TAX INFORMATION BULLETIN

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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 July 2006.

Ref.	**Draft type**	**Description**
QB0048	Question we've been asked	GST treatment of funding provided to Treaty of Waitangi claimants by the Crown through the Office of Treaty Settlements
QB0052	Question we've been asked	GST and land transferred as a condition of subdivision consent pursuant to section 220 of the Resources Management Act 1991 in return for payment
QB0053	Question we've been asked	GST and works provided as a condition of resource consent pursuant to section 108 of the Resources Management Act 1991

Please see page 45 for details on how to obtain a copy.

BINDING RULINGS

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

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

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

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

IMPORTERS AND GST INPUT TAX DEDUCTIONS PUBLIC RULING – BR PUB 06/03

Note (not part of ruling): This ruling is essentially the same as Public Ruling BR Pub 97/10, published in *Tax Information Bulletin* Vol 9, No 11 (November 1997) which replaced Public Ruling BR Pub 95/9, published in *Tax Information Bulletin* Vol 7, No 7 (January 1996). Public Ruling BR Pub 97/10 was extended by *Gazette* notice until 31 March 2005 and published in *Tax Information Bulletin* Vol 12, No 5 (May 2000). This Ruling is to apply for an indefinite period.

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

Taxation Law

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

This Ruling applies in respect of section 20(3) and the definitions of "invoice" and "document" in section 2.

The Arrangement to which this Ruling applies

The Arrangement is the importing of goods into New Zealand by registered persons for the purposes of making taxable supplies, the levying of GST on those goods by the New Zealand Customs Service under the Customs and Excise Act 1996, and the subsequent claiming of input tax deductions on that GST.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

A registered person who accounts for GST on an invoice basis may support a claim for a GST input tax deduction under section 20(3) for GST levied by the New Zealand Customs Service on goods imported into New Zealand with:

- the New Zealand Customs Service Electronic Entry document; or
- a Deferred Payment of Duty Statement or a Cash Statement.

The period for which this Ruling applies

This Ruling will apply to claims for input tax deductions on GST levied by the New Zealand Customs Service on goods imported into New Zealand on and following 1 April 2005 for an indefinite period.

This Ruling is signed by me on the 30th day of May 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 06/03

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 06/03 ("the Ruling").

The subject matter of the Ruling was previously considered in Public Ruling BR Pub 95/9 published in TIB Vol 7, No. 7 (January 1996). After the New Zealand Customs Service moved to a partly electronic system for lodging and clearing imports Public Ruling BR Pub 97/10 was published in TIB Vol 9, No 11 (November 1997) to replace the earlier ruling. It was extended by *Gazette* notice until 31 March 2005 and published in TIB Vol 12, No 5 (May 2000). This Ruling replaces Public Ruling BR Pub 97/10.

Background

In December 1995, following the Court of Appeal decision *Shell New Zealand Holding Co. Ltd. v CIR* (1994) 16 NZTC 11,163, Public Ruling BR Pub 95/9 was issued and published in TIB Vol 7, No 7 (January 1996). It provided that:

A registered person may use either a Customs Import Entry Form or a Deferred Payment of Duty Statement to support a claim for a GST input tax deduction under section 20 of the Goods and Services Tax Act 1985 for GST levied by New Zealand Customs on goods imported into New Zealand.

When that ruling was made the Customs Act 1966 was in force. On 1 October 1996 the Customs and Excise Act 1996 came into effect, repealing and replacing the Customs Act 1966. The Customs and Excise Act 1996 specifically provided for an electronic entry system (referred to as the Electronic Direct Import system in the previous ruling). Under this system an entry is made electronically by the agent and sent, electronically, either over the internet or using Electronic Data Interchange ("EDI") software, to the New Zealand Customs Service where the entry is confirmed and cleared and delivery given. Once the import entry is cleared, an electronic message is sent back to the agent, along with a delivery order. The agent can then print out the electronic documents for the importer. From 1 March 2004, every entry is required to be lodged electronically, either over the internet or through the EDI software.

Legislation

Section 2 of the Goods and Services Tax Act 1985 defines "invoice" as meaning:

A document notifying an obligation to make payment:

Section 2 also defines "document" as including:

Any electronic data, computer programmes, computer tapes, and computer discs.

Section 12 imposes GST on the importation of goods into New Zealand. It states:

(1) Notwithstanding anything in this Act, a tax to be known as goods and services tax shall be levied, collected, and paid in accordance with the provisions of this section at the rate of 12.5 percent on the importation of goods (not being fine metal) into New Zealand, being goods that are—

(a) Entered therein, or delivered, for home consumption under the Customs and Excise Act 1996; or

(b) Entered for delivery to a manufacturing area licensed under section 12 of the Customs and Excise Act 1996; or

(c) Before their entry, or delivery, for home consumption or, as the case may be, entry for delivery to a manufacturing area licensed under section 12 of the Customs and Excise Act 1996, dealt with in breach of any provision of the Customs and Excise Act 1996,—

by reference to the value of the goods as determined under subsection (2) of this section.

...

(3) Subject to this section, tax levied under subsection (1) of this section shall be collected and paid in accordance with the Customs and Excise Act 1996.

Section 20(3) states:

Subject to this section, in calculating the amount of tax payable in respect of each taxable period, there shall be deducted from the amount of output tax of a registered person attributable to the taxable period—

(a) In the case of a registered person who is required to account for tax payable on an invoice basis pursuant to section 19 of this Act, the amount of the following:

…

(ii) Input tax invoiced or paid, whichever is the earlier, pursuant to section 12 of this Act during that taxable period.

…

Section 2 of the Customs and Excise Act 1996 defines "duty" as:

A duty, additional duty, tax, fee, charge, or levy imposed on goods by any of the provisions of this Act, and includes—

…

(d) A duty or tax imposed by section 12 of the Goods and Services Tax Act 1985

Under section 39 of the Customs and Excise Act 1996, goods to be imported must be entered in a prescribed form (including by electronic means):

Entry of imported goods—

(1) Subject to any regulations made under section 40 of this Act, goods that are imported or that are to be imported must be entered by the importer—

(a) In such form and manner (including by electronic means into a computer or other device) as may be prescribed; and

(b) Within such time as may be prescribed or such further time as the Chief Executive may allow.

…

Section 86(1) of the Customs and Excise Act 1996 states:

Duty on imported goods a Crown debt—

(1) The duty on all goods imported constitutes, immediately on importation of the goods, a debt due to the Crown.

(2) Such duty is owed by the importer of the goods, and, if more than one (whether at or at any time after the time of importation) then jointly and severally by all of them.

(3) Subject to this Act, such debt becomes due and payable when—

(a) Goods have been entered in accordance with section 39 of this Act and the entry has been passed for home consumption; or

(b) Goods have been entered in accordance with section 39 of this Act for removal to a manufacturing area; or

(c) Goods have been wrongfully landed or otherwise wrongfully dealt with without having been entered pursuant to section 39 of this Act; or

(d) An offence has been committed against this Act in respect of the goods.

(4) Such debt is recoverable by action at the suit of the Chief Executive on behalf of the Crown.

…

Under section 88 of the Customs and Excise Act 1996, an entry for goods is deemed to be an assessment for the purposes of that Act:

Assessment of duty—

(1) An entry for goods made under this Act is deemed to be an assessment by the importer or licensee, as the case may be, as to the duty payable in respect of those goods.

(2) If the Chief Executive has reasonable cause to suspect that duty is payable on goods by a person who has not made an entry in respect of the goods, the Chief Executive may assess the duty at such amount as the Chief Executive thinks proper.

(3) The person liable for the payment of the duty shall be advised of the assessment by notice in writing.

…

Application of the Legislation

Section 12 provides that GST shall be levied and paid on goods imported into New Zealand. Section 2 of the Customs and Excise Act 1996 defines the GST on imported goods as a duty and section 86 of the Customs and Excise Act 1996 provides that this duty is a debt due to the Crown and is recoverable under the Customs and Excise Act.

Under section 20(3)(a)(ii), registered persons who account on an invoice basis are permitted to claim input tax at the earlier of invoicing or payment. Registered persons who account on a payments basis are not affected by the subject matter of the Ruling. Unlike other claims for input tax deductions, section 20(3)(a)(ii) only requires the importers to hold invoices to support their claims rather than tax invoices. This is because the New Zealand Customs Service does not make any supplies when it is levying GST on goods imported into New Zealand, and so is not required to issue tax invoices under section 24 of the Act. Given the electronic entry procedure, the question arises as to what documentation issued by the New Zealand Customs Service is acceptable as an "invoice" for the purposes of the Act.

The Court of Appeal in *Shell New Zealand Holding Co. Ltd v CIR* considered the issue of when an importer could claim an input tax deduction for GST levied on goods imported into New Zealand. The Court of Appeal noted that an "invoice" is defined in section 2 of the Goods and Services Tax Act as "a document notifying an obligation to make payment". The Court held that when the goods are entered, this constitutes the duty as a debt due to the Crown. Therefore, at the point that the Customs Import Entry Form was signed by the Customs Officer, the Court considered this to be notice to the importer of the obligation to make payment. As a result, the Customs Import Entry Form, which stated the total duty, total GST and the total amount payable, fell within the GST definition of "invoice". BR Pub 95/9 confirmed that an importer could use a Customs Import Entry Form to support a claim for a GST input tax deduction.

As of 1 March 2004, all commercial entries are now required to be lodged and cleared electronically. The issue is whether the electronic entry used is an invoice sufficient to support a claim for input tax deduction claims.

The electronic entry is cleared by the New Zealand Customs Service when the "Lodgement" and "Delivery" numbers are issued, rather than being signed by a Customs Officer. The debt due to the Crown is created when the entry is confirmed in this way and consequently the clearing of the entry can be considered equivalent to the previous procedure of the signing and stamping of a manual import entry. When the agent receives the electronic entry document they are notified of the total duty and GST owing on each entry.

The information received on the electronic version of an import entry has not changed materially from that of the manual entry. The electronic entry document shows the total duty, total GST, and total payable. It identifies the supplier and the recipient of the goods and services, describes the goods supplied with a detailed coding system, and quantifies the consideration for the supply. Therefore, the electronic entry document contains the information thought necessary by the Court of Appeal in *Shell New Zealand Holding Co. Ltd v CIR* to establish and identify the customs duty and GST owed by the importer to the Crown. Therefore, the electronic entry document constitutes an "invoice" for GST purposes so as to trigger the time of supply and the resulting input tax entitlement for GST invoice-based importers under section 20(3).

The New Zealand Customs Service also operates an optional deferred payment scheme for importers, under which it issues a Deferred Payment of Duty Statement for the duty owed by importers on all the goods they import during a particular month. The Deferred Payment Scheme has four billing cycles within a one-month period. Payment is deferred for 21 working days from the end of an importer's allocated billing cycle. The Deferred Payment

of Duty Statement is created from the information contained in the electronic entry document and so is also acceptable documentation to support a GST input tax deduction claim.

If an agent is not on the Deferred Payment Scheme, the New Zealand Customs Service issues Cash Statements. Under the Cash Statements scheme, the duty owed must be paid before the imported good is released. Again, the Cash Statement is created from the information contained in the electronic entry document and so is also acceptable documentation to support a GST input tax deduction claim.

Example

A taxpayer imports and sells European cars. She is registered for GST, accounts for tax payable on an invoice basis, and files GST returns on a two-monthly basis. The taxpayer imports cars worth $300,000 on 28 September. Her agent enters the details of the cars she has imported and their values into the correct electronic entry form and sends it electronically to the New Zealand Customs Service. Within a few minutes the New Zealand Customs accepts the import entry as correct, issues lodgement and delivery numbers, and electronically sends the cleared entry and a delivery order back to the taxpayer's agent stating the total duty, total GST, and total amount payable on the importation of those cars. The taxpayer's agent prints out copies of the electronic entry document and delivery order and gives them to the taxpayer. The taxpayer retains these for evidentiary purposes.

The taxpayer is on the Deferred Payment Scheme operated by the New Zealand Customs Service, and receives a Deferred Payment of Duty Statement on 23 October. The payment is deferred for 21 working days. The statement lists all the goods she has imported for the period 23 September to 23 October, and states the total amount of duty and GST payable.

The taxpayer's taxable period ends on 30 September. She is required to furnish her GST return for the months of August and September, stating the amount of GST she has to return for those two months. The taxpayer will include in her GST return for that taxable period an input tax deduction claim for the GST levied on the cars imported on 28 September.

The taxpayer only needs an invoice to substantiate her claim for an input tax deduction for the GST that the New Zealand Customs Service has levied on the imported cars. The taxpayer may claim the input deduction in the taxable period ending 30 September, because the electronic entry document contains all the necessary details to constitute an invoice for the purposes of the Goods and Services Tax Act 1985. She does not need to delay the claim until the period in which she receives the Deferred Payment of Duty Statement.

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.

INTEREST DEDUCTIBILITY—*PUBLIC TRUSTEE V CIR*

This interpretation statement expresses the Commissioner's view of the principles relating to interest deductibility from the Court of Appeal decision in *Public Trustee v CIR* [1938] NZLR 436.

The analysis in this statement considers the application of *Public Trustee* in *Williams v CIR* (1988) 10 NZTC 5,078 and the more recent case of *Borlase & Anor v Commissioner of Inland Revenue* (2001) 20 NZTC 17,261. The cases of *Pacific Rendezvous v CIR* (1986) 8 NZTC 5,146 and *Commissioner of Inland Revenue v Brierley* (1990) 12 NZTC 7,184 are also discussed.

There are four main parts to this statement. Part 1 is a summary of the Commissioner's view of when interest is deductible when applying *Public Trustee*. Part 2 is an expanded analysis section discussing the Commissioner's view. Some background and specific comments on alternative approaches not accepted by the Commissioner are covered in Part 3. Part 4 contains the conclusions.

