection (2) are not met; and

(b) an offset under that subsection would be available if—

(i) in any case where subsection (2)(c)(i) or (ii) or (e) is not met,—

(A) regard were had for the purposes of applying subsection (2)(c)(i), (ii), and (e) to a period (in this subsection referred to as the **loss company commonality period**) which is part only of the year of offset of the loss company; and

(B) section IF 1(3) were to apply as if the loss company had, in that part of the year of offset of the profit company which falls within the loss company commonality period, net income equal to that part of the profit company's net income for the year of offset specified in paragraph (c); and

(ii) in any case where subsection (2)(c)(iii) is not met in respect of a preceding loss year being the 1991–92 income year or a subsequent income year, regard were had for the purposes of applying that paragraph (c)(iii) to a period (in this subsection referred to as the **preceding year loss company commonality period**) which is part only of the preceding loss year; and

(c) in any case where subsection (2)(c)(i) or (ii) or (e) is not met, adequate accounts have been prepared by the profit company and furnished to the Commissioner which detail sufficiently that part of the amount that would, if this subsection did not apply to the net loss of the loss company, be the profit company's taxable income (in this subsection referred to as the **part-year profit**) for the whole of the year of offset of the profit company as is reasonably and fairly attributable to—

(i) in any case where the year of offset of the profit company is co-extensive with the year of offset of the loss company, the loss company commonality period (in this subsection in respect of that case referred to as the **profit company commonality period**); and

(ii) in any other case, that part of the year of offset of the profit company (in this subsection in respect of that case referred to as the **profit company commonality period**)—

(A) which includes (but is not limited to) all or part of the loss company commonality period; and

(B) in which the profit company and the loss company are members of the same group of companies; and

(C) in which continuity of ownership has been maintained in respect of the loss company; and

(d) in any case where subsection (2)(c)(iii) is not met in respect of a preceding loss year being the 1991–92 income year or a subsequent income year, adequate accounts have been prepared by the loss company and furnished to the Commissioner which detail sufficiently that part of the net loss (in this subsection referred to as the part-year loss, and that net loss to be calculated after taking into account any amount that has been offset against net income by any company other than the profit company) as is reasonably and fairly attributable to the preceding year loss company commonality period,—

the loss company may, in any notice given to the Commissioner in accordance with subsection (3) in respect of the net loss, the profit company, the loss company, and the year of offset, elect that, in respect of the net loss, the profit company, the loss company, and the year of offset,—

(e) in any case where subsection (2)(c)(i) or (ii) or (e) is not met, regard must be had in applying those paragraphs only to the loss company commonality period, and, where such an election is made,—

(i) for the purposes of determining the amount able to be offset by the profit company in respect of the loss company's net loss and the year of offset, subsection (2) applies as if the year of offset of the profit company were co-extensive with the profit company commonality period and the taxable income of the profit company for that deemed year were equal to the part-year profit; and

(ii) where and to the extent that—

(A) the whole or part net loss of the loss company could only be carried forward by the loss company under section IE 1(2) to the year of offset by virtue of section IF 1(3); and

(B) by virtue of this subsection an offset is allowed to the profit company,—

section IF 1(3) applies as if the loss company has, in that part of the profit company commonality period which falls within the loss company commonality period, net income equal to the part year profit; and

(f) in any case where subsection (2)(c)(iii) is not met in respect of a preceding loss year being the 1991–92 income

year or a subsequent income year, regard must be had in applying that paragraph (c)(iii) only to the preceding year loss company commonality period, and, where such an election is made, for the purposes of determining the amount able to be offset by the profit company in respect of the loss company's net loss and the year of offset, subsection (2) applies as if the preceding loss year were co-extensive with the preceding year loss company commonality period and the net loss of the loss company for such deemed year were equal to the part-year loss.

(6) [Grouping of loss limited where bad debt or share loss deduction previously claimed] Where—

(a) a company (referred to in this subsection as the loss company) has a net loss for any income year; and

(b) a deduction has been allowed under this Act or an earlier Act, in the 1993–94 or any subsequent income year (referred to in this subsection as the year of write off), to any company (referred to in this subsection as the write-off company) other than the loss company for—

(i) a bad debt; or

(ii) a decline in the value of any shares determined as follows:

(A) if the shares have not been disposed of, from a valuation made under subpart EB or otherwise; or

(B) if the shares have been disposed of by the taxpayer, as the amount by which the income of the company in respect of the disposal is less than the deduction allowed to the company in respect of the cost of the shares; and

(c) the application by the loss company of an amount which—

(i) gave rise to the debt; or

(ii) was paid by any person for the subscription of the shares—

was taken into account in calculating the net loss,—

no offset is available in respect of the net loss under subsection (2) in the year of write off or in any income year succeeding the year of write off in calculating the net income of any company which is the write-off company or which is at any time in the income year in which the net loss arises in the same group of companies as the write-off company, except to the extent that the net loss exceeds the aggregate of the deductions referred to in paragraph (b).

(7) [Amount of net loss less than aggregate amount of deductions claimed] Where—

(a) an amount of net loss apparently arising for a company (in this subsection referred to as the **loss company**) in an income year (in this subsection referred to as the **year of loss**) is offset by more than 1 company (in this subsection referred to as the **profit companies**) under subsection (2); and

(b) the actual net loss of the loss company for the year of loss is determined by the Commissioner to be less than the aggregate amounts offset in respect of the apparent net loss by the profit companies against their net income,—

then, notwithstanding any other provision of this section,—

(c) where the loss company so elects by notice in such form as the Commissioner may allow, given to the Commissioner within 6 months after the date upon which the Commissioner gave notice to the loss company of the determination of the reduced amount of the net loss or within such further time as the Commissioner may allow, the amount by which the actual net loss determined by the Commissioner is less than the aggregate of the amounts offset by the profit companies must be allocated to the respective profit companies as a reduction in the amounts available to them for offset in the manner the loss company elects, but any election which provides that the amount of the reduction allocated to a company which at the time of the election is no longer a member of the same group of companies as the loss company exceeds the amount of reduction which would arise under paragraph (d) is deemed not to have been made; and

(d) in any other case, the amount available to each of the profit companies for offset against their net income must be reduced by the same proportion as the proportion by which the apparent net loss was reduced to equal the actual net loss,—

and, where and to the extent that the reduction in an amount available for offset against the net income of any profit company results in any payment made under this section under an agreement for the profit company to bear or share in the net loss of the loss company being treated as a dividend, that dividend is deemed to be reduced to the extent to which the payment is refunded by the loss company to the profit company within the period of 6 months referred to in paragraph (c).

(8) [Application of former provisions to 1991–92 and earlier income years] For the purposes of subsection (2)(c)(iii) and (iv), a company is treated as being a member of the same group of companies as another company in respect of the 1991–92 income year or any earlier income year if those 2 companies were, in respect of that income year, members of the same group of companies for the purposes of section 191(5) and (7) of the Income Tax Act 1976 as in force before its repeal by section 25 of the Income Tax Amendment Act (No 2) 1992 by virtue of the provisions of that section 191, as modified by section IG 3.

(9) [Application of s IE 1(4)] Section IE 1(4) applies as if any deduction allowed under subsection (2) were relief afforded by section IE 1.

(10) [Accounts for part-year losses or gains] For the purposes of this section, where adequate accounts are required to be prepared and furnished to the Commissioner in respect of part of the net loss or taxable income for any income year of any company which is reasonably and fairly attributable to a period which is part only of that income year of that company, those accounts must be prepared, to the extent to which reasonable and fair, by applying the provisions of this Act to that period as if it were an income year.

(11) [Definition of "dual resident company"] In this section, **dual resident company** means, in relation to any income year, any company which in that income year or any part of that income year is—

(a) resident in New Zealand; and

(b) either—

(i) treated, under a double tax agreement, as not being resident in New Zealand for the purposes of the double tax agreement; or

(ii) also, by the law of another country or territory, liable to income tax in that country or territory by reason of domicile, residence, or place of incorporation.

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, Court of Appeal, Privy Council and the Supreme Court.

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.

DISTRICT COURT PROCEEDINGS REINSTATED

Case:	Graham Ashley Robert Palmer v The Commissioner of Inland Revenue
Decision date:	31 October 2005
Act:	Goods and Services Tax Act 1985
Keywords:	District Court, strike out, reinstated, summary judgment

Summary

The appellant was successful in having his statement of claim reinstated in the District Court.

Facts

On 5 February 1996 and 2 January 1998, the Commissioner issued GST refund cheques to two companies (for $29,013.21 and $59,422.03 respectively), both associated with Mr Palmer. These cheques were stopped shortly after being issued to allow for further investigation into the companies.

In the District Court, Mr Palmer claimed to have acquired those two cheques by Deeds of Assignment dated 21 February 1996, for the first cheque, and 20 January 1998, for the second. He argued that the Commissioner stopped the cheques without lawful cause or reason, and, having acquired the cheques, that he was entitled to summary judgment for the full amount of them. Mr Palmer's claims were brought after the expiry of the limitation period, and there were no grounds upon which the relevant limitation period could be extended or postponed. His claims were dismissed and the statement of claim struck out.

Mr Palmer appealed this decision to the High Court.

Decision

Mr Palmer's submissions contained several unsustainable arguments, and after some discussion with His Honour Justice Randerson, Mr Palmer accepted that the District Court Judge was right to dismiss the summary judgment application, but maintained that the proceedings should not have been struck out. This was the essential issue before His Honour, however, a variety of other issues were traversed, largely concerning the Limitation Act 1950.

On those matters, Justice Randerson concluded that the DC Judge had correctly applied the six year limitation period from the date on which the causes of action accrued: the date of issue of the cheques, or at latest, the date on which the cheques were stopped. He also refused to countenance any notion that Mr Palmer's claims could be regarded as claims for specific performance.

As to whether there were any grounds for postponement or extension of the limitation period, His Honour concluded that none of Mr Palmer's alleged grounds (including his own incarceration) fell within the scope of "disability" as defined in the Limitation Act 1950. Mr Palmer was, as he admits, aware of all the essential elements of his claims at the time the cheques were stopped, and there was no reason why the claims could not have been made within time.

Part payment of the cheques by the Commissioner was also argued by the appellant, but His Honour stated that "on the basis of the material presented at this late stage, I am not persuaded that it would be right to reach any conclusion one way or the other on [this point]." He noted that if there was some underlying agreement to refund the GST (as alleged by Mr Palmer) "then it may be that further discovery and investigation could reveal evidence of part-payment … however difficult that might appear at this stage."

He further noted that:

> "Although, on their face, the Deeds of Assignment relate to the transfer of rights of action on the cheques, the appellant may still able to obtain an assignment of the rights of the companies to the benefit of any breach of underlying agreements of the kind for which he contends or he may be able to rely on provisions in the tax legislation which permit a shareholder to request the payment of GST to that shareholder. As both companies have since been liquidated, the appellant plainly faces substantial difficulties in that respect."

There was some allegation by Mr Palmer that the DC Judge failed to give proper consideration to "fraud, breach of statutory duty and misfeasance in public office". However, none of these was raised by Mr Palmer's pleadings, and they were consequently dismissed.

On the essential issue – whether the matter should have been struck out in the District Court – Justice Randerson held that although "the Judge was undoubtedly led to the point on the pleadings … where he considered the Limitation Act defence was so clearly made out that it was a proper case … to strike out the proceeding", in view of the material His Honour had before him, the correct action now was to set aside the strike-out order. The appellant would then be able to obtain discovery and have his proceeding heard substantively if he so wished.

As a final note, His Honour said:

> "The appellant should not underestimate the very great difficulties he faces. He must establish there are still sums due to the companies by the Commissioner to which he personally has some entitlement and that any such claims are still within time. But, in my view, justice requires (particularly in the case of a lay litigant) that he be given the opportunity to pursue his claim, however difficult it may be."

STRIKING OUT JUDICIAL REVIEW APPLICATION

Case:	The Commissioner of Inland Revenue v Ch'elle Properties (NZ) Ltd
Decision date:	8 November 2005
Act:	Judicature Amendment Act 1972
Keywords:	Judicial Review, Strike Out, GST transactions, Illegality, Negligence, Statutory Duty, Bill of Rights.

Summary

The defendant claimed GST input credits on 114 property transactions which the Commissioner disallowed on the basis the arrangement was tax avoidance. The Taxation Review Authority and High Court agreed with the Commissioner. The defendant applied for a judicial review of the Commissioner's actions on the basis he acted illegally in initially withholding the refunds and in retrieving the refunds accidentally paid. In addition, the defendant also claimed the Commissioner acted negligently, breached a statutory duty and had not complied with the Bill of Rights Act.

Facts

Application

This was an application by the Commissioner to strike out a judicial review claim and action for damages by Ch'elle Properties Limited ("Ch'elle"), alleging illegality, negligence, breach of duty and acting contrary to the NZ Bill of Rights Act 1992.

Background

In November 1998 114 companies ("the A Companies") entered into conditional contracts with W Developments Ltd to purchase 114 lots of land in a subdivision. The A Companies were all incorporated by Mr Nigel Ashby ("Mr Ashby") who was the sole director of each company.

Each agreement provided for a purchase price of $70,000, with an initial deposit of $10 on execution and a further subsequent payment of $29,990. The remainder of the purchase price was payable on settlement.

In May 1999, Ch'elle entered into conditional agreements with the A Companies to purchase from each company a section of land in the subdivision for a total price in excess of $80 million.

As Ch'elle was registered for GST on an invoice basis, it could claim an input tax deduction immediately, but the A Group of companies, being on a cash basis, did not have to account for GST until settlement.

Ch'elle had applied for a Private Binding Ruling ("PBR") in August 1998 in relation to a similar property transaction it had entered into that same month. Ch'elle entered two more property transactions in September and November 1998. These initial property transactions were known as "the 3 North Shore Properties".

The PBR issued in June 1999 approved the payment of the GST refund for the August 1998 transaction on the basis it was a credit contract. The input credit based on the present day value of the property was paid to Ch'elle in September 1999.

For the period ended 31 May 1999, Ch'elle claimed input tax credits based on the present day value of the properties for the purchase of 13 properties, made up of the 3 North Shore Properties and 10 of the 114 property transactions. For the period ended 31 July 1999, Ch'elle claimed input tax credits on the remaining 104 properties based on the future value of the properties, resulting in a claim of nearly $9 million.

The Commissioner investigated the claims and subsequently disallowed them. The dispute went to the Adjudication Unit which found for the Commissioner on the basis that the transactions (except for the 3 North Shore Properties) formed part of a tax avoidance arrangement.

In January 2000 the refund for the May 1999 period was accidentally released to Ch'elle. In February 2000 the Commissioner withdrew the money from Ch'elle's bank account under section 43 of the GST Act.

On 12 September 2000 all 114 contracts between the A Companies and W Developments Ltd were cancelled for failure to settle. Vendors of two of the 3 North Shore

Properties were subsequently placed in liquidation and the properties on-sold to third parties by the liquidators.

Taxation Review Authority

The Taxation Review Authority ("TRA") found the GST refunds claimed by Ch'elle were central to the scheme, and that the mismatch of the parties' GST registration was central to the whole series of transactions. The entire arrangement had been put together to take advantage of this mismatch.

High Court

Ch'elle was unsuccessful in their appeal of the TRA decision. Justice Hansen agreed that the contracts were central to an arrangement that offended the underlying intention of the legislation.

Judicial Review Application

Ch'elle filed this claim in June 2004 seeking declaratory relief by way of judicial review and damages under the six causes of action set out below:

1) The Commissioner was illegally withholding $9 million of input tax credits as he had not invoked section 46 of the GST Act;

2) The Commissioner acted illegally when he recouped money paid accidentally to Ch'elle pursuant to section 43 of the GST Act;

3) The Commissioner acted illegally in making his assessment and during the disputes process and adjudication. Therefore the decisions of the TRA and High Court were invalid;

4) The Commissioner was negligent in that he breached a statutory duty of care and caused foreseeable loss;

5) The Commissioner breached a statutory duty;

6) The Commissioner had not complied with the New Zealand Bill of Rights Act in that he breached Ch'elle's right to natural justice.

The Commissioner contended the claim amounted to an abuse of process, was untenable and/or futile.

Decision

Although Justice Keane agreed that the Commissioner had failed to comply with section 46, the failure could not justify a declaration he was illegally withholding the money. Although the Court of Appeal in *Sea Hunter* found the Commissioner had a duty to pay out credits if section 46 was not complied with, he could still assess disallowing the claim. A taxpayer would then have to repay the money with interest. The decisions of the TRA and the High Court confirmed that Ch'elle was never entitled to the money and until those decisions were set aside, they stood. Ch'elle should have sought any declaratory relief before the challenge hearing.

Justice Keane considered a declaration that the Commissioner acted illegally in withdrawing the funds paid under section 43 could not serve any useful purpose. Although Justice Keane accepted section 43 was misused, nothing could be done now to remedy that misuse. In addition, Ch'elle was never entitled to the money.

Justice Keane considered the third cause of action - that the Commissioner breached his duty to act fairly, impartially and according to the law in making his assessment during the disputes process and adjudication of the claims - had been resolved or overtaken by the TRA and/or High Court decisions

Justice Keane found Ch'elle could not sustain a claim in negligence for breach of statutory duty as there was no such cause of action. Ch'elle could re-express this cause of action if the statutory context had a duty of care arising at common law. This would then require issues of proximity, forseeability and policy to be considered. Justice Keane considered everything pointed contrary to the Commissioner owing such a duty of care to Ch'elle. The relationship between the Commissioner and a taxpayer is one of creditor and debtor, and it is the Commissioner's job as the Crown's agent to collect revenue (taxes) for public purposes. He is charged with the care and management of taxes under section 6 of the Tax Administration Act and indispensable to the discharge of these duties is the accurate assessment of tax liability. To allow a taxpayer the ability to challenge or counteract an assessment through common law negligence would only subvert the creditor-debtor relationship and the balance achieved by the statutory scheme.

Justice Keane also considered that the Commissioner's ability to give a PBR in advance of a transaction did not change this conclusion. A PBR was simply a means to obtain an assessment in advance. In addition, the context within which a PBR could be given is carefully circumscribed (section 91E) and its effect was finite. In any event, Ch'elle could not have relied on the PBR as a safe foundation for all the transactions. It obtained what it was entitled to pursuant to that PBR – the credit relating to the specific transaction.

The conclusions as to negligence extended to the fifth cause of action, breach of statutory duty. The revenue statutes contained no clear indication that Parliament intended to create a private law duty on revenue officials.

He considered Ch'elle's sixth cause of action contending breach of the New Zealand Bill of Rights was misconceived. Although section 27(1) secures the right to "natural justice" it has never meant "substantive justice". The consistent authority is that 27(1) does not extend beyond procedural fairness. In any event, any breach of natural justice by the Commissioner would have been cured on the challenge before the TRA or appeal to the High Court.

All causes of action which Ch'elle relied on were either untenable, an abuse of process or futile. There was no basis on which Ch'elle could resurrect its claim by amended pleadings. The action as a whole was struck out.

CHANGE OF USE ADJUSTMENTS EXPLAINED

Case:	The Commissioner of Inland Revenue v Lundy Family Trust and Behemoth Corporation Limited
Decision date:	10 November 2005
Act:	Goods and Services Tax Act 1985
Keywords:	Change of use adjustments, property developers, residential renting, apportionment between taxable and non-taxable purposes, cost of the supply.

Summary

The Commissioner's appeal was partially dismissed.

Facts

This case related to adjustments under the old section 21(1) of the Goods and Services Tax Act 1985 ("the Act"). The two Disputants, a company and a trust, had purchased a number of properties for the purpose of property development. GST input credits were obtained. The properties were subsequently let out as residential dwellings (an exempt activity section 14(c)). The properties however, remained on the market for sale at all times.

The Commissioner and the Disputants agreed that adjustments were required under section 21(1) of the Act. The parties differed, however, as to the amounts of the adjustments and as to whether the Disputants were entitled to a further input tax credit once the properties returned to the taxable activity (normally when they were sold).

In the Taxation Review Authority ("the TRA") and the High Court the Commissioner was unsuccessful and the matter was appealed to the Court of Appeal.

In the Court of Appeal the Commissioner argued that there should have been an adjustment for each good or service supplied. That meant there must be an adjustment for the cost of the land and the buildings and the service costs (but acknowledged that it was too late for the land to be adjusted for in relation to these taxpayers). With respect to service cost the Commissioner was referring to rates and insurance etc.

Decision

Section 21(1)

When a property is acquired for the principle purpose of making taxable supplies (in this case property development), but is then applied for some purpose other than making taxable supplies (in this case residential renting), then section 21(1) requires an adjustment to be made reflecting that non-taxable purpose.

In essence, section 21(1) is a mechanism for ensuring claw back of unwarranted input tax credits where they are no longer related to a taxable activity.

Where residential renting is the non-taxable purpose for which the property is being applied, the property itself is the good that is deemed to be supplied under section 21(1). Pursuant to section 10(8) it is the lesser of the cost or market value of that property that is used to determine the appropriate value of that deemed supply (in the present case it is the "cost" of the supply that was relevant).