> The position outlined in this statement replaces the Commissioner's interpretation of *Public Trustee* in a statement in *Tax Information Bulletin* Vol 3, No 9 (June 1992). That statement in the TIB, to the extent that it relates to the interpretation and application of *Public Trustee*, is hereby withdrawn.
>
> This statement originates from issues paper IRRUIP 5: *Interest deductibility in certain arrangements*, which was issued for public consultation in March 2001. (IRRUIP 5 had superseded an earlier issues paper, IRRUIP 3.) IRRUIP 5 should not be relied upon as stating the Commissioner's current view on matters of interest deductibility.
>
> Other issues discussed in IRRUIP 5 may be covered in future statements.

PART 1 – SUMMARY

1. The interest deductibility test is satisfied if there is a sufficient connection between interest and assessable income. In *Public Trustee*, the borrowed funds were not used to acquire income earning assets, but were used to retain income earning assets.

2. When borrowings are used to acquire assets, the connection with assessable income is different in nature from any connection made when borrowings retain assets. The case of *Pacific Rendezvous* has held that if the borrowed funds are used to acquire income earning assets, that would in itself be sufficient to establish the connection between interest incurred on the borrowed funds and the derivation of assessable income. Where funds are instead used to retain income earning assets, the interest is not necessarily deductible. It may be deductible if, in the circumstances, a sufficient connection with assessable income exists.

3. Following *Public Trustee*, the Commissioner considers that interest on borrowings will be deductible when the borrowed funds retain income earning assets, if the taxpayer can establish that:

    - the liability that the borrowed funds were used to discharge was involuntary; and
    - the taxpayer definitely would have realised particular income earning assets, if the taxpayer had not borrowed; and
    - the liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

    The factors in the second and third bullet points may entail apportionment.

4. When the three factors are all present, taxpayers have certainty about how the Commissioner will apply the law. The Commissioner accepts that it may be possible for taxpayers to establish that interest is deductible when borrowings are made in order to retain assets, even though the three factors are not present. Interest may be deductible in such circumstances if the nexus is similar in strength to the nexus established when the three factors are

present. In considering these situations, a guiding principle will be whether, on the particular facts, the borrowing prevented a realisation of income earning assets. All the circumstances will be relevant in considering whether there is a sufficient connection with income.

5. *Pacific Rendezvous* and *Public Trustee* also establish that where there is a sufficient connection with assessable income, whether through income earning assets being acquired or retained, the fact that the borrowed funds concurrently serve another use, unrelated to income, will not break that sufficient connection.

PART 2 – ANALYSIS OF THE COMMISSIONER'S VIEW

BACKGROUND

Legislation

Income Tax Act 2004

Part D — Deductions

Subpart DA — General rules

DA 1 General permission
DA 1(1) Nexus with income
A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—
(a) incurred by them in deriving—
(i) their assessable income; or
(ii) their excluded income; or
(iii) a combination of their assessable income and excluded income; or
(b) incurred by them in the course of carrying on a business for the purpose of deriving—
(i) their assessable income; or
(ii) their excluded income; or
(iii) a combination of their assessable income and excluded income.
DA 1(2) General permission
Subsection (1) is called the **general permission.**
Defined in this Act: amount, assessable income, business, deduction, depreciation loss, excluded income, general permission, loss

DA 2 General limitations
DA 2(1) Capital limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation.**
DA 2(2) Private limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation.**
DA 2(3) Exempt income limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation.**
…
DA 2(7) Relationship of general limitations to general permission
Each of the general limitations in this section overrides the general permission.
Defined in this Act: amount, capital limitation, deduction, employment limitation, exempt income, exempt income limitation, general limitation, general permission, income from employment, loss, non-residents' foreign-sourced income, non-residents' foreign-sourced income limitation, private limitation, schedular income subject to final withholding, withholding tax limitation

DA 3 Effect of specific rules on general rules
DA 3(1) Supplements to general permission
A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.
DA 3(2) Express reference needed to supplement
A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.
DA 3(3) Relationship of general limitations to supplements to general permission
Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.
DA 3(4) Relationship between other specific provisions and general permission or general limitations
A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
DA 3(5) Express reference needed to override
A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—
(a) that it overrides the general permission or the relevant limitation; or
(b) that the general permission or the relevant limitation does not apply.
…
DB 1 Taxes, other than GST, and penalties
DB 1(1) No deduction
A person is denied a deduction for the following:
(a) income tax:
(b) a civil penalty under Part 9 of the Tax Administration Act 1994:
(c) a tax, a penalty, or interest on unpaid tax that is—

(i) payable under the laws of a country or territory outside New Zealand; and

(ii) substantially the same as a civil penalty as defined in section 3(1) of the Tax Administration Act 1994, or a criminal penalty under Part 9 of the Act, or interest imposed under Part 7 of the Act.

…

DB 6 Interest: not capital expenditure

DB 6(1) Deduction

A person is allowed a deduction for interest incurred.

DB 6(2) Exclusion

Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

DB 6(3) Link with subpart DA

This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

Defined in this Act: capital limitation, deduction, general limitation, general permission, interest

DB 7 Interest: most companies need no nexus with income

DB 7(1) Deduction

A company is allowed a deduction for interest incurred.

DB 7(2) Exclusion: qualifying company

Subsection (1) does not apply to a qualifying company.

DB 7(3) Exclusion: exempt income

If a company **(company A)** derives exempt income or another company **(company B)** in the same wholly-owned group of companies derives exempt income, subsection (1) applies to company A only if all the exempt income is 1 or more of the following:

(a) dividends; or

(b) income exempted under section CW 46 (Disposal of companies' own shares); or

(c) income exempted under section CW 48 (Stake money) and ancillary to the company's business of breeding.

DB 7(4) Exclusion: non-resident company

If a company is a non-resident company, subsection (1) applies only to the extent to which the company incurs interest in the course of carrying on a business through a fixed establishment in New Zealand.

DB 7(5) Exclusion: interest related to tax

Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

DB 7(6) Link with subpart DA

This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

Defined in this Act: business, capital limitation, company, deduction, dividend, exempt income, exempt income limitation, fixed establishment, general limitation, general permission, income, interest, New Zealand, non-resident company, qualifying company, supplement, wholly-owned group of companies, withholding tax limitation

Public Trustee *principle not relevant to section DB 7 deductions*

6. The interest deductibility legislation distinguishes between companies and other taxpayers. Interest incurred by companies is automatically deductible— that is, there is no requirement to satisfy a nexus test—except for certain exceptions. The impact of this is that the interest deductibility principle derived from *Public Trustee* will have limited application. *Public Trustee* will apply in relation to the deductibility of interest expense incurred by individuals, partners, trusts and qualifying companies, and to other companies unable to obtain a deduction under section DB 7.

7. Interest incurred by companies is deductible, subject to certain exceptions. Under section DB 7, interest incurred by a company is deductible, provided the statutory exceptions in subsections DB 7(2) – (5) do not apply. The exceptions are:

- qualifying companies;
- companies deriving exempt income except if that exempt income is dividends, exempt income arising from a disposal of a company's own shares or exempt income related to stake money and a breeding business;
- non-resident companies to the extent to which interest is not incurred in the course of carrying on a business through a fixed establishment in New Zealand; and
- interest on unpaid taxes payable to another country and substantially the same as civil or criminal penalties as defined under certain laws in New Zealand.

8. The effect of section DB 7 is discussed in T*ax Information Bulletin* Vol 13, No 11 (November 2001).

How the sections of the Act, other than section DB 7, apply in relation to interest deductibility

9. Section DB 6(1) provides that:

> A person is allowed a deduction for interest incurred.

10. Section DB 6(3) states that

> This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

11. Therefore, a person seeking to deduct interest is subject to the general permission, which states:

> **DA 1 General permission**
>
> **DA 1(1) Nexus with income**
>
> A person is allowed a deduction for an amount of expenditure or loss (including an amount

of depreciation loss) to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—
  (i) their assessable income; or
  (ii) their excluded income; or
  (iii) a combination of their assessable income and excluded income; or
(b) incurred by them in the course of carrying on a business for the purpose of deriving—
  (i) their assessable income; or
  (ii) their excluded income; or
  (iii) a combination of their assessable income and excluded income.

DA 1(2) General permission
Subsection (1) is called the **general permission.**

12. So in applying the Act to interest, a person must satisfy the test under the general permission that the expenditure (interest in this case) is incurred in deriving assessable income (or excluded income) or incurred in carrying on a business for the purpose of deriving assessable (or excluded income). This test is the same in all relevant respects to the test under the 1994 Act.

13. The concept of "excluded income" requires some comment. "Excluded income" is defined and specified to include, for example, GST, fringe benefits, certain life insurance premiums or claims derived by persons carrying on the business of life insurance, and other specific classes of income (see sections OB 1, BD 1(3) and subpart CX). The addition of the reference to "excluded income" in the general permission does not alter the principles applying to the deductibility of interest. Because the concept of "excluded income" is a statutory mechanism used to deal with certain types of income, and does not affect the principles of interest deductibility, "excluded income" is not referred to further in this statement.

14. The general permission is subject to the general limitations, pursuant to section DA 2(7). The general limitations include the private limitation and the capital limitation:

DA 2 General limitations
DA 2(1) Capital limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation.**

DA 2(2) Private limitation
A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the private limitation.

…

DA 2(7) Relationship of general limitations to general permission

15. The private limitation applies to interest expense, pursuant to sections DA 2(2). The capital limitation, on the other hand, does not apply. This result is achieved in the Act by the capital limitation being expressly overridden. Sections DA 3(4) and DA 3(5) state the general rule that a limitation (such as that applying to capital expenditure) does not apply if it is expressly overridden:

DA 3(4) Relationship between other specific provisions and general permission or general limitations
A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.

DA 3(5) Express reference needed to override
A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—

(a) that it overrides the general permission or the relevant limitation; or
(b) that the general permission or the relevant limitation does not apply.

…

16. The capital limitation is expressly overridden by section DB 6(3) (subsections DB 6(1) is reproduced to give context):

DB 6 Interest: not capital expenditure
DB 6(1) Deduction
A person is allowed a deduction for interest incurred.

…

DB 6(3) Link with subpart DA
This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.
Defined in this Act: capital limitation, deduction, general limitation, general permission, interest

Summary of the legislation relating to interest deductions

17. In summary, the legislation provides the following general rules relating to interest deductibility:

- Interest incurred by companies is usually automatically deductible;
- For other taxpayers, interest is deductible if it is incurred in deriving assessable income or incurred in carrying on a business for the purpose of deriving assessable income;
- Interest is not deductible if it is private or domestic in nature;
- Being capital in nature will not, on its own, mean that interest is non-deductible.

Case law on the deductibility of interest

18. Before *Public Trustee* is discussed, general principles relating to interest deductibility will be outlined.

Pacific Rendezvous

19. In *Pacific Rendezvous*, the Court of Appeal held that the test for interest deductibility was whether borrowed funds on which the interest is incurred have been used in deriving income or in a business carried on to derive income. Richardson J said:

> It is both necessary and sufficient that the capital was employed in the production of assessable income. "Employed" bears its plain ordinary meaning and is synonymous with "used". The difficulty lies in determining whether or not the statutory nexus is satisfied in the particular case.

20. The borrowed funds had all been put into additions and improvements. Although the company in that case had another dominant purpose of increasing the capital value of the property, and even received capital amounts, that was not relevant. The sole question was whether the capital was employed in the production of the assessable income, and the Court held that it was.

21. At that time the interest deductibility provision referred to capital "employed" in the production of income. The Court in *Pacific Rendezvous* said that there was no difference between "employed" and "used". It can be assumed therefore that in the context of interest deductibility the meaning of "employed" is the same as the meaning of "used". For the purposes of this statement, the word "used" will generally be used instead of "employed".

The old and the new interest deductibility tests— is the "use" of the funds still the test?

22. Richardson J commented in *Pacific Rendezvous* on the similarities between the interest deductibility test the Court was considering and the general deductibility test. The comments are of particular interest because the interest deductibility test was amended after *Pacific Rendezvous* to mirror the general deductibility test. Under the test the Court was considering in *Pacific Rendezvous*, interest was deductible if it was payable on capital employed in the production of assessable income. The general deductibility provision was satisfied if the expenditure was incurred in the gaining or producing of assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income.

23. Richardson J said that the considerations under both provisions will ordinarily be the same. Therefore, an examination of the use of borrowed funds remained relevant under the reworded interest deductibility provision. The legislation was amended again in the rewritten Income Tax Act 2004, to provide that expenditure (including interest) is deductible if it is incurred in deriving assessable income. In the Commissioner's opinion, this latest change has not affected the test. If a sufficient connection exists through the use of borrowed funds, the interest will be deductible.

24. The courts have continued to examine the use of the funds and continued to regard *Pacific Rendezvous* as the leading authority on interest deductions, despite the change in wording. For example, in *Borlase*, a 2001 decision, the High Court applied a "use" test. Since *Pacific Rendezvous*, Taxation Review Authority decisions concerned with interest deductions all examine the use of funds, for example, *Case L76* (1989) 11 NZTC 1,441, *Case L81* (1989) 11 NZTC 1,648, *Case R8* (1994) 16 NZTC 6,049 and *Case S17* (1995) 17 NZTC 7,127. A reason for the continued reliance on an examination of the borrowed funds is that usually the interest itself is not connected with the income earning activity. The interest is the cost of the funds and is not itself used in deriving income. Rather, it is the borrowed funds that are invested in an income earning activity or business, and so it is the borrowed funds that may have a connection with income (*Ure v FC of T* 81 ATC).

The relevance of other factors, including purpose

25. Although the use of funds remains the primary test, the courts have indicated that in some situations other factors may be relevant. Interest arising under financial arrangements is deductible if a sufficient connection is established, though there is no principal amount. *Roberts and Smith* can be argued to be authority that interest may be deductible if borrowing replaces funds used in an income earning activity, without the necessity of tracing the payment of the borrowings to the funds replaced. Following *Roberts and Smith*, arguably the deduction can be obtained if the funds are paid elsewhere (in that case to partners) and in effect replace capital in the partnership.