In terms of calculating the cost of the deemed supply the Court accepted that a taxpayer could make a one-off adjustment (which was suitable when there had been a total change in purpose) or periodic adjustments (which was suitable where the original taxable purpose continued to exist along with the subsequent non-taxable purpose).

Where periodic adjustments were made, these must relate to the costs of those goods or services (the properties in this case) or the lower market value. It was also stated that any periodic adjustments made could not exceed that cost.

In this case it was correct for the taxpayers to make periodic adjustments as the principal purpose remained making taxable supplies (property development).

The Court also acknowledged that the legislation provided no guidance on how the value of the deemed supply was to be calculated. The Court, noting this, accepted that the Commissioner's submission that depreciation was a suitable method of approximating the cost of the buildings and also the land between the periods. The Court concluded that both land and buildings are applied for the residential renting and the buildings are effectively no more used up than the land is.

This only deals with spreading the cost of buildings and land between the relevant periods and there still needs to be an apportionment between taxable and non-taxable uses for the particular periods. The Court acknowledged that this caused conceptual difficulties as where, in this case, the properties were applied 100% for both the taxable purpose and the non-taxable purpose.

The Court then turned to consider periodic service costs such as rates and insurance. The Court stated that it considered these costs quite different from the acquisition

costs. The Court considered the key question in this regard to be whether in each taxable period the goods or services (the rates etc) have been acquired for the principal purpose of making taxable supplies. If that is the case section 21(1) adjustments will then be required to the extent that those goods or services are applied for a non-taxable purpose.

In the present case, because the taxpayer's principal purpose continued, an input tax deduction was available in regards to the service costs associated with the properties. However, to the extent that those service costs related to both purposes, an adjustment under section 21(1) was required. The Court considered that an apportionment of 75/25 would recognise that the principal purpose remained the sale of the properties.

The Court then noted that this analysis was arguably different to that which the Commissioner had pursued when assessing and therefore the Court invited the Commissioner to file further submissions on whether this change of stance should be accepted.

Section 21(5)

The Court finished off by dealing with to what extent any section 21(5) adjustments were required. The Court stated the purpose of section 21(5) is to allow input tax credits where goods and services have not been acquired for the principal purpose of making taxable supplies, but only to the extent that they are applied for a taxable purpose.

The Court concluded that where section 21(1) adjustments had been made, section 21(5) would act to restore that input tax deduction where the goods or services are again applied to a taxable purpose.

The Court also agreed with the TRA and High Court that there was nothing in section 21(5) that makes any distinction between periodic adjustments and one-off adjustments. Therefore section 21(5) could claw back either where applicable.

PAYE REQUIRED TO BE PAID BY EMPLOYEE

Case:	Decision No: 17/05
Decision date:	15 November 2005
Act:	Income Tax Act 1994
Keywords:	PAYE, not deducted, employee, independent contractor

Summary

The TRA held that an employee was liable for PAYE not deducted or paid by his employer.

Facts

The disputant was engaged by his employer company as its Chief Executive Officer. His letter of offer (8 June 2000) purported to offer the position as either an employee or as an independent contractor–the choice was left to the disputant. No election was made by the disputant at that time.

The disputant maintained that a detailed employment contract was signed on 9 June 2000. The Commissioner contended that it was not in fact signed until a date in October or November 2000.

From the beginning of the disputant's employment, the disputant instructed the PAYE staff not to deduct PAYE from his remuneration, and that continued to be the case up until the 31 October 2000 period, during which the accounts staff were made redundant upon the insolvency of the employer. A receiver was appointed on 25 October 2000. The disputant then assumed direct responsibility for PAYE matters, and failed to deduct it from his wages.

The disputant contacted Inland Revenue in October and November 2000, explaining that he had been omitted from the employer's PAYE schedules as it had not been ascertained whether he was an employee or an independent contractor.

The disputant completed employer monthly schedule adjustments for the months in question on about 7 November 2000, but did not file them straight away as the employer was on the EMS system. The schedules were dated 24 October 2000, and were in the name of the payroll clerk, who had ceased employment on 15 September 2000.

The amended schedules were filed electronically on 15 December 2000.

Decision

His Honour Judge Barber began his judgment by setting out the facts as he found them, as there were several points in contention between the parties. As regards the employment contract, His Honour found that it could not have been completed when the disputant alleged, and must have been completed at some point in October 2000. However, His Honour also held (and the parties themselves agreed during the hearing) that the disputant was at all times an employee, and "any effort to restructure it in some other form was ineffective and an illegal effort to assign income". The disputant was, at law, always an employee.

Although the disputant argued that the salary he received was net of PAYE, Barber J held otherwise. PAYE had not been deducted and retained by the employer, nor passed on to the Commissioner. He noted: "The efforts of the

disputant to reconstruct matters to show otherwise have been valiant, but are unsuccessful before me."

As the disputant was an employee, and PAYE had not been deducted from payments made to him, NC 16 applied. The relevant parts of section NC 16(1) provide:

> "Where for any reason a tax deduction … is not made or is not made in full at the time of the making of any source deduction payment or payments, the employee must …" both furnish an employer monthly schedule and pay such deductions at prescribed times.

The disputant, as CEO, was aware of the financial difficulties his employer company was experiencing, and knew that it did not have the means to pay outstanding PAYE or further PAYE added to the schedules by and in respect of the disputant. Thus, "[t]he retrospective reconstruction by the disputant was made without authority from the directors of the employer company, or its Receiver." The disputant was also aware of the omission of PAYE from his salary at all material times.

His Honour concluded:

> "In the circumstances of this case, it is fair and just that the said PAYE amounts, which were not deducted by the employer due to the scheming of the disputant, now be assessed to him pursuant to the defendant's power to do that under s NC16 of the Act."

FAMILY TAXABLE ON SHARE TRADING ACTIVITY

Case:	Dowell & Ors as trustee for Estate Frank King Brenda King & Ann King v The Commissioner of Inland Revenue
Decision date:	21 October 2005
Act:	Income Tax Act 1976
Keywords:	Business, share trading, dealing, purpose of re-sale, agency

Summary

A family was taxable on the gains on share transactions undertaken by their stockbroker on their behalf. Such activity was to meet a set monetary rate of return demanded by the family.

Facts

This was an appeal from the TRA. The TRA case is *Case W43* (2004) 21 NZTC 11,403.

The taxpayers are a family with off-shore investments, the management of which was left entirely to their broker in England. The only instruction the broker had was to achieve a return of £1,800 per month to the family (£600 each). The taxpayers had no interest or regard in how this was achieved.

In late 1984 the investments were placed into a company based in Jersey. The family purportedly sold their investments to the company and advanced a loan to the company to pay for the investments, which was to be repaid at £1,800 per month. The investments were held in three accounts which were never to be mingled and the expenses of which could only be paid from the account to which it related. There was an administration agreement which effectively retained control of the funds in the hands of the family.

Considerable buying and selling of shares occurred in the relevant period (1989 to 1990 income tax years) but there was no change in the arrangements before and after the investments were moved into the company.

The TRA concluded that there was no taxable income from the share activity as there was no agency between the sharebroker and the family, the broker was not in business and the onus was on the Commissioner to prove the broker's intentions at each transaction. The TRA did conclude that the company held the shares as bare trustee for the family.

The Commissioner appealed the TRA decision regarding the share business or trading and the onus of proof issue. The taxpayers appealed the finding that there was a bare trust.

Decision

Justice Hansen allowed the Commissioner's appeal and dismissed the taxpayers' cross appeal.

He quickly rejected the TRA's conclusion that the Commissioner had any onus of proof upon him saying:

> In the first sentence cited [of paragraph 133] it appears the Authority is acknowledging there is an onus on the taxpayer. But the judge then immediately transfers the onus on the Commissioner to identify the individual share parcels that the Commissioner maintains were purchased with the object of resale. That onus is on the Kings, and not the Commissioner…."[paragraph 89]

He also quickly affirmed that the share broker was the agent for the taxpayers. He derived particular assistance from *A M Bisley & Co v The Commissioner of Inland Revenue* (1985) 7 NZTC 5,082 at 5,088 and then went on to say:

> "the fact they themselves [the taxpayers] did not carry on the business of share trading cannot in my view allow them to avoid the consequences of the actions of their agent….The appellants chose to effect and manage their investment portfolio in its entirety through the agency of [the share broker]. The fact the Kings did not give express instructions… to buy and sell shares does not in my view make it legally impossible for him to be in the business of buying and selling investments"[paragraph 94]

Of relevance was the fact the only instruction (to earn £1,800 per month) was only possible if there was profitable sharetrading: interest and investments alone

would not achieve this level of return. Justice Hansen saw this case as akin to the earlier decision in *Piers v The Commissioner of Inland Revenue* (1995) 17 NZTC 12,283.

Turning to the basis of assessment, Justice Hansen first considered section 65(2)(a) and whether the taxpayers were in business. Citing *Grieve v The Commissioner of Inland Revenue* [1984] 1 NZLR 101, he considered the facts surrounding the share activity and, in particular, its continuity and extent. He also criticised the TRA for failing to make an objective consideration of the circumstances (at paragraph [123]) and concluded there taxpayers were engaged in a business [paragraph 125].

Looking at section 65(2)(e) first limb (business of dealing), Justice Hansen reiterated the similarity of this case to *Piers* and noted there was a two-fold test to the section application: was the taxpayer conducting a business of dealing in personal property and secondly whether the property in question was part of that business [paragraph 129]. He noted that this section and section 65(2)(a) did overlap but section 65(2)(e) was more objective with the focus on the extent and frequency of the activity more than the purpose or motive for the activity [paragraph 137 and 141].

Justice Hansen then considered section 65(2)(e) second limb (property purchased for the purpose of resale) and again rejected any suggestion that there was an onus of proof on the Commissioner. Citing *National Insurance* (1999) 19 NZTC 15,135 and *National Distributors* (1989) 11 NZTC 6,346 it was concluded that in the circumstances the necessary inference on the subjective and dominant purpose of the sharebroker in trading the shares was that the shares were purchased with the purpose of re-sale [paragraph 153].

Dealing with the cross appeal upon whether or not the company was a bare trustee for the taxpayers, Justice Hansen considered the evidence was clear that the investments remained beneficially owned by the taxpayers and that the TRA was correct in this conclusion [paragraph 159 to 162].

Justice Hansen did note the taxpayers relied upon professional advice in structuring their affairs and asked the Commissioner to bear this in mind when considering penalties [paragraph 173].

JUDICIAL REVIEW FAILS

Case:	Dowell & Ors as trustee for Estate Frank King, Brenda King & Ann King v The Commissioner of Inland Revenue
Decision date:	21 October 2005
Act:	Judicature Amendment Act
Keywords:	Incorrect statute, Vela Fishing

Summary

Citing an incorrect statute did not invalidate an otherwise valid assessment either at common law or under the Act.

Facts

This was a judicial review. The Kings were assessed for income tax on income from their controlled foreign company in the tax years 1989 and 1990. The assessments were made relying upon the Income Tax Act 1994 whereas the correct Act should have been the Income Tax Act 1976.

The taxpayers sought, by judicial review, a declaration the assessments were nullities and were void.

Decision

Justice Hansen dismissed the judicial review.

He considered that section YB 5(4) ITA 1994 was a complete answer to the judicial review and relied upon the Court of Appeal's approach in *Vela Fishing* (2001) 20 NZTC 17,242 to the equivalent section, sec 227(4) TAA 1994 support this conclusion. Justice Hansen said at [paragraph 41]:

> "Section YB 5(4) makes it mandatory that any reference to the provisions of the 1994 Act are to be construed as including "in relation to the times, circumstances, or purposes in relation to which the corresponding provision in the enactments" repealed by section YB 5(3) was done under the corresponding provision…."

He rejected the Plaintiffs' suggestion there was now a division in the Acts between the levying and administration of income tax saying there was nothing to support this in the Act [paragraph 39].

Justice Hansen also accepted the Commissioner's argument based upon case authority that a misidentification of the source of statutory powers did not mean those did not exist. He accepted that failure to comply with the Act was not necessarily fatal to the action taken, but that this was to be considered on a sliding scale of seriousness. (paragraph [42] to [60])

Finally Justice Hansen also accepted the Commissioner's submission that s 114 TAA 1994 operated to save the assessments regarding of procedural irregularities . (paragraph [61] to [66]).

QUESTION WE'VE BEEN ASKED

This section of the *TIB* sets out answers to some enquireries we've received. We publish these as they may be of general interest to readers. A general similarity to items published here will not necessarily lead to the same tax result. Each case should be consifered on its own facts.

THE IMPACT OF COMPANY AMALGAMATIONS ON FINANCIAL ARRANGEMENT DETERMINATIONS

Income Tax Act 2004 and Tax Administration Act 1994

The Commissioner recently issued an Interpretation Statement (IS0081) concerning the impact of company amalgamations on binding rulings. A taxpayer has now asked whether the rights or obligations arising to an amalgamating taxpayer under a financial arrangement determination (determinations made under section 90, 90AC or 90A of the Tax Administration Act 1994 ("the TAA")) will pass to the amalgamated company on the amalgamation.

Under section 90AB(1) of the TAA, a person who becomes, or who intends to become, a party to a financial arrangement may apply to the Commissioner for a determination to be made under section 90AC(1). This item is concerned with these taxpayer specific determinations, not with general financial arrangement determinations which the Commissioner may also make under section 90AC(1). General determinations will apply to all taxpayers within the scope of the determination, irrespective of an amalgamation.

Section FE 8

There is nothing in either the TAA or the amalgamation provisions of the Income Tax Act 2004 ("the ITA") which specifically addresses the issue of whether an amalgamated company will succeed to any rights or obligations arising to an amalgamating company under a financial arrangement determination. However, section FE 8 of the ITA provides as follows:

FE 8 Where any amalgamating company ceases to exist on an amalgamation, the amalgamated company must, in accordance with section 209G of the Companies Act 1955 or section 225 of the Companies Act 1993, comply with all obligations of and meet all liabilities of, and be entitled to all rights, powers, and privileges of, the amalgamating company under the Inland Revenue Acts with respect to the tax year in which the amalgamation occurs and all preceding tax years.

It may be that there are "rights" arising under a financial arrangement determination. For example, sections 90(9), 90AD(3) and 90A(9) of the TAA provide that if a person has applied a determination under the relevant section, *"... an assessment made in respect of the person must be in accordance with the determination"*. However, whilst this may give rise to a "right" in respect of any assessment made by the Commissioner, it is arguable that in the context of self-assessment, it is more an "obligation". It is also noted that sections 90(2), 90AC(3) and 90A(2) provide that:

90(2) Any determination made under any of paragraphs (a), (c), (e), (g), (h), and (j) of subsection (1) **shall be binding on persons for the purposes of the old financial arrangements rules.**

...

90AC(3) A determination made under any of subsection (1)(a), (1)(d), (1)(h), (1)(i), or (1)(j) **is binding on persons who are subject to the financial arrangements rules**.

...

90A(2) Any determination made under subsection (1) **shall be binding on persons for the purposes of subpart FG of the Income Tax Act 2004.**

[Emphasis added]

It is considered that this language appears to suggest that (at least in those particular cases) the financial arrangement determination will give rise to an "obligation" rather than a "right".
However, as with any rights arising under a financial arrangement determination, any obligations would be succeeded to by the amalgamated company. Section FE 8, as well as talking about rights, powers and privileges, states that "*... the amalgamated company must ... comply with all obligations of and meet all liabilities of ... the amalgamating company under the Inland Revenue Acts ...*". Similarly, section 225(e) of the Companies Act 1993 provides that "*[t]he amalgamated company succeeds to all the liabilities and obligations of each of the amalgamating companies*".

Accordingly, it is considered that the rights or obligations arising to an amalgamating taxpayer under a financial arrangement determination (which would clearly be rights or obligations under the Inland Revenue Acts – namely the TAA) will pass to the amalgamated company on the amalgamation.

It could be argued that in a situation of an amalgamation resulting in the deemed disposal by the amalgamating company and acquisition by the amalgamated company of a financial arrangement (i.e. in the case of a non-qualifying amalgamation), there is effectively a new financial arrangement for tax purposes, which may alter the above conclusion.

However, the TAA provisions (noted above) which provide that financial arrangement determinations will be binding (thus giving rise to an obligation) state that they will be binding: "*on persons for the purposes of the old financial arrangements rules*" (section 90(2)), "*on persons who are subject to the financial arrangements rules*" (section 90AC(3)), and "*on persons for the purposes of subpart FG of the Income Tax Act 2004*" (section 90A(2)). The obligations under financial arrangement determinations relate to the application of the financial arrangements rules to the persons who are subject to them – i.e. the parties to the financial arrangement. The fact that there may be a disposal and acquisition of a financial arrangement for tax purposes (i.e. in the case of a non-qualifying amalgamation) does not alter the fact that the parties to the financial arrangement (which the amalgamated company would clearly be) are subject to the obligations (or entitled to any rights) under any financial arrangement determination which relates to the financial arrangement in question.

It is noted that the question of whether it may be argued that section FE 8 *restricts* the assumption of Inland Revenue Act rights, powers and privileges to those with respect to the income year in which the amalgamation occurs and preceding income years is considered in IS0081 *The Impact of Company Amalgamations on binding rulings* (*Tax Information Bulletin,* Vol 17, No 6 (August 2005)). That Interpretation Statement concludes that section FE 8 does not restrict the assumption of Inland Revenue Act rights, powers and privileges to those with respect to the year of amalgamation and previous years, as opposed to what would otherwise be the position under company law. This conclusion is equally applicable in terms of the assumption of Inland Revenue Act obligations and liabilities.

The principle of "continuance"

In any event, it is considered that the same result arises by virtue of the principle of "continuance", which is discussed in IS0081. As noted in IS0081, it is considered that the principle of continuance remains applicable for the purposes of the ITA, to the extent that it is not altered by specific provisions in the ITA. For present purposes, the principle of continuance is not altered in any way by specific provisions in the ITA.

Section FE 7(2)

It is also noted that section FE 7(2)(b)(i) of the ITA provides that in the tax year of amalgamation, and subsequent years, the amalgamated company is treated as if it had entered into the financial arrangement on the same date (and for the same consideration) as the amalgamating company. The effect of this provision is considered to be consistent with the result arising by virtue of the principle of continuance.

It may be argued that section FE 7(2) of the ITA further supports our view that the rights or obligations arising to an amalgamating taxpayer under a financial arrangement determination will pass to the amalgamated company on the amalgamation.

Conclusion

For the above reasons, it is concluded that the rights or obligations arising to an amalgamating taxpayer under a financial arrangement determination will pass to the amalgamated company on the amalgamation. This will be the case whether the amalgamation is a qualifying amalgamation or a non-qualifying amalgamation.

INTERPRETATION STATEMENTS

This section of the *Tax Information Bulletin* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

SHORTFALL PENALTY FOR TAKING AN ABUSIVE TAX POSITION

1. SUMMARY

1.1 All legislative references in this statement are to the Tax Administration Act 1994 unless otherwise stated.

1.2 This statement provides an interpretative explanation of the shortfall penalty imposed by the Commissioner under section 141D of the Act on taxpayers who take an abusive tax position. Where a taxpayer takes an abusive tax position, the result may be that too little tax is paid or payable, as tax liabilities are reduced, removed, deferred or postponed, or tax benefits claimed.

1.3 The abusive tax position penalty is 100% of the tax shortfall. "Abusive tax position" is defined in section 141D. For the penalty to apply, the taxpayer must have taken an unacceptable tax position, and either:

- under section 141D(7)(b)(i), have entered into an arrangement, where the dominant purpose of the arrangement is of avoiding tax, whether directly or indirectly, or
- under section 141D(7)(b)(ii), where there is no arrangement, or no arrangement of the type outlined in section 141D(7)(b)(i), have taken the taxpayer's tax position with a dominant purpose of avoiding tax, whether directly or indirectly.

2. BACKGROUND

2.1 Following a review of the compliance and penalties legislation, the Tax Administration Amendment Act (No 2) 1996 introduced new rules. The purpose of the new rules, as set out in section 139, is to encourage voluntary compliance and to impose consistent and impartial penalties which reflect the seriousness of the breach of tax obligations.

2.2 The penalties rules have again been reviewed and a discussion document *Taxpayer Compliance, Standards and Penalties: a review* was released in August 2001. To date, some amendments have been made as a result of this review. Those amendments include – reductions in the rate of some shortfall penalties on the basis of the taxpayer's previous behaviour (section 141FB), and the amendment to the shortfall penalty imposed under section 141B – to one which applies when a taxpayer takes an unacceptable tax position. Further amendments were made in the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003. The amendments that have already been passed have prompted the withdrawal of various shortfall penalty standard practice statements about tax positions taken on or after 1 April 2003.