26. Another factor that may sometimes be relevant is a taxpayer's purpose. In *Pacific Rendezvous*, Richardson J said a taxpayer's purpose may be relevant, but only in considering whether capital has been employed in the production of assessable income.

Brierley

27. *Pacific Rendezvous* was followed in *Brierley.* In *Brierley*, the taxpayer had borrowed money to take up annual cash issues made by the public company. A number of different types of returns, including non-assessable amounts, were received by the taxpayer.

28. The Commissioner argued that there were several uses to which the borrowed moneys were put, and only one was a use connected with income. Like *Pacific Rendezvous*, the taxpayer's purpose included deriving capital gain amounts and other non-assessable amounts. The Commissioner considered that the interest should be apportioned not just on the basis of the taxpayer's purposes, but on the basis of the actual amounts the taxpayer received.

29. The Court concluded:

> It is the standard case of an investment which may provide both an income and a capital return. It was in that same situation that the Court in *Pacific Rendezvous* held that the moneys borrowed were fully employed in the production of assessable income even though they were also used for a purpose other than the production of assessable income, and even though capital profits were actually realised during the relevant income years. In short, it was not considered appropriate to dissect and apportion in such a case where separate uses in respect of different parts of the assets involved or for different periods of time could not be identified.

THE PUBLIC TRUSTEE CASE

30. *Public Trustee* concerned an estate that did not have sufficient cash to pay death duties. The death duties constituted a charge on all of the assets of the estate. The trustee of the estate borrowed to pay the death duties. In a majority judgment, the Court held that the interest was deductible.

31. The leading judgment was given by Myers CJ. At p. 452, Myers CJ said:

> For the determination of this question the substance of the transaction must be regarded. The death duties were a charge on the whole estate. If the estate had had the necessary money available in cash and had paid the duties with that cash, and had then found it necessary to borrow … for the purpose of maintaining the income of the estate, and had borrowed accordingly, could it be doubted that in such circumstances the interest on the money borrowed would be deductible under para. (h) of s. 80 (1)? What the estate has in fact done is substantially the same thing, and has the same effect.
>
> …
>
> The true inference, I think, in the present case is that the money borrowed enabled the trustee to pay out of the estate the amount of the death duties and left the money so borrowed or its equivalent in capital assets in the estate to be employed in the production of income.

32. He then went on to say (at p. 453):

> Where moneys are borrowed as in this case, it seems to me that they are in reality borrowed for the dual purposes of enabling the death duties to be paid and of maintaining the income from the assets of the estate.

33. Myers CJ considered that there was a sufficient connection between the interest and the Public Trust's income earning assets. Myers CJ considered that the borrowing "left the money so borrowed or its equivalent in capital assets".

34. Myers CJ says in this passage that the situation he was dealing with was equivalent to the situation where an estate had had the necessary money available in cash and had paid the duties with that cash, and had then found it necessary to borrow. His Honour viewed the situation as one where it was necessary to borrow, and not one where the taxpayer had a choice of methods to meet liabilities. His Honour referred again to this element of necessity in distinguishing *Ward and Co., Ltd. v Commissioner of Taxes* [1923] A.C. 145 and *Federal Commissioner of Taxation v Munro* (1926) 38 C.L.R. 153. Myers CJ said that unlike the facts of *Ward*, the death duties were not a voluntary debt. After discussing the *Munro* case, Myers CJ said at p. 454:

> Here, the death duties were not a voluntary debt. They were a debt of the estate, which was charged upon the estate, and which the trustee was compelled to pay. The Death Duties Act, 1923, authorizes him to borrow money upon the security of the assets of the estate in order to enable him to pay the duties. It was not therefore a voluntary expense incurred by the estate as the Privy Council held the payment in *Ward and Co.'s* case to have been. Here, also, the money was borrowed in order to prevent reduction of the income. The borrowed money was not employed, to quote the words of Isaacs, J. [in *Munro*], for purposes alien to or independent of the property, and, to use the language of Knox, C.J. the loan here *was* instrumental in or conducive to the production of the assessable income. It cannot be said that the debt was incurred for a purpose wholly unconnected with the production of the assessable income of the estate. On the contrary, it was incurred for the very purpose of maintaining the income of the estate and preventing its reduction.

35. The involuntary element in *Public Trustee* will be discussed later in this statement.

What is meant by the "use" of borrowed funds

36. Two of the most recent Court of Appeal judgments on the deductibility of interest, *Pacific Rendezvous* and *Brierley*, have held that the statutory provision is concerned with how the capital was used during the period in which the interest in question was incurred. The next issue is to understand what is meant by "use" in the context of interest deductibility.

37. In *Public Trustee* the borrowed funds were applied in payment of the death duties. The actual payment made with the funds was to the Crown in satisfaction of a death duties liability. It was argued that the funds were used to retain assets. The dissenting judge in *Public Trustee*, Northcroft J, had the following view about how the borrowed funds were used:

> … if money be borrowed to discharge a debt of the owner of the business which debt is otherwise unconnected with the business and if the alternative be a sale of business assets with a consequent diminution of profits, then, in my opinion, this would be capital employed in the payment of the debt and not in the production of income. The result would be the maintenance of income, but nevertheless, the employment of the capital would not be in the production of income but in the payment of the debt.

38. Northcroft J's view was not shared by the majority. The majority held that the capital was used in the payment of the debt and to retain assets. Callan J held that borrowed capital used in retaining assets is employed in the production of assessable income, just as capital used in acquiring assets is employed in the production of assessable income. Therefore, the case is authority that in identifying how borrowed funds are used as required by the statutory test, the use of funds will not only be the actual application, but will include the outcome of the application. This interpretation is consistent with the meaning of "use" in the *Concise Oxford Dictionary* (11th ed, Oxford University Press, 2004):

> **use** take, hold, or deploy as a means of achieving something.

39. This definition involves two aspects: deployment (i.e. application) and outcome. In the Commissioner's view, the majority in *Public Trustee* considered that "use" includes these dual aspects in the interest context. In *Public Trustee*, the funds were applied to pay death duties, but were held to be used in two ways—to pay the death duties and to retain assets forming part of the income earning activity.

40. A similar conclusion was reached in *Pacific Rendezvous*. In *Pacific Rendezvous*, the actual application of the funds was presumably payment to builders and other contractors for the construction of the assets. The use of the funds was held to be in acquiring assets for the motel business and in augmenting the company's capital.

41. Although there were differences in the facts in *Public Trustee* and *Pacific Rendezvous*, in that in one assets were retained and in the other assets were acquired, Richardson J in *Pacific Rendezvous* referred to funds being used in the production of assessable income in *Public Trustee*. The Court in *Pacific Rendezvous* considered that in both cases, the borrowed funds were used to derive assessable income.

42. In *Williams*, another case concerned with interest deductibility and retention of income earning assets, Barker J also stated this view, saying that payments made to retain assets are no different in principle to payments made to acquire assets.

Establishing the sufficient connection in *Public Trustee*

43. With this understanding of the meaning of "use" or "employment" in the context of interest deductibility (the outcome achieved by the application of the borrowed funds), the degree of the connection with income in *Public Trustee* will now be considered.

44. The statutory test requires a connection between the deriving of assessable income and the relevant interest. The courts have held that this connection must be of a sufficient strength (*Pacific Rendezvous*). When borrowings are used to fund income earning assets, the test is to consider whether there is a sufficient connection between assessable income derived from those assets and the interest incurred.

45. In the *Pacific Rendezvous* situation, it is true to say that, generally, application of funds to acquire assets which form part of the income earning activity or business means that the funds are used in that income earning activity or business. In most cases it will necessarily follow that the application of the borrowed funds connects those funds with the assessable income derived from the assets forming part of the income earning activity or business. Borrowed funds used directly on consumable items that contribute to the derivation of assessable income also have a direct connection with income. It is difficult to conceive of a stronger connection between borrowed funds and income earning assets than exists in these two situations.

46. In contrast, where a taxpayer argues that borrowed funds retain income earning assets, the sufficient connection required is not so easily established. The connection with assessable income, through retention of the assets, does not arise as a matter of necessity from the application of the borrowed funds. In the two New Zealand cases, *Public Trustee* and *Williams*, where the Courts have accepted that interest is deductible when borrowings retain income earning assets, certain factors were present which the Commissioner considers established the sufficient connection with assessable income in those cases. These factors are that:

    - the liability that the borrowed funds were used to discharge was involuntary; and
    - the taxpayer definitely would have realised particular income earning assets, had the taxpayer not borrowed; and
    - the liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

47. The Commissioner considers that where these factors are present, the borrowing retains particular income earning assets, and the sufficient connection

between the interest and assessable income is established. If the last two factors are established only to a certain extent, an apportionment or adjustment will be required. Each of these factors, and also apportionment and adjustments, are discussed further below.

Concurrent uses of borrowed funds

48. *Pacific Rendezvous* established that if borrowed funds are used in deriving assessable income, and the sufficient connection is established, it does not matter that the funds are also used to achieve a non-taxable outcome. In the Commissioner's opinion, this same reasoning applies to the *Public Trustee* situation. If the sufficient connection is established through the use of the borrowed funds, that connection is not lost if there is a second, non-income-related outcome. In *Public Trustee*, the two outcomes were the payment of death duties, and the retention of income earning assets.

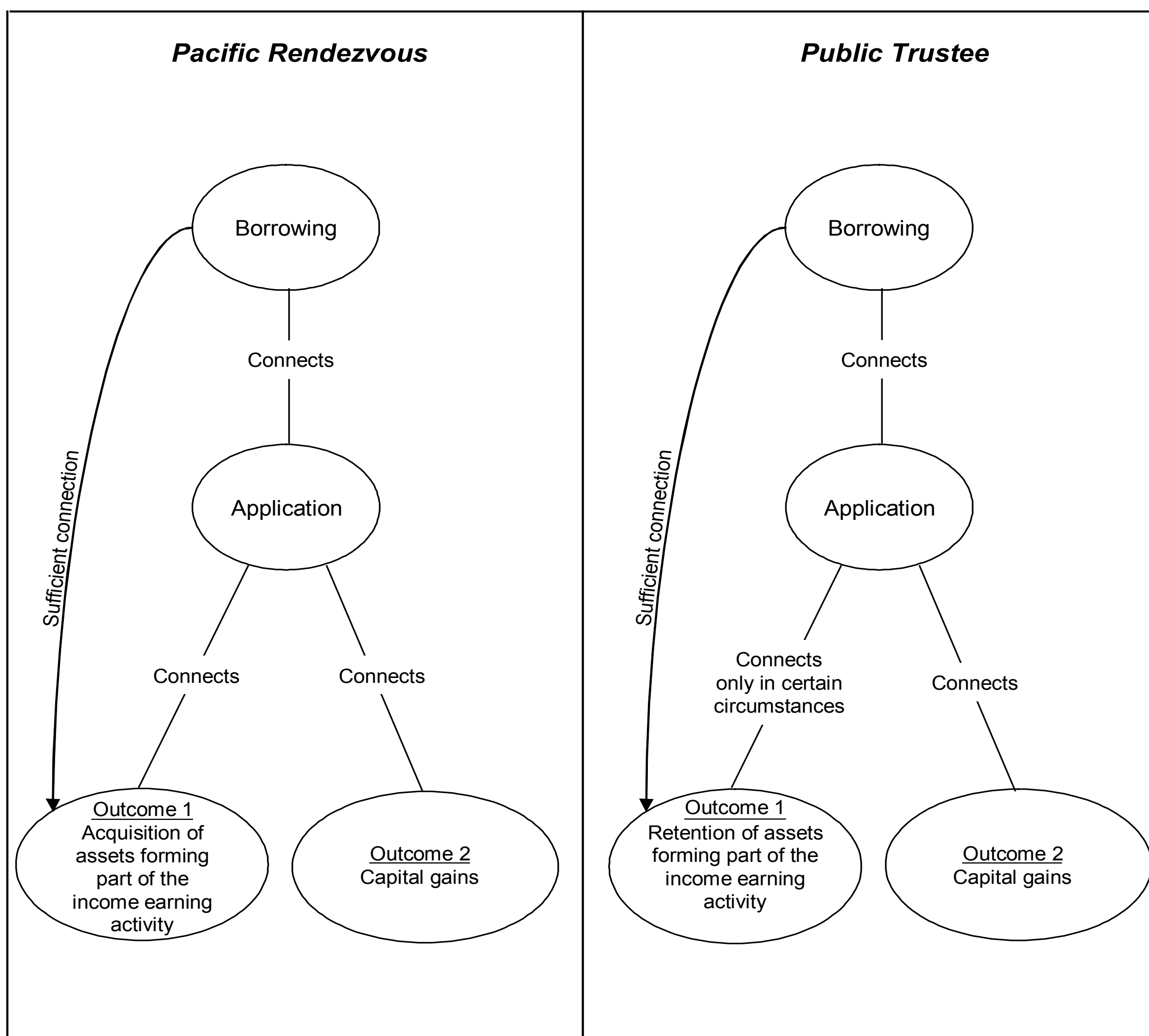
49. *Pacific Rendezvous* and *Public Trustee* are compared in the following diagram. The degree of connection in each case, and the concurrent outcomes can be seen.

Application of *Public Trustee* by the High Court

50. The decision in *Public Trustee* has been applied in two High Court cases in relation to whether interest is deductible.