2.3 This Interpretation Statement provides an explanation of some interpretative aspects of one of the shortfall penalties – the shortfall penalty for taking an abusive tax position covered by section 141D. The statement applies, except as otherwise specified, to tax positions taken on or after 1 April 2003 (although all associated references to the Income Tax Act are to the provisions of the 2004 Act for ease of reference). The now withdrawn *Standard Practice Statement INV-215 Shortfall penalties – abusive tax position* (published in *Tax Information Bulletin*, Vol 10, No 3, March 1998) applies to tax positions taken before 1 April 2003.

3. LEGISLATION

3.1 A shortfall penalty for taking an abusive tax position is imposed under section 141D:

> **141D** Abusive tax position
>
> (1) The purpose of this section is to penalise those taxpayers who, having taken an unacceptable tax position, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits.
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an abusive tax position (referred to as an "abusive tax position").

(3) The penalty payable for taking an abusive tax position is 100% of the resulting tax shortfall.

(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.

(4) This section applies to a taxpayer if the taxpayer has taken an unacceptable tax position and the tax shortfall from the tax position is more than $20,000.

(5) Section 141B(6) applies for determining the time when a taxpayer takes an abusive tax position.

(6) A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of—

(a) A general tax law; or

(b) A specific or general anti-avoidance tax law.

(7) For the purposes of this Part and section 177C, an "abusive tax position" means a tax position that,—

(a) Is an unacceptable tax position at the time at which the tax position is taken; and

(b) Viewed objectively, the taxpayer takes—

(i) In respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

(ii) Where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

3.2 The following terms are defined in section 3(1):

In this Act, unless the context otherwise requires,—

…

"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:

…

"Correct tax position" means the correct tax position established under one or more tax laws:

…

"Shortfall penalty" means a penalty imposed under any of sections 141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections:

…

"Tax law" means—

(a) A provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces:

(b) An Order in Council or a regulation made under another tax law:

(c) A non-disputable decision:

(d) In relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act.

…

"Tax position" means a position or approach with regard to tax, under one or more tax laws, including without limitation a position or approach with regard to–

(a) A liability for an amount of tax, or the payment of an amount of tax:

(b) An obligation to deduct or withhold an amount of tax, or the deduction or withholding of an amount of tax:

(c) A right to a tax refund, or to claim or not to claim a tax refund:

(d) A right to a credit of tax, or to claim or not to claim a credit of tax:

(e) The provision of a tax return, or the non-provision of a tax return:

(f) The derivation of an amount of gross income or exempt income or a capital gain, or the inclusion or non-inclusion of an amount in gross income:

(g) The incurring of an amount of expenditure or loss, or the allowing or disallowing as a deduction of an amount of expenditure or loss:

(h) The availability of net losses, or the offsetting or use of net losses:

(i) The attaching of a credit of tax, or the receipt of or lack of entitlement to receive a credit of tax:

(j) The balance of a tax account of any type or description, or a debit or credit to such a tax account:

(k) The estimation of the provisional tax payable:

(l) Whether the taxpayer must request an income statement or respond to an income statement issued by the Commissioner:

(m) The application of section 33A(1):

(n) A right to a rebate:

…

"Tax shortfall", for a return period, means the difference between the tax effect of –

(a) A taxpayer's tax position for the return period; and

(b) The correct tax position for that period, –

when the taxpayer's tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person.

…

"Taxpayer's tax position" means—

(a) A tax position taken by a taxpayer in or in respect of–
  (i) A tax return; or
  (ii) An income statement; or
  (iii) A due date:

4. SHORTFALL PENALTY FOR TAKING AN ABUSIVE TAX POSITION

INTRODUCTION

4.1 Section 141D imposes a shortfall penalty on a taxpayer for taking an "abusive tax position" in the taking of a taxpayer's tax position, with application to tax obligations for periods commencing on or after 1 April 1997.

4.2 The shortfall penalty for an abusive tax position is 100% of the resulting tax shortfall (section 141D(3)).

4.3 An "abusive tax position" is defined in section 141D(7) as follows:

> (7) For the purposes of this Part and section 177C, an "abusive tax position" means a tax position that,—
>
> (a) Is an unacceptable tax position at the time at which the tax position is taken; and
>
> (b) Viewed objectively, the taxpayer takes—
>
> (i) In respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or
>
> (ii) Where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

4.4 Under section 141D(7), an "abusive tax position" means a tax position that is an unacceptable tax position which the taxpayer takes, either:

- in respect or as a consequence of an arrangement that is entered into with a dominant purpose of avoiding tax (in situations involving an arrangement), or
- with a dominant purpose of avoiding tax (in situations not involving an arrangement).

4.5 Before answering the question of whether there is an abusive tax position, in terms of section 141D(7), it should be noted that there are some preliminary requirements that must also be satisfied before the penalty can potentially apply:

(1) the taxpayer must have taken a tax position

(2) the tax position must be an incorrect tax position under or as a result of a general tax law or a specific or general anti-avoidance tax law

(3) the time at which a taxpayer's tax position has been taken has been determined in accordance with section 141B(6)

(4) the taxpayer's tax position leads to a tax shortfall, and the tax shortfall exceeds $20,000

(5) the taxpayer has taken an unacceptable tax position.

4.6 "Unacceptable tax position" is a separate shortfall penalty and is defined in section 141B(1). A separate Interpretation Statement for the unacceptable tax position shortfall penalty has been published in *Tax Information Bulletin*, Vol 17, No 9, November 2005. For tax positions taken before 1 April 2003, the requirement was for an "unacceptable interpretation", which was defined under the previous version of section 141B(1). For ease of reference, the remainder of this Interpretation Statement will only refer to an "unacceptable tax position".

4.7 It should also be noted that the penalty for an abusive tax position under section 141D has had minor amendments (with effect from 1 April 2003, except for the introduction of section 141D(3B)

which applies with effect from 26 March 2003). The changes to the abusive tax position penalty are:

- the link with the section 141B requirement for an "unacceptable tax position" (which was previously an "unacceptable interpretation" in both sections)
- an increase in the previous threshold of $10,000 to the current threshold of $20,000, and
- the introduction of the section 141D(3B) reduction provision.

4.8 The penalty for taking an abusive tax position is 100% of the resulting tax shortfall (section 141D(3)). This is subject to various reductions potentially available under sections 141FB (previous behaviour), 141G (voluntary disclosure), 141H (reduction for disclosure of unacceptable tax position), 141I (temporary shortfall) and 141J (limitation of reduction). The penalty is also subject to a 25% increase under section 141K if the taxpayer obstructs the Commissioner in determining the correct tax position. The following related standard practice statements may assist in the interpretation and application of these adjustment provisions:

- INV-231 *Temporary shortfall - permanent reversal* (published in *Tax Information Bulletin,* Vol 11, No 8, September 1999)
- INV-251 *Voluntary disclosures* (published in *Tax Information Bulletin*, Vol 14, No 4, April 2002)
- INV-260 Notification of a pending audit or investigation (published in *Tax Information Bulletin*, Vol 12, No 2, February 2000)
- INV-295 *Reduction of shortfall penalties for previous behaviour* (published in *Tax Information Bulletin,* Vol 16, No 3, April 2004)
- INV-490 *GST returns – correcting minor errors* (published in *Tax Information Bulletin*, Vol 10, No 6, June 1998)
- INV-570 *Shortfall penalties – application where returns are amended before due date* (published in *Tax Information Bulletin*, Vol 11, No 2, February 1999).

4.9 Section 141D(3B) also allows for a reduction of the abusive tax position shortfall penalty 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.

4.10 *Standard Practice Statement* INV-290 (published in *Tax Information Bulletin*, Vol 16, No 2, March 2004) describes how the Commissioner will apply the section 141EB Promoter Penalties provision. In discussing the various requirements of section 141EB, the SPS also comments on what the Commissioner considers to be "independent advice" at paragraphs 42 to 45 of that statement. Those comments are also considered relevant as guidance in the application of section 141D(3B)(c).

4.11 Section 94A states that the Commissioner may make or amend an assessment of a civil penalty (which includes the section 141D shortfall penalty in question) in the same way as the Commissioner may make or amend an assessment of the substantive tax. In challenging the imposition of the penalty, the onus of proof rests with the taxpayer to show that they did not take an abusive tax position (section 149A(2)(b)). The standard of proof is the balance of probabilities (section 149A(1)).

4.12 The remainder of this Interpretation Statement will focus on the interpretation and application of the abusive tax position shortfall penalty under section 141D.

ABUSIVE TAX POSITION

Section 141D(7)

4.13 If all the other requirements for section 141D are satisfied, it is then necessary to determine whether section 141D(7) applies. Section 141D(7) defines an "abusive tax position", which will apply either under section 141D(7)(b)(i) in situations involving an arrangement, or under section 141D(7)(b)(ii) in situations not involving an arrangement of the type in section 141D(7)(b)(i). Section 141D(7)(b)(i) and section 141D(7)(b)(ii) will be dealt with separately.

Dominant purpose of avoiding tax

4.14 It is noted that for the section 141D abusive tax position penalty to apply, either the arrangement or the taxpayer (depending on whether section 141D(7)(b)(i) or section 141D(7)(b)(ii) is applied) must have a dominant purpose of avoiding tax.

4.15 The term "dominant purpose" is not defined in the TAA. The Concise Oxford Dictionary (10th ed, Oxford University Press) defines "dominant" as follows:

> **1** most important, powerful, or influential.

4.16 The same dictionary defines "purpose" as follows:

> **1** the reason for which something is done or for which something exists.

4.17 The Court of Appeal case *CIR v National Distributors Ltd* [1989] 3 NZLR 661, while only needing to interpret the word "purpose" in terms of the legislation at issue, noted that where there is more than one purpose present, taxability turns on what was the dominant purpose. In terms of the "dominant purpose", Richardson J (as he then was) stated the following at page 666 of that decision:

> Adoption of a dominant purpose test in relation to the particular property purchased allows a sensible **focus** as a practical matter **on what was truly important to the taxpayer at the time of acquisition**.
>
> [Emphasis added]

4.18 At page 667, His Honour also stated the following:

> In Hunter at p 125 Turner J observed that the motive which inspired the transactions was no doubt that they provided an advantageous method of remitting funds from England to New Zealand, but that in acquiring the stock the taxpayer had done so for the purpose of selling it again. And McCarthy J noted a p 127 that **purpose must, naturally, be distinguished from motive or expectations**…
>
> [Emphasis added]

4.19 Therefore, according to the dictionary meaning of the words, and Richardson J's judgment in *National Distributors*, it is considered that the "dominant purpose" is the most important or influential reason to the taxpayer at the relevant time.

4.20 This is consistent with how the term was considered by the Full High Court of Australia in *FCT v Spotless Services Limited & Anor 96* ATC 5,201 (in the context of the Australian general anti-avoidance provision which focuses on the dominant purpose of the arrangement). The following was stated at page 5,206:

> Much turns upon the identification, among various purposes, of that which is "dominant". **In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose**. In the present case, if the taxpayers took steps which maximised their after-tax return and they did so in a manner indicating the presence of the "dominant purpose" to obtain a "tax benefit", then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied.
>
> [Emphasis added]

The meaning of "avoiding tax"

4.21 The term "avoiding tax" is not defined in the TAA. However, the term "tax avoidance" is defined in section OB 1 of the ITA as follows:

> **Tax avoidance**
>
> includes—
>
> (a) directly or indirectly altering the incidence of any income tax:
>
> (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
>
> (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax

4.22 The term "tax avoidance" is also defined in the GST Act, for the purposes of the GST Act, as follows:

> **76(8)** For the purpose of this section—
>
> …
>
> **"Tax avoidance"**
>
> includes—
>
> (a) A reduction in the liability of a registered person to pay tax:
>
> (b) A postponement in the liability of a registered person to pay tax:
>
> (c) An increase in the entitlement of a registered person to a refund of tax:
>
> (d) An earlier entitlement of a registered person to a refund of tax:
>
> (e) A reduction in the total consideration payable by a person for a supply of goods and services.

4.23 As noted in the Commentary on the Bill and section 141D(6)(a), the term "avoiding tax" is not limited to the concept of "tax avoidance". It is considered that section 141D(6) and the Commentary on the Bill show that the term "avoiding tax" should be interpreted widely. Section 141D(6) states:

> **141D(6)** A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of—
>
> (a) A general tax law; or
>
> (b) A specific or general anti-avoidance tax law.

4.24 At pages 15 and 16 of the Commentary on the Bill the wide interpretation of the term "avoiding tax" is again stated:

> The penalty for abusive tax positions will apply not only in situations where a general or specific anti-avoidance provision is invoked, but also where other provisions have been applied. The need for the Commissioner to rely explicitly on an anti-avoidance provision does not necessarily indicate that the tax position is more deserving of a high penalty than an aggressive interpretation intended to avoid tax but which fails under another provision.
>
> The concept of "avoiding tax" encompasses the deferral of tax and the claiming of tax credits.

4.25 The abusive tax position penalty can apply in situations where there has been "tax avoidance" (and therefore section BG 1 of the ITA or section 76 of the GST Act are invoked) or where neither of these provisions apply, but there is nevertheless evidence of a dominant purpose of avoiding tax. In practice, in situations where section BG 1 of the ITA or section 76 of the GST Act is successfully invoked, determining whether the requirement of "avoiding tax" is satisfied for the abusive tax position shortfall penalty will usually be resolved by the "tax avoidance" inquiry for the anti-avoidance provisions.

4.26 However, the abusive tax position shortfall penalty is also chargeable in situations where the anti-avoidance provisions do not apply, but the conduct nevertheless shows a dominant purpose of avoiding tax (section 141D(6)(a)). Thus, the term "avoiding tax" is a wider concept than "tax avoidance", to ensure the penalty applies whether or not the anti-avoidance provisions have been invoked.

4.27 In summary, the term "avoiding tax" includes the concept of "tax avoidance" under the general or specific anti-avoidance provisions, and those situations where tax is avoided or is attempted to be avoided, but the general or specific anti-avoidance provisions are not invoked. The term "dominant purpose of avoiding tax" means that the arrangement's (section 141D(7)(b)(i)) or the taxpayer's (section 141D(7)(b)(ii)) most influential and prevailing or ruling purpose is to avoid tax.

Factors that may indicate a "dominant purpose of avoiding tax"

4.28 The Commentary on the Bill discussed indicators that may suggest a dominant purpose of avoiding tax at page 15 as follows:

> Indicators of a dominant purpose of avoiding tax may include artificiality, contrivance, circularity of funding, concealment of information and non-availability of evidence, and spurious interpretations of tax laws.

4.29 The indicators referred to in the Commentary on the Bill can be of assistance in determining whether an arrangement or a taxpayer has a dominant purpose of avoiding tax. The following are some of the factors that may be taken into account when considering whether there is a dominant purpose of avoiding tax.

Artificiality and contrivance

4.30 Have the transactions been designed to appear to comply with the legislation? The legal form may not reflect the substance (even though the legal form is effective).

4.31 Consideration will be given to the commercial reality of the arrangement. Are the arrangements or schemes "self-cancelling" (ie, neutral commercial consequences, leaving only tax effects)?

4.32 The importance of the commercial purpose of the transaction as compared to the tax benefit that the relevant taxpayer obtained must be examined.

Circularity of funding

4.33 Funding going around in a circle, usually through a tax haven, resulting in income being tax exempt and the related expenditure tax deductible may be considered as an indicator of a tax avoiding arrangement.

Concealment of information and non-availability of evidence

4.34 Concealment of information may occur through the use of a tax haven. By going through a tax haven, disclosure protection may result due to the particular tax haven's secrecy laws. These laws usually do not allow information to be released to tax authorities, thereby providing an obstacle to the gathering of information to establish whether the transaction or arrangement is artificial or contrived.

Spurious interpretations

4.35 Spurious interpretation covers situations where a tax position taken has no or very little basis at law or the interpretation made or position taken is frivolous.

"Directly" or "indirectly"

4.36 Sections 141D(7)(b)(i) and (ii) refer to a tax position taken with a dominant purpose of avoiding tax "whether directly or indirectly". It is considered that in some situations the avoiding of tax may be direct and in other situations it may be indirect.

4.37 There is no discussion about the inclusion of the words "directly or indirectly" in the discussion documents relating to the abusive tax position penalty or in the Commentary on the Bill. It appears that the use of the words "directly or indirectly" in limbs (i) and (ii) was to ensure that the abusive tax position penalty applies as widely as possible and maintain consistency with the definition of "tax avoidance" in section OB 1 of the Income Tax Act.

Section 141D(7)(b)(i) – the first limb

4.38 Section 141D(7)(b)(i) applies in situations where there is an arrangement with a dominant purpose of avoiding tax:

> (7) For the purposes of this Part and section 177C, **an "abusive tax position" means a tax position that**,—
>
> (a) **Is an unacceptable tax position** at the time at which the tax position is taken; **and**
>
> (b) Viewed objectively, **the taxpayer takes**—
>
> (i) **In respect, or as a consequence, of an arrangement** that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or
>
> ...
>
> [Emphasis added]

4.39 For section 141D(7)(b)(i) to apply, the taxpayer must have taken a tax position that is an unacceptable tax position, and taken it "in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax…"

Whose purpose is to be tested?

4.40 Section 141D(7)(b)(i) does not indicate who or what the "dominant purpose" is to be tested in respect of, and could arguably be about either the dominant purpose of the taxpayer or the dominant purpose of the arrangement. While it could be argued that the test of the "dominant purpose" in section 141D(7)(b)(i) should be as to the dominant purpose of the taxpayer (particularly given the use of the words "entered into"), it is considered that the better view is that the dominant purpose of the *arrangement* is tested.

Grammatical connection

4.41 Section 141D(7)(b)(i) provides for a taxpayer's tax position, viewed objectively, having been taken "in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly". Therefore, the grammatical connection of the "dominant purpose" in section 141D(7)(b)(i) is not clearly to the arrangement or the taxpayer. The provision merely suggests that the taxpayer's tax position would need to flow from (in respect of, or as a consequence of) an arrangement which is entered into with a dominant purpose of tax avoidance. However, it is considered that the wording of the provision does not require the taxpayer to have a dominant purpose of tax avoidance for it to apply.

4.42 In support of the proposition that the arrangement's "dominant purpose" is to be tested in section 141D(7)(b)(i), it is noted that the provision is split into two limbs. The first limb applies in situations involving an arrangement, and the second limb applies in situations not involving an arrangement (or not involving an arrangement of the type in the first limb). Reading the provision in such a way as to link the dominant purpose in the first limb to the taxpayer would make the splitting of the section into two limbs entirely unnecessary. The same result could have been reached by providing in one provision or limb that in all situations it is the dominant purpose of the taxpayer that is to be tested.

Case law

4.43 That it is the purpose of the arrangement that is to be tested was also stated by Ronald Young J, in *Erris Promotions and others v CIR* (2003) 21 NZTC 18,330 at paragraph 374:

> The second part of the definition requires an abusive tax position to be taken. As has been said, this requires, in addition to an unacceptable interpretation, that at the same time, viewed objectively, the position of the taxpayer must be as a consequence of **an arrangement** that is entered into **which has as its dominant purpose tax avoidance**. And so I must consider if the dominant purpose of the joint venture, viewed objectively, was tax avoidance. **Here s141D(7)(b)(i) is concerned not with the taxpayers intent or knowledge but with whether their claim for depreciation losses arose as a consequence from a scheme which had as its dominant purpose tax avoidance**.
>
> [Emphasis added]

4.44 Such an interpretation is also consistent with the operation of the Income Tax Act 2004 ("the ITA") general anti-avoidance provision. Section BG 1 of the ITA refers to a "tax avoidance arrangement" being void. The definition of "tax avoidance arrangement" in section OB 1 of the ITA refers to the *purpose or effect* of the *arrangement* being tax avoidance.

4.45 In *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027, Venning J discussed the abusive tax position shortfall penalty. At paragraph 327, His Honour stated that the plaintiffs challenged the Commissioner's imposition of 100% abusive tax position penalty for the 1998 income year on two principal grounds. The first ground was that the penalties were not validly imposed; and the second that, in the circumstances, the penalties were not appropriate, or if they were appropriate, the penalties ought not to have been imposed at 100% on the basis of an abusive tax position. After concluding that the penalty was validly imposed, Venning J concluded that the plaintiffs had taken an abusive tax position. He referred to the decision of Ronald Young J in *Erris Promotions* and stated at paragraphs 367 to 370:

[367] Mr Stewart [counsel for the plaintiffs] emphasised the need for the Court to make a finding of dominant purpose. He submitted that Ronald Young J was incorrect in *Erris Promotions* to suggest the dominant purpose relates to the arrangement itself. He submitted that the better view was it is the purpose of the taxpayer to which the section is directed.

[368] In *Erris Promotions v CIR* (2003) 21 NZTC 18,330 Ronald Young J said at para 374:

> The second part of the definition requires an abusive tax position to be taken. As has been said, this requires, in addition to an unacceptable interpretation, that at the same time, viewed objectively, the position of the taxpayer must be as a consequence of an arrangement that is entered into which has as its dominant purpose tax avoidance. And so I must consider if the dominant purpose of the joint venture, viewed objectively, was tax avoidance. Here s 141D(7)(b)(i) is concerned not with the taxpayers intent or knowledge but with whether their claim for depreciation losses arose as a consequence from a scheme which had as its dominant purpose tax avoidance.