Williams v CIR

51. In *Williams v CIR* the facts were that the taxpayer and his wife, who had been farming during their married life, had separated. The former wife registered a notice of claim under section 42 of the Matrimonial Property Act 1976 against the taxpayer's title to the farm. Eventually the parties entered into an agreement under section 21 of the Matrimonial Property Act. Section 21 enables spouses to contract out of the Matrimonial Property Act. The agreement in *Williams* was stated to be entered into in settlement of the litigation and provided for the division of matrimonial and separate property. The taxpayer was required to pay his ex-wife a lump sum, some of that within six weeks and the remainder after five years. The taxpayer borrowed to comply with the terms of the agreement.



52. Barker J held that the interest was deductible, on the grounds that the borrowing retained the income earning assets. In the Commissioner's opinion, the connection was sufficient because the liability was involuntary, the taxpayer would have sold the farm if he had not borrowed, and the liability arose in connection with the farming assets retained. The concurrent use of the money to meet the matrimonial claim did not affect this conclusion.

Borlase v CIR

53. *Public Trustee* was also applied in the High Court decision in *Borlase & Anor v Commissioner of Inland Revenue*. In that case, the husband and wife taxpayers moved from one city to another on account of the husband's work. They retained their former home, which was subject to a mortgage of $23,326, and let it. They bought a home in which to live in the second city for $185,000. They borrowed $208,000 to buy the home and to refinance the mortgage on their old home. The mortgage was secured over both properties. The taxpayers sought to deduct interest relating to both properties, arguing that by borrowing they retained their rental property.

54. Pankhurst J held that the funds were used to purchase a private dwelling. *Public Trustee* did not apply because, unlike *Public Trustee* and *Williams*, the requirement to pay and the amount of the payment were not involuntary because they were not external to and beyond the control of the taxpayer. Further, in the Commissioner's opinion, another factor contributing to the fact that the connection was not established was that the liability had not arisen in connection with income earning assets.

THE THREE FACTORS FROM *PUBLIC TRUSTEE*

55. When taxpayers argue that borrowings are made in order to retain income earning assets, the Commissioner's opinion is that a sufficient connection will be established and the interest on those borrowed funds will be deductible when:

- the liability that the borrowed funds were used to discharge was involuntary; and
- the taxpayer definitely would have realised income earning assets, if the taxpayer had not borrowed; and
- the liability arose in connection with the income earning assets retained.

Each of these three factors will now be discussed.

The first factor—the liability that the borrowed funds were used to discharge was involuntary

56. In *Public Trustee* the borrowed funds were used to pay death duties. Myers CJ said in *Public Trustee* that the circumstances he was dealing with were equivalent to those where an estate had had the necessary money available in cash, paid the duties with that cash, and then found it necessary to borrow. His Honour viewed the situation he was considering as one where it was necessary to borrow, and not one where the taxpayer had a choice of methods to meet liabilities. His Honour also referred to the involuntariness of the liability in distinguishing *Ward* and *Munro*.

57. In *Munro*, the Court had rejected the idea that because loans were secured over rent-producing property, the interest would be deductible, despite the fact that the loans were used for private purposes. Isaacs J concluded in *Munro* (p.197):

> But in employing the borrowed money for purposes independent of the property, leaving its condition entirely unaffected, that result cannot be postulated.

58. In *Public Trustee* Myers CJ quoted *Munro*, including the above statement of Isaacs J (*Public Trustee* at p 454), and italicised the quote as follows:

> The assessable income of the taxpayer was in *no way referable* to the transaction with the bank out of which the liability to pay interest arose, and the loan by the bank *was in no way instrumental in or conducive to the production of the assessable income* ...
>
> *The debt having been incurred for a purpose wholly unconnected with the production of assessable income of the respondent*, I think it impossible to say that the interest paid on the amount of the debt was money wholly and exclusively laid out or expended for the production of his assessable income.

59. Directly after this quotation, Myers CJ said:

> Here, the death duties were not a voluntary debt. They were a debt of the estate, which was charged upon the estate, and which the trustee was compelled to pay. The Death Duties Act, 1923, authorizes him to borrow money upon the security of the assets of the estate in order to enable him to pay the duties. It was not therefore a voluntary expense incurred by the estate as the Privy Council held the payment in *Ward and Co.'s case (supra)* to have been. Here, also, the money was borrowed in order to prevent reduction of the income. The borrowed money was not employed, to quote the words of *Isaacs* J., for purposes alien to or independent of the property, and, to use the language of *Knox* C.J., the loan here *was* instrumental in or conducive to the production of the assessable income. It cannot be said that the debt was incurred for a purpose wholly unconnected with the production of the assessable income of the estate. On the contrary, it was incurred for the very purpose of maintaining the income of the estate and preventing its reduction.

60. Myers CJ made the point that a crucial factor which differentiated the facts of *Public Trustee* from *Munro* was that the liability was involuntary. Unlike the taxpayer in *Munro*, the taxpayer in *Public Trustee* did not have any discretion over the fact of the liability arising and the amount of the liability. The fact that the debt was involuntary was a factor in concluding that but for the borrowing, the assets really would have been sold. In *Munro*, arguably the taxpayer could have arranged matters so that he was not faced with the choice of borrowing or selling, and further, it was only a possibility that the assets would be sold if the interest was not paid and the lenders consequentially exercised their rights over the assets.

61. Myers CJ also relied on the involuntary nature of the liability to distinguish the Privy Council decision in *Ward*. The fact that the liability was involuntary therefore formed part of Myers CJ's reasoning. Glazebrook and James[1] have argued that the reference to involuntariness was unnecessary, because the case was distinguishable on the basis that the expenditure was not incurred for the direct purpose of producing profits, so was not deductible under the general deductibility test that, at the time, required expenses to be exclusively incurred in deriving income. They say that the reference to involuntariness was merely a convenient means of distinguishing *Ward*. In the Commissioner's opinion, it was relevant in *Ward* that the expense was incurred voluntarily, because if it was, in the circumstances it was harder to say that it was exclusively incurred in deriving assessable income. The fact that the involuntary nature of the expense was relevant to the judgment in *Ward* made it relevant therefore in distinguishing *Ward* in *Public Trustee.* Myers CJ did in fact note the point from Callan J's judgment that the wording of the legislative test was different, and also that the nature of the expense in *Ward* was different than in *Public Trustee*, but despite these differences, his Honour still made a point of distinguishing *Ward*. *Ward* was concerned with expenditure aimed at preventing the destruction of the profit making thing—and so was *Public Trustee. Ward* was therefore relevant law.

62. The involuntary nature of the liability was seen as crucial by Pankhurst J in *Borlase* to the application of *Public Trustee*:

> [26] The case [*Public Trustee*] is now of course of long-standing [sic]. But in my view it is also well-settled that the involuntary nature of the expenditure (payment of death duties) is pivotal to the outcome. Significantly there have been very few cases since in which it has been accepted that some form of private expenditure was involuntary, such that income [sic] on borrowings against an income-producing asset were deductible in whole or in part. One such case is *Williams v C of IR* (1988) 10 NZTC 5,078 in which the taxpayer borrowed against the security of his farm (an income-producing asset) in order to settle his wife's matrimonial property claim. Given the involuntary nature of the payment, it was accepted that the funds were used to retain an income-producing asset, and hence the interest expense was deductible.

63. Keane DJ held in *Case L76* that *Public Trustee* did not apply, because the lack of discretion present in *Public Trustee* did not arise. The taxpayer in that case financed the purchase of a home with borrowings rather than break her short-term interest earning investments.

64. In the Australian case *Begg v FC of T* (1937) 4 ATD 257 the facts were similar to *Public Trustee* and it was also decided in the taxpayer's favour. It could be argued that involuntariness was not a decisive factor in this decision, but, on the other hand, the judge did find that the liability arose in a manner that was outside the taxpayer's control. The issue in *Begg* was whether interest paid on moneys borrowed by an executor to pay succession and estate duties and other outgoings for the general administration of the estate was deductible. Reed AJ said that the borrowing preserved the assets, and that there was a relation between the payment of the interest and the production of the assessable income. In coming to this conclusion, his Honour said that "the very circumstances under which [the executors] acquired the estate imposed a liability, the satisfaction of which would necessarily reduce that income". So because of this fact, the executors had no choice whether to incur the liability, or, in other words, it was involuntary. Also, it is notable that this case has been criticised and not applied in the later decisions of *Roberts and Smith* and *Hayden v FCT* (1996) 33 ATR 352.

65. In conclusion, although Myers CJ did not explicitly state involuntariness to be a factor in ensuring deductibility in the circumstances he was considering, his Honour relied on the fact that the expense was involuntary to distinguish *Ward* and *Munro* and spoke of borrowings that were necessary. The involuntariness of the liability was seen as a crucial factor in *Borlase* and *Case L76,* and was arguably present in Begg.

The Commissioner's opinion

66. In the Commissioner's view, the presence of the involuntary factor (along with the other two factors) means that the statutory test for deductibility is satisfied, because the connection with assessable income is stronger when the liability met is incurred involuntarily. The connection is strengthened because it is more likely that income earning assets would have been sold when there was no choice but to meet the liability. Therefore, in the circumstances, the borrowing retains income earning assets and prevents them from having to be sold.

[1] "*Taxation Implications of Company Law Reform*" by Susan Glazebrook and Jan James, New Zealand Journal of Taxation Law and Policy, Volume 1, pages 152 to 158.

What is meant by "involuntary"

67. Pankhurst J in *Borlase* discussed what was meant by an "involuntary" liability. His Honour held that the expenditure on a domestic house was discretionary, rather than voluntary. His Honour said:

> In both *Public Trustee* and *Williams* the requirement to pay, and the quantum of the payment at issue was truly external to and beyond the control of the taxpayer. The same cannot be said of the expenditure in this case.

68. Therefore, a liability will be involuntary if the taxpayer has no control over the circumstances of the liability arising and the quantum of the payment.

69. It might be argued that there was some possibility in *Williams* of the taxpayer being able to influence the amount of the settlement, and similarly in *Public Trustee* to mitigate the amount of the death duties. However, the extent of the taxpayer's control over the liability in both cases was limited. Pankhurst J in *Borlase* considered that the quantum of the liability in *Williams* was outside the control of the taxpayer. Any ability to negotiate the amount was not mentioned in *Williams* as a feature of the liability. Barker J describes the settlement process which involved competing claims from both parties following separation, negotiations through counsel and a settlement agreement made under section 21 of the Matrimonial Property Act. Given the statutory overlay and the formal nature of the settlement, the taxpayer had little scope to alter the amount of his liability. In *Public Trustee*, as the amount of the liability was based on the amount of the estate's assets at the time of death, a time before the taxpayer Trustee had control over the assets, any ability to alter the amount of the liability must be seen as limited. Pankhurst J considered the liability in *Public Trustee* to be involuntary and did not refer to any ability of the taxpayer to alter the amount. Therefore, the Commissioner considers that a liability will be involuntary in this context where the taxpayer has no control over the amount of the liability, or only very limited scope to negotiate the final amount of a liability, which has arisen involuntarily.

70. It may be that a future court would accept that a liability, though not involuntary to the degree just discussed, was still sufficiently involuntarily incurred so as to establish a sufficient connection with assessable income. A court may go further and hold that even in the absence of an involuntary liability, other circumstances establish that the borrowing prevents income earning assets from being sold so that the nexus with assessable income is established. The Commissioner will consider such situations on a case-by-case basis.

The second factor—the taxpayer definitely would have otherwise realised income earning assets

Case law

71. In *Public Trustee* Myers CJ found on the facts that the borrowing left the money in the estate and enabled the Trustee to maintain the income from the assets. In other words, if it had not borrowed it could not have maintained the income because it would have sold income earning assets. Callan J found on the facts that:

> … the payment of the duties with the borrowed money saved from sale an ascertainable portion of the tangible assets by the use of which the assessable income was produced.

72. Similarly in *Williams*, if the taxpayer had not borrowed he would have had to have sold income earning assets. Barker J in *Williams* stated the facts as follows, referring to the taxpayer's subjective intention:

> The objector was then faced with the necessity of raising money to comply with the terms of the agreement. He had no major asset, other than the farm; he did not want to sacrifice the farm at a giveaway price. In order to remain in farming, he eventually borrowed from a trust …

73. In these two cases, the facts were such that the Court could conclude that but for the borrowing, the taxpayer definitely would have realised income earning assets. The focus is on what the taxpayer actually would have done if the taxpayer had not borrowed.

The Commissioner's opinion

74. In the Commissioner's opinion, this factor is central to establishing a nexus when it is argued that borrowings are made in order to retain assets. When it is clear from the facts that the taxpayer definitely would have sold income earning assets if it had not borrowed, the Commissioner will treat the interest as deductible (assuming the other two factors are present i.e. the liability is involuntary and the liability arose in connection with the income earning assets retained). When it is less clear what the taxpayer would have done if it had not borrowed, the Commissioner may still form the view that interest is deductible, but will still need to be satisfied that the borrowings in fact had the effect of preventing income earning assets from being sold.

When can it be concluded that the taxpayer would have otherwise sold?

75. Establishing whether the taxpayer really would have realised the income earning assets involves considering the taxpayer's state of mind before the borrowing. This involves a consideration of

a hypothetical situation based on the taxpayer's intentions – what would this particular taxpayer have done if the funds had not been borrowed? Certain factual features will help to answer this question.

76. If the circumstances suggest that it was necessary or inevitable that the taxpayer would have otherwise realised income earning assets, for example, if the taxpayer only had income earning assets, it might be argued that an intention to have otherwise realised income earning assets is not necessary. However, the Commissioner's view is that in no situation is it certain from the objective facts alone that a taxpayer would have otherwise realised assets, because there is always the possibility that the taxpayer would have chosen not to pay the liability, or managed to obtain funds in some other way, had the taxpayer not borrowed.

77. It will be relevant to consider whether the taxpayer had actually formed a definite intention to realise income earning assets, had the funds not been borrowed. In some situations, a taxpayer may not have clearly formed a view of what would have been done if the borrowing had not taken place. There may have been some plan to realise income earning assets, but the taxpayer may not have put any thought into which option the taxpayer really would have taken if the funds had not been borrowed. If these are the facts, the taxpayer may not necessarily be able to satisfy the Commissioner that the requisite intention had been present to realise assets if the amount had not been borrowed.