[369] I agree with Ronald Young J's approach. The only matter that can be viewed objectively, as the subsection is drawn, is whether the arrangement was entered [into] with a dominant purpose of avoiding tax. The purpose of the section "to penalise those taxpayers who … have entered into … arrangements … with a dominant purpose of taking … tax positions that reduce or remove tax liabilities or give tax benefits" as set out in subsection 141D(1) is not met if the objective test is to be applied only to whether the taxpayer took a tax position in respect or as a consequence of an arrangement. The objective test applies to the assessment of dominant purpose.

[370] In the present case the plaintiffs may well have had a general interest in investing long-term in a douglas fir forest. But for the reasons set out earlier, viewed objectively the dominant purpose of the arrangement entered in this case was undoubtedly to achieve the taxation benefits of the arrangement, at least for the first years before any corrective legislation was passed. The evidence satisfies me that were it not for those tax benefits the plaintiffs would not have entered into the investment in the Trinity Scheme. The plaintiffs became part of the Trinity Scheme with the dominant purpose of achieving those tax benefits.

4.46 Thus, the High Court has considered the dominant purpose in section 141D(7)(b)(i) on two occasions. Ronald Young J in *Erris Promotions* stated that section 141D(7)(b)(i) is concerned with the arrangement's dominant purpose and is not concerned with the taxpayer's purpose. Venning J in Accent Management considered a submission from counsel for the plaintiff that Ronald Young J in *Erris Promotions* was incorrect to suggest the dominant purpose relates to the arrangement itself, with counsel arguing that it was the purpose of the taxpayer that was relevant. After quoting the paragraph from *Erris Promotions* in which Ronald Young J stated that section 141D(7)(b)(i) concerns the dominant purpose of the arrangement rather than the taxpayer, Venning J commented that he agreed with Ronald Young J's approach. Thus, the High Court has confirmed on two occasions that section 141D(7)(b)(i) tests the dominant purpose of the arrangement.

Pre-legislative materials

4.47 That it is the purpose of the arrangement that is to be tested (rather than the purpose of the particular taxpayer) in section 141D(7)(b)(i) is further confirmed in the pre-legislative materials that led to the enactment of the provision. In the second discussion document, *Taxpayer compliance, standards and penalties 2: detailed proposals and draft legislation* (April 1995) (the "second discussion document"), draft legislation of what became section 141D was published. In the draft legislation, the words chosen more clearly indicated that it was the arrangement's dominant purpose that was to be tested. The following is the draft legislation and commentary for what is now section 141D, as it appeared in the second discussion document:

Draft Legislation

(5) In this section –

(a) "Abusive tax position" means a tax position which –

(i) At the time the taxpayer takes the taxpayer's tax position is not a reasonably arguable position; and

(ii) Is taken in respect of, or as a consequence of entering into, an abusive arrangement;

(b) "Abusive arrangement" means an arrangement that, viewed objectively, has a dominant purpose of avoiding tax, whether directly or indirectly;

…

Commentary

…

Subsection (5)(b)

An abusive arrangement means **an arrangement which**, viewed objectively, **has a dominant purpose of avoiding tax**. …

[Emphasis added]

4.48 As is apparent from the wording, the section as it was published as draft legislation, could *only* apply in situations in which there was an arrangement.

4.49 However, it was always intended that the penalty could potentially be applicable even where general or specific anti-avoidance provisions were not invoked in respect of the substantive tax issue. The intention that the section was to apply to a wide range of situations, including situations that did not involve an arrangement, is evidenced by a comment at paragraph 7.12 of the second discussion document:

> It is intended that the penalty for abusive arrangements apply not only in situations where a general or specific anti-avoidance provision is invoked, but also where other provisions have been applied. This recognises that the need to rely on an anti-avoidance provision does not necessarily indicate that the arrangement or tax position in question is inherently more deserving of a high penalty than are abusive interpretations of other provisions of the Acts.

4.50 However, before the legislation was enacted, it was realised that this original intention was at risk, and that (on the wording of the draft legislation) the penalty was potentially applicable only when there was an arrangement. By splitting the provision into two limbs, the scope of the provision was widened and therefore all potential "abusive tax positions" were able to be covered by the section.

4.51 In the Commentary on the Bill that enacted the provision, T*axpayer Compliance, Penalties, and Disputes Resolution Bill: Commentary on the Bill* (September 1995), it was stated in the introductory section of the Commentary on the Bill that any significant policy changes (from the draft legislation to the sections as published in the Bill) would be commented on, in the commentary for each section. There was no statement in the commentary that the policy intention behind the abusive tax position provision had changed.

4.52 Therefore, while there were in fact changes made to the provision, which resulted in somewhat ambiguous wording, the original intention of the drafters in relation to an arrangement's purpose in certain situations did not change.

Conclusion on the first limb

4.53 Accordingly, it is considered that the better view is that the dominant purpose of tax avoidance in section 141D(7)(b)(i) relates to the arrangement rather than the purpose of the taxpayer that is taking the tax position in question. Section 141D(7)(b)(i) will be satisfied where a taxpayer has taken their tax position directly or indirectly in respect of or as a consequence of an arrangement that they have personally entered into, and the dominant purpose of the arrangement is tax avoidance.

Section 141D(7)(b)(ii) – the second limb

4.54 Section 141D(7)(b)(ii) applies where the taxpayer has a dominant purpose of avoiding tax, either in situations where there is no arrangement, or in situations where it is not shown that the arrangement has a dominant purpose of avoiding tax:

> (7) For the purposes of this Part and section 177C, **an "abusive tax position" means a tax position that**,—
>
> (a) **Is an unacceptable tax position** at the time at which the tax position is taken; and
>
> (b) Viewed objectively, **the taxpayer takes**—
>
> (ii) Where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly
>
> [Emphasis added]

What is the scope of the second limb?

4.55 Section 141D(7)(b)(ii) applies where the tax position in question does not relate to an arrangement described in subparagraph (i). In such cases, the subparagraph will apply where there is an unacceptable tax position, and the taxpayer takes the tax position with a dominant purpose of avoiding tax. The "dominant purpose" of avoiding tax under section 141D(7)(d)(ii) is clearly a test of the taxpayer's purpose, and will be tested at the time at which the taxpayer's tax position is taken.

4.56 Section 141D(7)(b)(ii) is potentially applicable when there is no arrangement, or where there is an arrangement, but it cannot be shown that the arrangement itself has a dominant purpose of avoiding tax. In such situations, the provision will apply where the taxpayer has a dominant purpose of avoiding tax.

Campbell Investments decision

4.57 The decision in *CIR v Campbell Investments & Anor* (2004) 21 NZTC 18,559 provides an example of the application of the abusive tax position shortfall penalty to a particular set of facts. In *Campbell Investments* the taxpayer was a syndicate with a taxable activity of leasing commercial properties. The syndicate members were Mr Montgomery, Mrs Montgomery and a family trust (the trustees of which also included Mr and Mrs Montgomery). The syndicate claimed that it transferred its 2 commercial properties to the syndicate members on 5 October 1997 for consideration of 1 peppercorn. On 22 May 1998 Mr and Mrs Montgomery executed an agreement for sale and purchase between themselves and the trustees of the family trust purporting to sell their

interests in the properties, with settlement occurring on the earlier date of 30 January 1998. Payment was effected by way of a mortgage executed in favour of the trustees of the family trust on 30 July 1998.

4.58 The syndicate returned GST on the rentals for the properties for the 2 month period ended 31 January 1998. On 19 August 1998 the syndicate filed an amended return requesting a refund of the GST on the rentals that it claimed it had wrongly returned, as it claimed that the properties had been transferred to the syndicate members on 5 October 1997. The syndicate argued that it was no longer required to return GST on the rentals (and the syndicate members were not GST registered, so also were not required to return GST on the rentals).

4.59 The Commissioner assessed the syndicate for GST output tax for the GST period ending 31 January 1998 on the transfer of the properties that was purported to have occurred on 30 January 1998. The Commissioner also sought to impose a shortfall penalty on the syndicate for taking an abusive tax position.

4.60 In the High Court decision, Wild J held that the 5 October 1997 transaction was not a supply of the property from the syndicate to the syndicate members. His Honour stated that all that occurred on 5 October 1997 was a transfer of legal title in the properties to the beneficial owners for a peppercorn, which was irrelevant to the syndicate's continuing taxable activity. Further, Wild J held that the agreement for sale and purchase of the properties dated 22 May 1998 was not effective to create a supply of the properties on 30 January 1998. He held that the syndicate supplied the properties to the family trust on 30 July 1998 – the time when payment was made through the execution of the mortgages.

4.61 As a result, Wild J concluded that the syndicate was liable for output tax on the supply of the properties to the trust in the GST period ending 31 July 1998 – not in the period ending 31 January 1998 as assessed. This meant that no tax shortfall from the supply of the properties arose in the January 1998 GST period. However, Wild J held that the amended return for the period ending 31 January 1998 excluding the rentals received by the syndicate did give rise to a tax shortfall.

4.62 While not discussing the application of the abusive tax position penalty in significant detail, Wild J considered that the various steps taken by the parties were an arrangement that had a dominant purpose of avoiding tax. His Honour concluded that the syndicate was liable to account for GST on the rents received as indicated by the original return filed and the continued payment of the rents into the syndicate's bank account. Wild J stated at paragraph 51 as follows:

> I regard the Syndicate's tax position as abusive because it attempted (retrospectively) to give the 5 October 1997 transaction a GST significance it was not intended to have at the time it was entered into and did not have. That is established by the continued payment of rents from the properties into the Syndicate's bank account…

4.63 Accordingly, Wild J upheld the imposition of the abusive tax position shortfall penalty in relation to the rents. While Wild J did not work through and comment on each of the statutory requirements as set out in this Interpretation Statement, he appears to have been influenced by the arrangement being "artificial and contrived" and involving "spurious interpretations".

4.64 Wild J further stated (*obiter*) that the syndicate should have accounted for GST on the supply of the properties to the family trust on 30 July 1998. He noted that this gave rise to a tax shortfall, and in his view, the syndicate took an abusive tax position by not accounting for the supply in its GST return for the period ending 31 July 1998. The position was abusive as the syndicate had attempted to backdate the sale and purchase agreement on 22 May 1998, and had attempted to give the 5 October 1997 transaction GST significance (as a supply of the properties for a peppercorn) when it was not a supply of the properties at all.

RELATIONSHIP WITH OTHER SHORTFALL PENALTIES

4.65 Determining which of the shortfall penalties applies to a tax shortfall will always depend upon the facts of any given situation. Each of the shortfall penalties is charged as a percentage of the tax shortfall, depending on the seriousness of the breach.

4.66 The not taking reasonable care and unacceptable tax position shortfall penalties are the lowest of the penalties in terms of culpability and are charged at a rate of 20% of the tax shortfall.

4.67 The gross carelessness shortfall penalty is chargeable where a taxpayer is grossly careless in taking their tax position. This will usually be where, objectively, the taxpayer has acted recklessly in taking their tax position and the circumstances suggest a complete or high level of disregard for the consequences of their actions. The penalty for gross carelessness is chargeable at 40% of the tax shortfall. This is higher than the not taking reasonable care and unacceptable tax position shortfall penalties, but less than the penalty for taking an abusive tax position, reflecting the relative levels of culpability.

4.68 The abusive tax position shortfall penalty requires a higher level of culpability. As shown above, the penalty requires the dominant purpose of either the taxpayer or the arrangement to be to avoid tax,

which is a higher level of culpability than the recklessness required for the gross carelessness penalty. For a taxpayer charged with the gross carelessness shortfall penalty the circumstances will suggest the taxpayer had a complete or high level of disregard for the consequences, rather than a dominant purpose, or even any purpose, of avoiding tax. The percentage of the tax shortfall chargeable for the abusive tax position penalty reflects the relative seriousness of the breach, at 100% of the tax shortfall.

4.69 The onus of proof for the abusive tax position, gross carelessness, unacceptable tax position, and not taking reasonable care penalties rests with the taxpayer.

4.70 The highest shortfall penalty in terms of culpability and the percentage of the tax shortfall chargeable is the evasion shortfall penalty. An example of a situation where the evasion shortfall penalty would apply is where the taxpayer knows that an obligation to pay tax exists, but evades the assessment of tax by simply not paying that which is known to be owing (section 141E(1)(a)). The penalty will also apply, for example, if the taxpayer knowingly does not make a deduction which is required to be made by a tax law (section 141E(1)(c)). The level of the penalty, at 150% of the resulting tax shortfall, reflects the seriousness of the breach.

4.71 For the evasion shortfall penalty the onus of proof rests with the Commissioner.

4.72 The distinction between the dominant purpose of avoiding tax required for the abusive tax position penalty to apply, and knowingly evading tax for the evasion shortfall penalty to apply, goes beyond the difference in the onus of proof. In situations where (for example) the actions of a taxpayer or an arrangement show that the taxpayer's affairs are structured to *reduce or defer a potential or prospective liability* to tax and this is done with a dominant purpose to avoid tax, the abusive tax position penalty will apply. In contrast, for the evasion penalty to apply (for example) the taxpayer knows that a liability to tax exists, but knowingly *ignores that liability* and completely fails to pay the amount of tax the taxpayer knows it is required to pay.

CONCLUSION

4.73 The section 141D abusive tax position shortfall penalty can apply whether or not there is an arrangement. For section 141D(7)(b)(i) to apply, there must be an arrangement, and the dominant purpose of that arrangement must be tax avoidance. Section 141D(7)(b)(ii) applies where there is no arrangement, or there is no arrangement of the kind described in section 141D(7)(b)(i) and the dominant purpose of the taxpayer in taking their tax position is tax avoidance. The phrase "dominant purpose of avoiding tax" means that the most influential and prevailing purpose of the arrangement, or the taxpayer (depending on whether section 141D(7)(b)(i) or section 141D(7)(b)(ii) is applied) is to avoid tax.

5. EXAMPLES

EXAMPLE 1

The taxpayers are a clothing manufacturing company and the four individuals who are shareholders in that company. Two of those individuals are executive directors and full-time employees of the company and the other two shareholders are the respective wives of those executives.

The shares in the company are sold by the individuals to C, a company controlled by W, through a tax loss group of companies also controlled by W. Declarations of trust are completed so that the four shareholders hold the shares on trust for C. The share purchase is funded by a loan from the vendor shareholders to C. The net profit of the taxpayer company is paid as an administration charge to C at six-monthly intervals. Approximately 77.5% of that administration charge is paid to the taxpayers in reduction of the loan secured by the mortgage of shares.

The shareholders also operate the company business under a management contract and receive income for doing that. An important part of the deal is that the individual taxpayers have a buy-back option over the taxpayer company's business. The deal is subsequently extended for a further three years by surrendering the buy-back option for $4.5 million. The business is then reacquired by the taxpayers several years later.

Is the abusive tax position shortfall penalty chargeable on these facts, under either of section 141D(7)(b)(i) or (ii)?

The transactions involved amount to an arrangement. The activities of the taxpayers and the arrangement entered into by the taxpayers are primarily designed to relieve the taxpayer company and the individual taxpayers from liability to pay income tax or, at least, to reduce or postpone any such liability. The arrangement is a tax avoidance arrangement which is void under section BG 1 of the ITA. In fact, the High Court in *Miller and Ors v Commissioner of Inland Revenue; McDougall and Anor v Commissioner of Inland Revenue; Managed Fashions Ltd and Ors v CIR* (1997) 18 NZTC 13,219 described a situation such as this as being as "blatant an example of tax avoidance as can be imagined."

The tax positions taken by the taxpayers in entering into the arrangement are not about as likely as not to be correct. The individual taxpayers retained the benefit of all significant elements of their original ownership and management of the company in addition to allowing them the benefit of receiving tax-free revenue less the administration and consulting fees. By filing their individual tax returns each taxpayer has taken an incorrect tax position. Therefore, the taxpayers have each taken an unacceptable tax position, and assuming the $20,000 threshold is met, would satisfy section 141D(4).

The next requirement is that either the arrangement or the individual taxpayers have a dominant purpose of avoiding tax. The arrangement entered into by the taxpayers was convoluted and unnecessarily complex. The transactions in the arrangement show that the arrangement had a dominant purpose of avoiding tax. As stated by Baragwanath J in the High Court decision in *Miller* at page 13,235:

> Whether the transactions are examined minutely according to their black letter or more broadly in context I am unable to escape the conclusion that they constitute a device the dominant purpose and effect of which is tax avoidance. In my view they clearly infringe s 99 both literally and according to the "propriety test" that I have employed.

Therefore, on these facts, the abusive tax position penalty would be chargeable under section 141D(7)(b)(i), as the dominant purpose of the arrangement entered into by the taxpayers was avoiding tax. If the arrangement did not have a dominant purpose of avoiding tax, the abusive tax position shortfall penalty would instead be chargeable under section 141D(7)(b)(ii), as the dominant purpose of the taxpayers in taking their tax positions was avoiding tax.

[This example is based on the facts and decision in *Case R25* (1994) 16 NZTC 6,120 and the appeal decision, *Miller and Ors v Commissioner of Inland Revenue; McDougall and Anor v Commissioner of Inland Revenue; Managed Fashions Ltd and Ors v CIR* (1997) 18 NZTC 13,219.]

EXAMPLE 2

The taxpayer is a shareholder in a loss attributing qualifying company (LAQC). The LAQC is an investor in a mass marketed investment scheme. The investment is made by way of acquiring an interest in a joint venture.

The taxpayer, who is on the top marginal tax rate, is interested in the losses the investment scheme would generate and which could be off-set against his other income. The taxpayer is aware that his/her return from the investment would arise from the tax savings the scheme generated, rather than the ultimate profitability of the scheme.

The joint venture claims deductions resulting in losses allocated to the investors. For investors on the top marginal tax rate the tax benefits of the losses over the first 3 years exceeds the amount of the original investment made by the taxpayer. The ultimate profitability of the joint venture is highly uncertain.

Is the abusive tax position shortfall penalty chargeable on these facts, under either of section 141D(7)(b)(i) or (ii)?

The mass marketed investment scheme is a tax avoidance arrangement which is void for tax purposes under section BG 1 of the Income Tax Act. Even if no sales of the joint venture's product take place, every investor will still obtain a substantial return on their investment due to the tax benefits from the deductions claimed. There is little or no commercial aspect to the scheme that can be substantiated.

The dominant purpose of the joint venture arrangement is the avoidance of tax. The taxpayer, in entering into the scheme also has a dominant purpose of avoiding tax. In these circumstances the tax position taken in claiming the deductions is incorrect because of the application of section BG 1. It is not about as likely as not to be correct. Therefore, assuming the tax shortfall exceeds $20,000, both the LAQC and the taxpayer have taken unacceptable tax positions and section 141D(4) will be satisfied. Further, both the LAQC and the taxpayer have taken tax positions as a consequence of the joint venture arrangement that has a dominant purpose of avoiding tax. However, pursuant to section 141FD of the TAA (or section 141FC for tax positions taken between 1 April 1998 and 1 April 2005), the abusive tax position shortfall penalty can only be applied to either the LAQC or the taxpayer.

Therefore, on these facts, the abusive tax position shortfall penalty would be chargeable under section 141D(7)(b)(i), as claiming the deductions involved taking a tax position in respect or as a consequence of an arrangement which had a dominant purpose of avoiding tax. If the arrangement did not have a dominant purpose of avoiding tax (yet was still void under section BG 1), the abusive tax position shortfall penalty would instead be chargeable under section 141D(7)(b)(ii). The taxpayer, in claiming the deductions, has taken a tax position with the dominant purpose of avoiding tax.

[The facts in this example are similar to the facts in *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 and *Erris Promotions and others v CIR* (2003) 21 NZTC 18,330 where the High Court held in each case that the arrangement had a dominant purpose of avoiding tax, and therefore section 141D applied.]

REGULAR FEATURES

DUE DATES REMINDER

February 2006

7 End-of-year income tax

2005 end-of-year income tax due for people and organisations with a March balance date and who do not have an agent

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

28 GST return and payment due

March 2006

7 Provisional tax instalments due for people and organisations 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

31 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2005–2006*. This calendar reflects the due dates for small employers only—less than $100,0000 PAYE and SSCWT deductions per annum.

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Draft question we've been asked	*Comment deadline*
☐ QB0047: Effect of repeal of Income Tax Act 1994 on depreciation determinations issued before repeal	28 February 2006
☐ QB0049: GST and fees paid for the processing, monitoring and granting of resource consent, pursuant to section 36 of the Resource Management Act 1991	28 February 2006

Draft interpretation statement	*Comment deadline*
☐ INS00072: Care and Management of Taxes	28 February 2006

Draft standard practice statement	*Comment deadline*
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