78. It may be difficult from a practical perspective for a taxpayer to establish what the taxpayer had in mind immediately before the funds were borrowed. The practicality of testing a subjective intention was considered in *Grieve v C of IR* (1984) 6 NZTC 61,682. Although the context was different, it is considered that the same difficulty applied, so the Court's approach is relevant. Richardson J said in *Grieve*: "Now the existence of a bona fide intention is often tested or assessed having regard to objective factors such as the conduct of the person concerned." Therefore, in order to prove to the Commissioner's satisfaction that a taxpayer would have realised income earning assets, it will be appropriate to consider objective evidence to support a conclusion regarding the taxpayer's state of mind. Proof that the intention to realise income earning assets had been formed might be supported by documentation, and a past history of realising the type of income earning assets owned at the time of borrowing.

79. If a taxpayer had some income earning assets and some other assets (non-income earning assets or assets earning exempt income) at the time of borrowing, the taxpayer would have had several choices apart from realising income earning assets or borrowing. In that situation it may often be difficult for the taxpayer to provide objective evidence supportive of an intention to have otherwise realised income earning assets, particularly if cash is one of the non-income earning assets. In contrast, it might be easier for a taxpayer with only income earning assets at the time of borrowing to prove that the intention was to have otherwise realised income earning assets.

80. This element of *Public Trustee*—that the taxpayer definitely would have otherwise realised income earning assets if the taxpayer had not borrowed—may entail apportionment. Apportionment will be appropriate when:

- a taxpayer can satisfy the onus of proof only to a certain extent, that is, the taxpayer can prove only that some income earning assets definitely would have been realised if not for the borrowing, but cannot prove to the required standard that other income earning assets would have been realised; and
- a taxpayer borrows to retain both income earning and non-income earning assets; and
- a taxpayer would have otherwise realised income earning assets, but the amount realised would have been a lesser amount than the amount borrowed.

Apportionment is discussed further below.

Could the taxpayer in Public Trustee *have realised non-income producing assets?*

81. In *Public Trustee* the estate consisted partly of assets producing assessable income but principally of assets producing non-assessable income (p 445). The taxpayer had borrowed money to pay death duties that related not only to assets producing assessable income, but also to assets producing non-assessable income. The Commissioner and the taxpayer agreed that, if the Court found for the taxpayer, deductible interest would equal:

total interest x (assets producing assessable income/total assets)

82. The formula arrived at between the parties assumed that the taxpayer would have realised both income producing and non-income producing assets on a pro rata basis, and that interest would have been deductible on the basis of the proportion of income producing assets. On the basis of the formula, the Court assumed that some income earning assets definitely would have been realised, and the interest was deductible to the extent it related to those assets. Therefore, the Court did not need to consider which assets would be realised.

83. This formula was agreed to between the parties and was not sanctioned by the Court. The

Commissioner now considers that the taxpayer must show that particular income earning assets definitely would have otherwise been realised, and would no longer simply agree to a pro rata approach.

No assets to realise

84. *Public Trustee* applies when borrowings retain income earning assets and a sufficient connection with income derivation is established. In some instances, a taxpayer may not have sufficient value in income earning assets that could be retained through borrowing to meet a liability. The interest would not be deductible to the extent that the amount borrowed exceeded the value of the particular income earning assets retained. An example would be a business consultant whose only business assets comprise a computer, telephone, facsimile and furniture, who could not realise sufficient funds from the realisation of those items to meet a liability.

The third factor—the liability arose in connection with the income earning assets retained

85. The third factor that needs to be present is a liability that arises in connection with the income earning assets retained. In *Public Trustee*, Myers CJ noted that the liability was charged over the income earning assets (p 452):

> The question then is whether the money which was borrowed by the estate from the *Public Trustee* under special statutory authority and which was charged over the whole estate – i.e. the assets producing both assessable and non-assessable income alike – was employed "in the production of income". For the determination of this question the substance of the transaction must be regarded. The death duties were a charge on the whole estate.

86. Also, Myers CJ in *Public Trustee* distinguished *Munro* (where interest was held not to be deductible) on the basis that in *Munro* the liability was in no way referable to the income earning assets.

87. In *Williams*, the only other New Zealand case where a court has held that interest incurred in retaining income earning assets is deductible, the liability also arose in connection with the income earning assets. The liability represented the taxpayer's ex-wife's interest in the farm assets and was calculated with reference to the value of those assets.

88. Support for this view can also be found in *Begg*. *Begg*, discussed above, was the Australian case decided in the taxpayer's favour. In considering whether interest was deductible, the Court found that the liability arose in connection with the assets forming part of an estate. Reed AJ said:

> … the very circumstances under which [the executors] acquired the estate imposed a liability, the satisfaction of which would necessarily reduce that income.

The Commissioner's opinion

89. When the liability has arisen in connection with the income earning assets retained, the connection with assessable income is strengthened, because there is another link between the interest and the liability. This aspect of the connection is not as strong as it is in the *Pacific Rendezvous* situation, where the borrowings were applied directly to a liability that was the acquisition of income earning assets themselves. On the other hand, the connection is not as remote as it is in the situation where the liability does not relate at all to the income earning assets retained. There is no authority that the sufficient connection can be established in this latter scenario.

Apportionment relating to the third factor

90. Apportionment will be required when the factors that have been discussed are present only to a certain extent. Apportionments relating to the second factor were outlined above. An apportionment will be required in relation to the third factor if the liability met by the borrowed funds arose in connection with both income earning assets and non-income earning assets. This adjustment involves calculation of a ceiling, being the maximum deduction available.

How are assets valued?

91. The essence of the P*ublic Trustee* case is that interest on borrowings may be deductible if, in the circumstances, the borrowings retain income earning assets. To put it another way, the assets would have otherwise been realised but for the borrowing and the amount realised would have been used to meet the liability. The relevant value of the assets in considering the extent to which borrowed funds retain income earning assets is therefore the realisable value, less the costs of realisation, or in other words, the net realisable value.

Examples showing apportionment

92. The circumstances of a taxpayer's mix of assets and the valuation of the liability will affect the calculation of apportionment when applying the Commissioner's interpretation of *Public Trustee*, as the following examples illustrate.

Example 1—a mix of income and non-income earning assets

93. In this example, taxpayer A has both income earning and non-income earning assets. The income earning assets have a net realisable value

of $60 and the non-income earning assets have a net realisable value of $40. Taxpayer A borrows to fund an involuntary liability of $10. If Taxpayer A can prove that he would have otherwise realised only income earning assets to the required extent, the $10 liability would have been met out of the $60 obtained from the realisation of those assets, so all of the interest would be deductible.

94. If, instead, it can be established that he would have realised the non-income earning assets first, then the $10 liability would have been met out of the $40 obtained from non-income earning assets, and so none of the interest would be deductible.

95. If, on the facts, he would have realised some income earning and some non-income earning assets, then the interest deduction will be calculated according to those proportions.

96. If there is no convincing evidence that Taxpayer A definitely would have otherwise sold income earning assets, none of the interest will be deductible.

Example 2—how to calculate the deduction when the liability is only partially related to income earning assets and the taxpayer has a mix of income earning and non-income earning assets

97. In Example 1, it has been assumed that the liability arose in connection with the income earning assets. In some situations, the liability may be only partially related to income earning assets. If so, the deduction will be available only to the extent to which the liability arose in connection with the income earning assets. A taxpayer in this situation may have a mix of non-income earning and income earning assets. Two adjustments would be needed for such a taxpayer to calculate the deductible portion of the interest.

98. In Example 2, Taxpayer B faces a liability which is related to only 20% of her income earning assets. The interest will only be deductible to the extent that the liability arose in connection with income earning assets. The maximum deduction here would be 20%, as that portion is the extent to which the liability arose in connection with the income earning assets. Taxpayer B has income earning assets with a net realisable value of $60 and non-income earning assets with a net realisable value of $40.

99. As in Example 1, if Taxpayer B can prove she would have realised only income earning assets, the $10 liability would have otherwise been met out of the $60 received from the realisation of income earning assets, had Taxpayer B not borrowed. However, although 100% of the retained assets are income earning assets, only 20% of the interest would be deductible because it relates to income earning assets only to that extent.

100. If, instead, Taxpayer B would have realised the non-income earning assets first, none of the interest would be deductible, and, if Taxpayer B would have realised some income earning and some non-income earning assets, then the interest deduction will be calculated according to those proportions, but to a maximum of 20%.

101. If there is no convincing evidence that Taxpayer B definitely would have otherwise sold income earning assets, none of the interest will be deductible.

SITUATIONS FALLING OUTSIDE THE THREE FACTORS

102. The general test is that interest will be deductible when there is a sufficient connection between the interest and assessable income. When it has been argued that interest is deductible where borrowings retain income earning assets, the Courts have so far decided that interest is deductible when the three factors have been present (*Public Trustee* and *Williams*) and have held that it is not deductible when the factors are not present (see for example *Borlase* and *Case S87* (1995) 17 NZTC 7,545). When the three factors are present, the Commissioner considers interest is deductible, and so taxpayers can have certainty about how Inland Revenue will apply the law.

103. However, it is acknowledged that there may be situations where the sufficient connection is met where not all of the three factors are present. Inland Revenue will consider deductibility in situations falling outside the three factors on a case-by-case basis. In considering these situations, Inland Revenue will be asking whether the nexus between earning assessable income and the application of the borrowed funds is sufficient. That is, whether the degree of connection between interest and assessable income approaches the degree present in the facts of *Public Trustee* and *Williams*, or whether the degree of connection is closer to the facts in, for example, *Borlase*, *Case L76* or *Case S87*. In asking this question, a guiding principle will be whether the borrowing does in fact have the effect of preventing income earning assets from being sold. In the Commissioner's opinion, this consideration reflects the broad principle underlying the approaches of the Courts that have accepted interest is deductible when borrowings retain assets. It will also be relevant to consider other elements that establish a connection with assessable income. An example of another element that may contribute to a connection with assessable income is a connection between the liability met by the borrowed funds and the income earning assets.

PART 3 – FURTHER BACKGROUND AND OTHER APPROACHES CONSIDERED

The floodgates argument

104. The Commissioner's approach to interpreting the cases in this area is not governed by a concern that a wide interpretation would "open the floodgates" and therefore mean that, in the Commissioner's eyes, too much interest would be deductible. This suggestion had previously been made about an earlier view expressed in the area of interest deductibility. Rather, the Commissioner's view is based on applying the statutory words as they have been interpreted by the Courts. Interest is only deductible if a sufficient connection can be established, and the use of the words "to the extent that" in the statutory provision indicates that it was assumed that certain interest would not meet this test and apportionment of non-deductible interest would be appropriate in some circumstances.

Difficulties in satisfying the test

105. This statement has outlined the factors that need to be present if the taxpayer is to be certain that the Commissioner will agree that interest is deductible when applying the *Public Trustee* case. In some circumstances it may be difficult for practical reasons for taxpayers to satisfy the Commissioner that these factors are present. It could also be said that the situations where the three factors are present may be limited. However, in the Commissioner's view, the Courts have only accepted that interest is deductible when *Public Trustee* is argued if these factors have been present. Further, as has been pointed out, the Commissioner may agree that interest is deductible when the three factors are not present, if the taxpayer can establish that there is a sufficient connection between interest and the taxpayer's assessable income.

106. The compliance problems are not relevant to all taxpayers. This area of case law will generally not apply to company taxpayers because interest incurred by companies is in most cases deductible without the necessity of satisfying the nexus test. The rules applying to companies are discussed earlier in this statement and in *Tax Information Bulletin* Vol 13, No 11 (November 2001).

107. Finally, it should be noted that any practical considerations relate to what is only a secondary test of deductibility. If interest has a connection with assessable income through the borrowed funds being used to acquire income earning assets or otherwise through a direct use in an income earning activity or business, there is no need to rely on *Public Trustee* and any practical considerations relating to that case do not arise.

More restrictive approach in other jurisdictions

108. The Commissioner's approach discussed in this statement permits greater deductibility than would apply in some other comparative jurisdictions. The judicial trend overseas has been to deny deductions when retention of assets is argued. In the Australian Full Federal Court decision in *Roberts* and *Smith*, Hill J referred to *Begg* as a "difficult case" and said:

> The case has stood for a long time and the present is not an appropriate occasion to consider its correctness. There may, however, be thought to be some difficulties in reconciling what was said there with the decision of the High Court in Munro.

109. Hill J's opinion was therefore that there was an insufficient nexus with assessable income in *Begg*.

110. In *Hayden v FCT* (1996) 33 ATR 352 the Federal Court did not apply *Begg* and did not consider that there was a principle that borrowing may retain income earning assets. The taxpayer was the executor of a deceased estate. As a result of an action by the testator's son, the Supreme Court made an order that provision be made out of the estate for the testator's son of the amount of $150,000. The liability was therefore incurred involuntarily. The executor borrowed the amount and paid it to the son. A factor influencing her decision to borrow was to avoid selling two properties and so carry out the testator's wish to preserve the properties for the ultimate use of a religious organisation.

111. The taxpayer argued that the interest was incurred to satisfy the order so as to maintain the income earning assets of the estate. Spender J in the Federal Court rejected this argument, and held that the focus must be on the use to which the borrowed funds are put. His Honour discussed *Public Trustee* and *Begg*, noting that both decisions were factually similar to the one he was concerned with. His Honour found himself unable to reconcile *Public Trustee* and *Begg* with the decision in *Munro*.

112. Canadian authorities have generally been decided on the basis that for interest to be deductible, borrowed funds must be directly used in producing income. In The *Queen v Phyllis Bronfman Trust* [1987] 1 CTC 117, a decision of the Supreme Court, the trustees borrowed to make distributions to the beneficiary of the trust rather than realise assets. The Chief Justice held that the courts could not ignore the direct use of the borrowed funds. The direct use of the funds was to make capital allocations to the beneficiaries, a use that earned the trust no income. The decision in *Bronfman* was followed in the Canadian Federal Court in *74712 Alberta Ltd v Minister of National Revenue* [1997] 2 C.T.C. 30. The taxpayer in *74712 Alberta* borrowed to pay a guarantee in respect of its parent companies' debt obligations. The Court applied

Bronfman Trust, deciding that the interest was not incurred for the purpose of earning income and was not deductible.

113. The decisions in *Bronfman* and *Alberta* limited the application of the decision in *Trans-Prairie Pipelines Ltd. v MNR* [1920] CTC 537. In *Trans-Prairie* the taxpayer issued debentures and used the money to redeem preference shares. The Exchequer Court held that although the direct use of the money was to return amounts to preference shareholders, the interest was deductible because the money borrowed through the debentures had the effect of filling the hole left by the amount that was returned to the shareholders. Therefore, the borrowed funds were used for the purpose of earning income. In the Tax Court decision in *Chase Manhattan Bank of Canada v R* [1997] 2 CTC 3097, McArthur T.C.J. held that following the decisions in *Bronfman* and *74712 Alberta, Trans-Prairie* "has been confined to its own special circumstances".

114. The Canada Customs and Revenue Agency has a practice of allowing indirect interest deductions in a limited range of situations. These situations, such as money borrowed to redeem shares, are seen as a class of arrangements where borrowed money replaces funds in a business. The CCRA does not recognise retention of income earning assets as a principle of deductibility.

Use of money interest

115. This statement has its origins in two issues papers issued by the Public Rulings Unit on interest deductibility issues. The second of these issues papers, IRRUIP 5, discussed the issue of the deductibility of use-of-money interest. The issue of the deductibility of use-of-money interest is not considered in this statement. The Commissioner intends to consider whether to publish a view on the deductibility of use-of-money interest in a separate statement or statements.

Reasons for rejecting other analyses

116. In reaching the conclusions in this statement, the Commissioner has considered and rejected arguments for other analyses of the cases. These will now be briefly outlined.

Argument 1—Pacific Rendezvous and Public Trustee are distinguishable

117. In IRRUIP 5 the Commissioner expressed the view that the situation in *Public Trustee* is different in nature from that in *Pacific Rendezvous*, because in *Public Trustee* the connection with assessable income was indirect, and not direct as it was in *Pacific Rendezvous*. In *Pacific Rendezvous* there were two direct outcomes arising from the application of the borrowed funds—the receipt of assessable income and the receipt of capital gains. In contrast, in *Public Trustee* arguably only one outcome arose directly from the application of the funds, and that outcome was not related to assessable income. The other outcome, which was related to assessable income, arose only indirectly from the application of the funds. Therefore, it can be argued that the cases are precedents for two quite different principles.

118. Applying this analysis in IRRUIP 5, it was suggested that in the *Public Trustee* situation, certain factors will need to be present to make a sufficient connection with assessable income (which view the Commissioner also takes in this statement). The point of difference with this statement is the argument that as the two cases can be seen as standing for two distinct principles, the private prohibition applies differently to each. The argument was that under the *Public Trustee* principle, a deduction could never be taken for interest where the direct application of the funds is for private use. This was because under the statutory scheme, the prohibition against deductions for private expenditure applies even though the permissive provision in section DD 1 is satisfied. The principle from *Pacific Rendezvous* that a second non-income related use does not invalidate a connection with assessable income does not apply to this situation because that case is distinguishable. The result also could be argued to be consistent with the intention of the Act to tax income, and to prohibit deductions of a private nature.

119. The problem with this approach is that there is a strong argument that there is no conceptual difference between *Public Trustee* and *Pacific Rendezvous*. In both cases the funds were used in an income earning activity or business, and the second non-income producing use was achieved simultaneously with the use connected with income. Although the connection with assessable income in the *Public Trustee* scenario is indirect, once the sufficient connection is established, through the involuntariness of the liability, the fact that the taxpayer definitely would have otherwise realised income earning assets and the fact that the liability arose in connection with the assets, the situation would seem then to be analogous to *Pacific Rendezvous*. Any simultaneous use, although not related to assessable income, should not require an apportionment.

120. Further, the approach would seem to be inconsistent with the decision in *Williams*. In *Williams* a deduction was available even though one use of the funds—to fund a matrimonial claim—appeared to be private in nature.

Argument 2—*Pacific Rendezvous *and* Brierley *are wrong; other cases suggest apportionment

121. Another approach would be to apply the private prohibition in both the *Public Trustee* and *Pacific*

Rendezvous situations, and to view the decisions in *Pacific Rendezvous* and *Brierley* as wrong or misunderstood on this point. Arguably, an apportionment should be made when borrowed funds are used to some extent for a use that is a prohibited deduction. *Ronpibon Tin NL v FC of T; Tongkah NL v FC of T* (1949) 78 CLR 47 at p 59), approved in *Banks* and *Buckley & Young*, arguably supports the proposition that apportionment is required not only when expenditure can be divided between a part related exclusively to income and a part related exclusively to something other than income (a "time and space apportionment"). The Court in *Ronpibon Tin* considered that apportionment is required not only when the expenditure can be divided on a time and space basis, but also when the expenditure serves two outcomes indifferently.

122. In *Pacific Rendezvous*, Richardson J appeared to consider the only issue was whether a time and space apportionment was appropriate. It could be argued that the question of whether an apportionment should be made for expenditure which serves both income earning and other purposes indifferently was not sufficiently appreciated in *Pacific Rendezvous*. Arguably it was open to the Court to apply the principle from *Ronpibon Tin* and require an apportionment. The expenditure in Pacific Rendezvous can be seen as expenditure which served both income earning and other purposes indifferently. In contrast to *Pacific Rendezvous*, in *Public Trustee*, the Court treated the expenditure as achieving both income-related and non-income related outcomes indifferently and the interest was apportioned.

123. However, the Commissioner's view is that despite possible contrary indications in *Ronpibon*, *Banks* and *Buckley & Young*, the law on interest deductibility in New Zealand seems settled on this point. In two authoritative cases—*Pacific Rendezvous* and *Brierley*—the Court of Appeal has given the view that an apportionment is not required when borrowed funds are all used in an income earning activity, despite co-existing advantages.

Argument 3—special nature of capital

124. A third possible approach also assumes that the private prohibition applies in both the *Pacific Rendezvous* and the *Public Trustee* situations. The argument is that the private prohibition would have applied in *Pacific Rendezvous* if the non-income use had been a private one. Similarly it could be argued that the private prohibition would have applied in *Public Trustee*, had it existed at that time. The private prohibition was introduced into the Land and Income Tax Act 1954 in 1968. The issue before the Court in *Public Trustee* was whether the deduction should be denied for a lack of connection with assessable income, not whether it was private in nature. Also, had the prohibition applied, on the facts of *Public Trustee*, it could have been argued that the payment of death duties by a trustee is not a private use of funds.

125. This argument is that it was the nature of the non-income use of borrowed funds in *Pacific Rendezvous*, and in *Brierley*, that meant that an apportionment was not required. This use of the borrowed funds in *Pacific Rendezvous* and *Brierley* was to achieve a capital gain. In *Brierley*, Richardson J recognised that it could be said that an asset is always employed in the production of both assessable income and prospective capital benefits. His Honour said that it would be contrary to the capital/revenue distinction and the scheme of the Act, to refuse a deduction for an assumed capital element of interest. Similarly, Cooke J said in *Pacific Rendezvous* that in applying funds, "often a taxpayer would not be prudent to have regard for income only; capital appreciation is commonly an important consideration". It could be argued that when funds are used for two uses, and one of those is private, such private use is not intrinsically linked with the use of the funds in the income earning activity as capital gains are, and therefore the interest should be apportioned.

126. However, Richardson J in *Pacific Rendezvous* stated a broader principle, and did not refer to the nature of the non-income outcome. His Honour said that interest is deductible if the borrowed capital was all used in the income earning activity. His Honour did not qualify this statement by adding that in contrast, the deduction would have been apportioned if the second use had instead been a use that was not a capital one. Richardson and Cooke JJ said that the test is simply to examine the use of the borrowed funds, and if all of the funds are used in an income earning activity, then the interest is deductible. Although Cooke J went on to explain this in terms of the intrinsic link between interest and capital, it is not clear that his Honour was intending to limit non-deductibility to joint income/capital outcomes. On balance, it is considered that the better view is that *Pacific Rendezvous* stands for this wider principle.

Argument 4—the deductibility test provides for a wide range of deductions

127. Another potential approach is to view the general permission in section DA 1 as broad enough to apply to interest incurred in respect of expenditure not directly connected with the income earning activity, without the need to apply *Public Trustee.* An example is interest incurred on money borrowed to pay tax. This argument was more obvious under a previous wording of the deductibility provision, which specifically provided for deductions necessarily incurred in carrying on a business for the purpose of deriving gross income. However, the cases have held that the "necessarily incurred in

carrying on a business" test is, like the more general test, concerned with the relationship between an expense and the income earning activity. The connection with assessable income must be sufficient for expenditure, including interest, to be deductible.

128. In the example of borrowing to pay tax, a payment of tax might be a transaction typical of a business, but it is not part of the carrying on of the income earning activity or business. Interest incurred on money borrowed and used for such transactions is not sufficiently connected with assessable income merely on the basis that these are business transactions. Payment of tax is a payment made after income has been derived. In *Smiths' Potato Crisps (1929) Ltd v IR*. [1948] AC 508, Lord Normand said at pp 529-530 "... income tax is an impost made upon profits after they have been earned, and ... a payment out of profits after they have been earned is not within the purposes of the trade carried on by the taxpayer."

Comparison with the Commissioner's previous statements

***Issues paper* - IRRUIP 5 (2001)**

129. IRRUIP 5 was published to replace IRRUIP 3. The conclusions in IRRUIP 5, and the reasons why the Commissioner has departed from that view, have already been outlined under the heading "Argument 1- *Pacific Rendezvous* and *Public Trustee* are distinguishable". In summary, the view put forward in IRRUIP 5 was that *Public Trustee* was fundamentally different from *Pacific Rendezvous*, and that the private prohibition in section BD 2 prevents a deduction of interest where the direct application of the funds is a private use. The Commissioner now considers that the two cases are analogous in this regard as in both cases the borrowed funds were used in relation to assessable income. The Commissioner considers that in the circumstances of both cases the private prohibition will not prevent a deduction if the borrowed funds are used to acquire or retain income earning assets. Another difference is the Commissioner's view of the circumstances in which the sufficient connection is met. The Commissioner's view is now that *Public Trustee* will apply if the liability met by the borrowed funds was involuntary, to the extent to which the taxpayer can prove that the taxpayer definitely would have otherwise realised particular income earning assets to meet the liability, and to the extent to which the liability arose in connection with the income earning assets. The Commissioner may take the view that interest is deductible in situations when these three factors are not present, if the nexus is sufficient. In considering whether the nexus is sufficient, the Commissioner will consider whether, in the circumstances, the borrowing has the effect of preventing a realisation of income earning assets.

130. IRRUIP 5 also dealt with deductibility issues arising from the decision in *Roberts* and *Smith*. The Commissioner's intention is that these issues will now be dealt with in a separate statement or statements. IRRUIP 5 should not be relied upon as stating the Commissioner's current view in relation to interest deductibility issues.

***Tax Information Bulletin* Vol 3, No 9 (June 1992)**

131. In TIB Vol 3, No 9 the Commissioner's view of the *Public Trustee* decision was stated to be as follows:

> Interest is deductible if a taxpayer establishes that the capital was borrowed to meet involuntary expenditure to retain assets used in producing assessable income. However, if the capital was borrowed for purposes quite alien from the income producing asset (such as meeting personal obligations), the interest will not be deductible. The onus is on the taxpayer to establish that the interest is deductible, and what portion of it is deductible.

132. The view in the TIB is that the liability must be involuntary, and that the liability met with the borrowed funds must not be "alien" from the income producing assets, or, in other words, must be connected in some way with the income earning assets. In these respects, the view in the TIB and the view in this statement are similar. This statement analyses in more depth when borrowing retains income earning assets, and concludes that for assets to be retained, the taxpayer must at least prove that the borrowing prevented a realisation of income earning assets. Also, the Commissioner has clarified that a private use of the funds will not on its own prevent a deduction of the interest, and, that in such a situation, interest may be deductible if there is another use of the borrowed funds that has a sufficient connection with assessable income to establish deductibility.

133. The item in TIB Vol 3, No 9, to the extent that it relates to *Public Trustee*, is replaced by this statement.

PART 4 – CONCLUSIONS

Establishing the sufficient connection – acquiring and retaining

134. The test of interest deductibility is whether there is a sufficient connection between the interest incurred and the income earning activity or business. This connection is established and interest will be deductible if the borrowed funds are used in an income earning activity or business. "Used" or "employed" refers to the outcomes achieved by the application of the borrowed funds.

135. Funds are used in an income earning activity or business if they are used to acquire assets or otherwise directly in that activity or business, or to retain assets which form part of that activity or business.

136. When funds are applied to acquire income earning assets, that acquisition has a direct link with the income derivation activity and the connection with the income earning activity or business is established. In contrast, when funds retain assets, the application of the funds—to pay death duties, to settle a matrimonial obligation, or to buy a private house, for example—does not necessarily contribute to the income earning activity business without further facts being present.

The Commissioner's opinion on when interest will be deductible when income earning assets are retained

137. The Commissioner will be satisfied that a sufficient nexus with assessable income is established where the borrowing retains income earning assets if the taxpayer can establish that:

- the liability that the borrowed funds were used to discharge was involuntary; and
- the taxpayer definitely would have realised particular income earning assets, if the taxpayer had not borrowed; and
- the liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

138. This interpretation of *Public Trustee* is consistent with the High Court decisions in *Williams* and *Borlase*.

139. When the three factors are present, taxpayers have certainty about how the Commissioner will apply the law.

Situations falling outside the three factors

140. Inland Revenue will consider situations falling outside the three factors on a case-by-case basis. In each case Inland Revenue will be considering whether the nexus between interest and assessable income is sufficient. That is, whether the degree of connection between interest and assessable income approaches the degree present in the facts of *Public Trustee* and *Williams*, or whether the degree of connection is closer to the facts in, for example, *Borlase*, *Case L76* or *Case S87*. In asking this question, it will be relevant to consider:

- whether the borrowing does in fact have the effect of preventing income earning assets from being sold, and
- other elements that establish a connection with assessable income.

Concurrent non-income earning use

141. When borrowed funds are used to retain income earning assets, a concurrent non-income earning use of the funds will not on its own prevent a deduction of the interest (*Pacific Rendezvous, Borlase*, and *Williams*).

The involuntary factor

142. Myers CJ stated that the borrowing in *Public Trustee* had been necessary and relied on the fact that the liability was involuntary to distinguish *Ward* and *Munro*. Pankhurst J in *Borlase* stated that the involuntary nature of the liability is an essential element of the *Public Trustee* test. The fact of a liability being involuntary contributes to the formation of a sufficient connection with assessable income, and is therefore consistent with the statutory test.

143. A liability is involuntary if the requirement to pay, and the quantum, is external to and beyond the control of the taxpayer (*Borlase*).

Apportionment

144. Apportionment is appropriate when applying *Public Trustee* to reflect the extent to which:

- a taxpayer can satisfy the onus of proof;
- the borrowing retains non-income producing assets;
- the amount otherwise realised from the income earning assets would have been a lesser amount than the amount borrowed.

145. In addition, an adjustment may be required to reflect the extent to which the liability arose in connection with income earning assets.

LEGISLATION AND DETERMINATIONS

This section of the TIB covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK DETERMINATION 2006

This determination may be cited as "The National Average Market Values of Specified Livestock Determination, 2006".

This determination is made in terms of section EC 15 of the Income Tax Act 2004 and shall apply to specified livestock on hand at the end of the 2005-2006 income year.

For the purposes of section EC 15 of the Income Tax Act 2004 the national average market values of specified livestock, for the 2005-2006 income year, are as set out in the following table.

National Average Market Values of Specified Livestock

Type of Livestock	Classes of Livestock	Average Market Value per Head
		$
Sheep		
	Ewe hoggets	58.00
	Ram and wether hoggets	48.00
	Two-tooth ewes	87.00
	Mixed-age ewes (rising three-year and four-year old ewes)	77.00
	Rising five-year and older ewes	57.00
	Mixed-age wethers	39.00
	Breeding rams	172.00
Beef cattle		
	Beef breeds and beef crosses:	
	Rising one-year heifers	402.00
	Rising two-year heifers	626.00
	Mixed-age cows	753.00
	Rising one-year steers and bulls	497.00
	Rising two-year steers and bulls	712.00
	Rising three-year and older steers and bulls	856.00
	Breeding bulls	1645.00
Dairy cattle		
	Friesian and related breeds:	
	Rising one-year heifers	562.00
	Rising two-year heifers	1037.00
	Mixed-age cows	1187.00
	Rising one-year steers and bulls	419.00
	Rising two-year steers and bulls	665.00
	Rising three-year and older steers and bulls	850.00
	Breeding bulls	1126.00
	Jersey and other dairy cattle:	
	Rising one-year heifers	482.00
	Rising two-year heifers	956.00
	Mixed-age cows	1128.00
	Rising one-year steers and bulls	292.00
	Rising two-year and older steers and bulls	529.00
	Breeding bulls	867.00

Type of Livestock	Classes of Livestock	Average Market Value per Head
		$
Deer		
	Red deer:	
	Rising one-year hinds	78.00
	Rising two-year hinds	172.00
	Mixed-age hinds	191.00
	Rising one-year stags	109.00
	Rising two-year and older stags (non-breeding)	197.00
	Breeding stags	968.00
	Wapiti, elk, and related crossbreeds:	
	Rising one-year hinds	99.00
	Rising two-year hinds	195.00
	Mixed-age hinds	220.00
	Rising one-year stags	129.00
	Rising two-year and older stags (non-breeding)	229.00
	Breeding stags	930.00
	Other breeds	
	Rising one-year hinds	42.00
	Rising two-year hinds	82.00
	Mixed-age hinds	109.00
	Rising one-year stags	57.00
	Rising two-year and older stags (non-breeding)	111.00
	Breeding stags	251.00
Goats		
	Angora and angora crosses (mohair producing):	
	Rising one-year does	32.00
	Mixed-age does	50.00
	Rising one-year bucks (non-breeding)/wethers	30.00
	Bucks (non-breeding)/wethers over one year	35.00
	Breeding bucks	103.00
	Other fibre and meat producing goats (Cashmere or Cashgora producing):	
	Rising one-year does	32.00
	Mixed-age does	45.00
	Rising one-year bucks (non-breeding)/wethers	27.00
	Bucks (non-breeding)/wethers over one year	33.00
	Breeding bucks	88.00
	Milking (dairy) goats:	
	Rising one-year does	170.00
	Does over one year	250.00
	Breeding bucks	300.00
	Other dairy goats	25.00
Pigs		
	Breeding sows less than one year of age	228.00
	Breeding sows over one year of age	258.00
	Breeding boars	286.00
	Weaners less than 10 weeks of age (excluding sucklings)	60.00
	Growing pigs 10 to 17 weeks of age (porkers and baconers)	103.00
	Growing pigs over 17 weeks of age (baconers)	147.00

This determination is signed by me on the 24th day of May 2006.

Martin Smith
Chief Tax Counsel

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.

REDUCTION OF SHORTFALL PENALTIES FOR PREVIOUS BEHAVIOUR SPS 06/03

Introduction

1. This Standard Practice Statement (SPS) sets out Inland Revenue's practice for reducing shortfall penalties for previous behaviour.

2. In particular, this SPS discusses the reduction for previous behaviour of:

   (a) shortfall penalties imposed for evasion under section 141E(1), and

   (b) other shortfall penalties imposed under any of sections 141A to 141D.

Contents

3. Set out below are the headings of key issues discussed in this SPS:

Heading	Paragraph number
Introduction	1 to 2
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Discussion	
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Disqualifying penalty	50 to 52
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Application

4. This SPS sets out Inland Revenue's position on the application of the law in this area.

5. The SPS applies to shortfall penalties imposed on or after 21 December 2004.

6. This SPS replaces SPS *INV 295 Reduction of Shortfall Penalties for Previous Behaviour* originally published in *Tax Information Bulletin* Vol 16, No 3 (April 2004). SPS *INV 295* applies to shortfall penalties imposed before 21 December 2004.

7. Please refer to the following SPSs:

   - *INV 251 Voluntary Disclosures*,
   - *INV 260 Notification of a Pending Audit or Investigation*, and

   the following Interpretation Statements:

   - *IS0053 Shortfall penalty for not taking reasonable care*,
   - *IS0055 Shortfall penalty – unacceptable interpretation and unacceptable tax position*,
   - *IS0060 Shortfall penalty for gross carelessness*, and
   - *IS0061 Shortfall penalty for taking an abusive tax position*,

   for further details on Inland Revenue's practice on imposing and reducing shortfall penalties. These statements were published in *Tax Information Bulletins* and are available on Inland Revenue's website, **www.ird.govt.nz**. SPS *INV 260* has expired, but still generally indicates current practice.

8. Unless specified otherwise, all legislative references in this SPS refer to the Tax Administration Act 1994 (TAA).

9. For the purpose of this SPS, the term "current penalty" refers to the shortfall penalty for which a previous behaviour reduction under section 141FB is being considered.

10. The term "satisfactory behaviour period", as used in this SPS, is not defined in the TAA but refers to the specified period under section 141FB(4) for the purpose of the definitions of "disqualifying offence" (ie an offence under sections 143 and 144) and "disqualifying penalty" (ie where the current penalty is not imposed for evasion under section 141E(1)). The term "satisfactory behaviour period" and the legislative terms "disqualifying offence" and "disqualifying penalty" will be discussed later in the SPS.

11. All taxpayers start with a "clean slate" for the purpose of section 141FB. If a taxpayer has had a shortfall penalty imposed or a conviction entered before 26 March 2003 (when section 141FB was originally enacted), that penalty or conviction is not taken into account in determining whether a current penalty will be reduced for previous behaviour.

Summary

12. Inland Revenue reduces a current penalty under section 141FB(1) or (2) for previous behaviour depending on the type of shortfall penalty.

13. Pursuant to section 141FB(1) and (2), the current penalty will be reduced by 50% if the taxpayer is not:

    (a) convicted of a "disqualifying offence", and/or

    (b) liable for a "disqualifying penalty".

14. Generally, section 141FB applies separately to each tax type, such as PAYE, income tax and fringe benefit tax (FBT).

15. However, if the taxpayer is convicted of a "disqualifying offence" pursuant to paragraph (a) of that term's definition in section 141FB(3), then a later shortfall penalty for any tax type cannot be reduced by 50%. The "satisfactory behaviour period" does not apply (see paragraphs 38 to 40 of this SPS for details).

16. Where a taxpayer is liable to pay a current penalty for evasion imposed under section 141E(1) and the penalty is not reduced for voluntary disclosure, any later shortfall penalty for evasion for the same tax type cannot be reduced by 50% under section 141FB(1). The "satisfactory behaviour period" does not apply in these cases (see paragraphs 44 to 45 of this SPS for details).

17. Nevertheless, a shortfall penalty that is reduced for voluntary disclosure is not a "disqualifying penalty". It will not affect the taxpayer's eligibility to the 50% reduction of any later shortfall penalty imposed.

18. For the purpose of section 141FB(2), when separate current penalties are imposed under any of sections 141A to 141D for different tax shortfalls identified in the same investigation or voluntary disclosure, each penalty will be treated as if the taxpayer was not liable for the other penalty provided the taxpayer:

    (a) takes both tax positions on the same date, and/or

    (b) is not liable for a shortfall penalty during the "satisfactory behaviour period" (as defined in paragraph 38 of this SPS) that ends on the earliest date on which the taxpayer takes the tax position relating to the tax shortfall.

Background

19. The August 2001 discussion document titled *Taxpayer compliance, standards and penalties*: *a review* (the discussion document) identified the following benefits from applying the previous behaviour reduction provision to all current penalties:

    (a) Taxpayers perceive those taxpayers who repeatedly offend to be more harshly penalised, reflecting their failure to begin complying voluntarily.

    (b) A concern that the shortfall penalty rates are excessive is addressed. (Especially in relation to voluntary disclosures where the rules are seen as penalising taxpayers who are attempting to comply.)

    (c) The shortfall penalty rate for first time evasion is aligned with the evasion rate in Australia and Canada.

20. Section 141FB was originally enacted to implement the recommendations outlined in the discussion document including that a taxpayer's past compliance should be taken into account when imposing shortfall penalties.

21. Since the publication of SPS *INV 295 Reduction of Shortfall Penalties for Previous Behaviour*, section 141FB has been amended in respect of shortfall penalties imposed on or after 21 December 2004.

22. The new section 141FB contains a policy change in that offences under sections 143 to 145 are now considered when determining whether a taxpayer has a satisfactory record of previous compliance.

23. The term "disqualifying offence" has been inserted into the new section 141FB. A taxpayer may not be eligible for a reduction of a current penalty if convicted of a "disqualifying offence". The term "disqualifying penalty" is retained in the new section 141FB.

24. The term "satisfactory behaviour period" (see paragraph 38 of this SPS for details) is designed to be sufficiently long to demonstrate that the taxpayer's behaviour has changed, yet brief enough to not excessively burden the taxpayer.

Legislation

25. The relevant legislative provisions are:

    - the definition of "tax position" in section 3, and
    - sections 141A to 141E, 141FB, 143, 143A, 143B, 143F to 143H, 144 and 145.

Discussion

General

26. Section 141FB was replaced pursuant to the Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Act 2004. The new provision permits two types of previous behaviour reduction for shortfall penalties. Section 141FB(1) establishes the grounds for a 50% reduction of a shortfall penalty imposed for evasion under section 141E(1). Section 141FB(2) establishes the grounds for a 50% reduction of any other type of shortfall penalty imposed under sections 141A to 141D.

27. Both subsections (1) and (2) of section 141FB refer to a "disqualifying offence" and a "disqualifying penalty" as the relevant criteria for determining eligibility to the 50% reduction.

28. The term "disqualifying offence" is defined in section 141FB(3) to mean:

    (a) An offence under section 143A, 143B, 143F, 143G, 143H or 145 for which a conviction is entered—

        (i) On or after 26 March 2003; and

        (ii) Before the taxpayer takes the tax position to which the current penalty relates:

    (b) An offence under section 143 or 144 that relates to the type of tax to which the current penalty relates and for which a conviction is entered—

        (i) On or after 26 March 2003; and

        (ii) After the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and

        (iii) Before the taxpayer takes the tax position to which the current penalty relates:

29. The term "disqualifying penalty" is defined in section 141FB(3) to mean:

    (a) For the purpose of subsection (1), a shortfall penalty that—

        (i) Relates to the type of tax to which the current penalty relates; and

        (ii) Is for evasion or a similar act; and

        (iii) Is not reduced for voluntary disclosure by the taxpayer; and

        (iv) Relates to a tax position that is taken on or after 26 March 2003 and before the date on which the taxpayer takes the tax position to which the current penalty relates:

    (b) For the purpose of subsection (2), a shortfall penalty that—

(i) Relates to the type of tax to which the current penalty relates; and

(ii) If the current penalty is—

(A) For gross carelessness or taking an abusive tax position, is a shortfall penalty for evasion or a similar act or for gross carelessness or taking an abusive tax position:

(B) For not taking reasonable care or taking an unacceptable tax position, is a shortfall penalty of any sort; and

(iii) Is not reduced for voluntary disclosure by the taxpayer; and

(iv) Relates to a tax position that is taken—

(A) On or after 26 March 2003; and

(B) After the date that precedes, by the period specified in subsection (4), the date on which the taxpayer takes the tax position to which the current penalty relates; and

(C) Before the date on which the taxpayer takes the tax position to which the current penalty relates.

Reduction for shortfall penalties for evasion imposed under section 141E(1)

30. Pursuant to section 141FB(1), a current penalty for evasion imposed under section 141E(1) will be reduced by 50% if the taxpayer is not:

- convicted of a “disqualifying offence”, and/or
- liable for a “disqualifying penalty”.

Disqualifying offence

31. A current penalty, ie a shortfall penalty for evasion imposed under section 141E(1), will not be reduced for previous behaviour when a taxpayer is convicted:

(a) on or after 26 March 2003, and

(b) before the taxpayer takes the tax position to which the current penalty for evasion relates,

for:

(i) a knowledge offence under section 143A, or

(ii) an offence for evasion or a similar act under section 143B, or

(iii) an offence in relation to inquiries made by Inland Revenue under section 143F, or

(iv) an offence in relation to court orders under section 143G, or

(v) obstruction under section 143H, or

(vi) other offences with no specified penalty under section 145.

32. Furthermore, when the taxpayer is convicted:

(a) on or after 26 March 2003, and

(b) within the relevant “satisfactory behaviour period” (see paragraph 38 of this SPS), and

(c) before the taxpayer takes the tax position to which the current penalty for evasion relates,

for:

(i) an absolute liability offence under section 143, or

(ii) certain offences under section 144 in relation to the Stamp and Cheque Duties Act 1971,

a current penalty relating to the same tax type as the offence for which the conviction is entered will not be reduced for previous behaviour. However, any later shortfall penalty for the same tax type will be reduced for previous behaviour if the conviction does not fall within the relevant “satisfactory behaviour period” for that shortfall penalty.

Meaning of when a conviction is entered

33. Generally, a conviction is entered after the final determination of the case, when the defendant is sentenced. Note that a guilty plea, per se, will not be a conviction. In particular, a judge may permit a guilty plea to be withdrawn before sentencing.

34. If a taxpayer enters a guilty plea that is later ratified by the judge, the conviction is entered at the date of ratification. However, ratification will often not occur until sentencing.

35. If a taxpayer is convicted but discharged, the taxpayer will still be treated as convicted. However, if the taxpayer is discharged without conviction, then a conviction has not been entered and there is no “disqualifying offence” for the purpose of section 141FB.

Tax types

36. Generally, section 141FB applies separately to each tax type, such as PAYE, income tax and FBT. Therefore, a penalty imposed in relation to one tax type does not preclude a previous behaviour reduction for a later shortfall penalty relating to a different tax type.

37. However, if the taxpayer is convicted of a “disqualifying offence” pursuant to paragraph (a) of that term’s definition in section 141FB(3), then a later shortfall penalty for any tax type cannot be reduced by 50%.

Satisfactory behaviour period

38. For the purpose of the definitions of "disqualifying offence" (ie an offence under sections 143 and 144) and "disqualifying penalty" (ie where the current penalty is not imposed for evasion under section 141E(1)), pursuant to section 141FB(4), the "satisfactory behaviour period" means:

- two years preceding the date on which the taxpayer takes the tax position to which the current penalty relates for the following tax types:
  - (a) the taxpayer's application of the PAYE rules,
  - (b) FBT,
  - (c) goods and services tax (GST), and
  - (d) resident withholding tax, or
- four years preceding the date on which the taxpayer takes the tax position to which the current penalty relates for all other tax types (including income tax).

39. The commencement date of the "satisfactory behaviour period" is calculated by retrospectively applying the relevant period defined in paragraph 38 from the date that the taxpayer takes the tax position relating to the current penalty.

40. However, if the taxpayer is convicted of a "disqualifying offence" pursuant to paragraph (a) of the term's definition in section 141FB(3) (see paragraph 31 of this SPS), then a later shortfall penalty for any tax type cannot be reduced under these rules, regardless of the period elapsed. That is, there is no relevant "satisfactory behaviour period".

Disqualifying penalty

41. If a taxpayer has not been convicted of a "disqualifying offence" and is not liable for a "disqualifying penalty", a current penalty for evasion under section 141E(1) will be reduced by 50%.

42. However, a current penalty for evasion will not be reduced by 50% pursuant to section 141FB(1) if the taxpayer is liable to pay an earlier shortfall penalty for evasion that:
    - (a) relates to the same tax type, and
    - (b) is not reduced for voluntary disclosure, and
    - (c) relates to a tax position taken on or after 26 March 2003 and before the date of the tax position to which the current penalty relates.

Impacts of voluntary disclosure in the context of a current penalty for evasion

43. An earlier shortfall penalty for evasion that is reduced for voluntary disclosure is not a "disqualifying penalty". Therefore, it will not affect the taxpayer's eligibility to the 50% reduction of the current penalty for evasion.

Effects of imposing a shortfall penalty for evasion under section 141E(1)

44. The imposition of a shortfall penalty for evasion will affect the taxpayer's eligibility to the 50% reduction of later shortfall penalties in some cases. That is, if the shortfall penalty for evasion is not reduced for voluntary disclosure, any later shortfall penalty for evasion for the same tax type will not be reduced by 50% under section 141FB(1). There is no "satisfactory behaviour period" in respect of a shortfall penalty for evasion in these cases.

45. However, the "satisfactory behaviour period" will apply in cases where the later shortfall penalty is imposed under any of sections 141A to 141D (also see paragraphs 46 to 52 of this SPS). For example, a later penalty imposed for lack of reasonable care under section 141A for an income tax shortfall will be reduced by 50% under section 141FB(2) if the previous shortfall penalty for evasion, that is not reduced for voluntary disclosure, relates to an income tax position taken outside the four-year "satisfactory behaviour period".

Reduction for current penalties imposed under any of sections 141A to 141D

46. Pursuant to section 141FB(2), a current penalty imposed under any of sections 141A to 141D will be reduced by 50% if the taxpayer is not:
    - convicted of a "disqualifying offence", and/or
    - liable for a "disqualifying penalty" within the "satisfactory behaviour period."

Disqualifying offence

47. Section 141FB(2) applies to a current penalty that may be imposed for:
    - (a) not taking reasonable care under section 141A, or
    - (b) taking an unacceptable tax position under section 141B, or
    - (c) gross carelessness under section 141C, or
    - (d) taking an abusive tax position under section 141D.

48. Pursuant to section 141FB(2), a current penalty, ie imposed under any of sections 141A to 141D, will not be reduced by 50% for previous behaviour when:
    - a taxpayer is convicted of a "disqualifying offence" listed under paragraph (a) of that term's definition in section 141FB(3) (see paragraph 31 of this SPS),

- on or after 26 March 2003, and
- before the date of taking the tax position to which the current penalty relates.

A later shortfall penalty for any tax type will not be reduced for previous behaviour because of the "disqualifying offence".

49. Furthermore, a current penalty (ie imposed under any of sections 141A to 141D) will not be reduced by 50% for previous behaviour when:

- a taxpayer is convicted of a "disqualifying offence" listed under paragraph (b) of that term's definition in section 141FB(3) (see paragraph 32 of this SPS),
  - on or after 26 March 2003, and
  - before the date of taking the tax position to which the current penalty relates, and
  - within the relevant "satisfactory behaviour period".

(See paragraphs 33 to 35 of this SPS regarding the meaning of when a conviction is entered.)

Disqualifying penalty

50. A current penalty, ie a shortfall penalty imposed under any of sections 141A to 141D, will not be reduced for previous behaviour if the taxpayer is liable to pay a "disqualifying penalty".

51. Where a current penalty is imposed for gross carelessness under section 141C or for taking an abusive tax position under section 141D, a "disqualifying penalty" is a shortfall penalty that:

(a) relates to the same tax type as the current penalty, and

(b) is imposed for gross carelessness, taking an abusive tax position or evasion or a similar act, and

(c) is not reduced for voluntary disclosure, and

(d) relates to a tax position taken on or after 26 March 2003 that is within the "satisfactory behaviour period" (see paragraph 38 of this SPS) and before the date of the taxpayer's tax position to which the current penalty relates.

52. Where a current penalty is imposed for not taking reasonable care under section 141A or for taking an unacceptable tax position under section 141B, a "disqualifying penalty" is a shortfall penalty of any sort that:

(a) relates to the same tax type as the current penalty, and

(b) is not reduced for voluntary disclosure, and

(c) relates to a tax position taken after 26 March 2003 which is within the "satisfactory behaviour period" and before the date of the taxpayer's tax position to which the current penalty relates.

Tax shortfalls arising from a single investigation or voluntary disclosure – section 141FB(5)

53. For the purpose of this SPS, an "investigation" means any examination of a taxpayer's financial affairs verifying that the taxpayer has paid the correct amount of tax and is complying with the tax laws.

54. Clear wording will be used in any communication to taxpayers when a decision to investigate has been made. Requests for information to enable the Commissioner to decide whether to investigate are not themselves part of an investigation. Examples of investigation activities include:

- income tax, GST and payroll checks (for example, capital/revenue discrepancies and GST on real property transactions),
- payroll, GST and FBT registration checks, and
- any other types of review by Inland Revenue.

55. For the purpose of section 141FB(2), when separate current penalties are imposed under any of sections 141A to 141D for different tax shortfalls identified in the same investigation or voluntary disclosure, each penalty will be treated as if the taxpayer was not liable for the other penalty provided the taxpayer:

(a) takes both tax positions on the same date, and/or

(b) is not liable for a shortfall penalty during the "satisfactory behaviour period" (as defined in paragraph 38 of this SPS) that ends on the earliest date on which the taxpayer takes the tax position relating to the tax shortfall.

Standard Practice

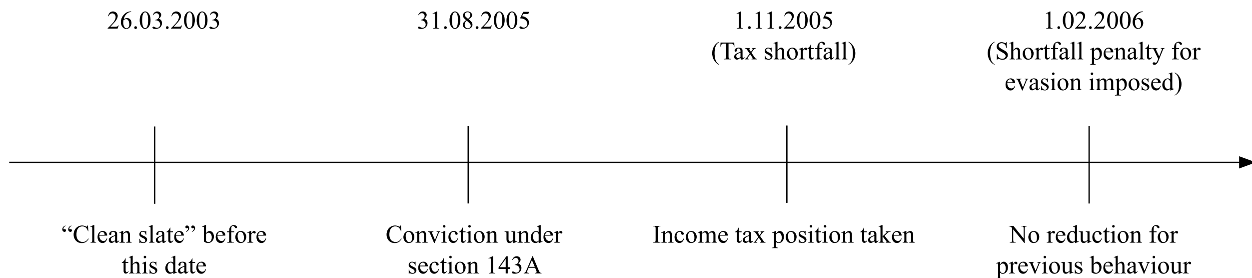
56. This SPS discusses the application of section 141FB. In particular, it describes the grounds for reducing a current penalty for evasion under section 141E(1) and for other grounds under sections 141A to 141D.

57. Inland Revenue's standard practice in relation to the application of the previous behaviour reduction is illustrated by the following examples:

Example 1: disqualifying offence and current penalty for evasion

On 31 August 2005, a conviction is entered against a taxpayer for a knowledge offence under 143A. On 1 November 2005, the taxpayer takes a tax position that the taxpayer's income tax liability for the 2005 tax year is nil. Following an Inland Revenue investigation, a current penalty for evasion is imposed on 1 February 2006 for an income tax shortfall for the 2005 tax year. The taxpayer is not liable for another shortfall penalty.

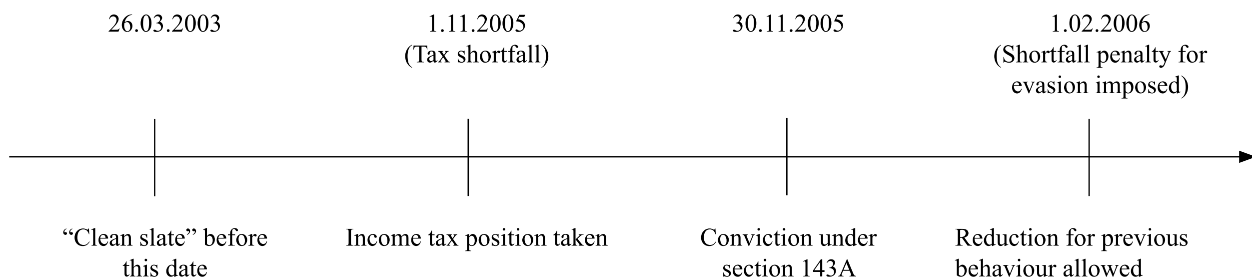
The current penalty will not be reduced by 50% pursuant to section 141FB(1) because the taxpayer is convicted of a "disqualifying offence" after 26 March 2003 and before the taxpayer takes the tax position to which the current penalty for evasion relates.



Example 2: disqualifying offence occurs after the tax position taken

Applying the same facts as example 1 but a conviction is entered against the taxpayer under section 143A on 30 November 2005. The current penalty for evasion will be reduced by 50% pursuant to section 141FB(1) because the

"disqualifying offence". Furthermore, the taxpayer is not liable for a "disqualifying penalty".



Example 3: disqualifying penalty and current penalty for evasion

A taxpayer takes a tax position on 1 May 2005. Following an Inland Revenue investigation, a current penalty for evasion is imposed on 1 August 2005 for an income tax shortfall for the 2004 tax year. The taxpayer has not been convicted of a "disqualifying offence". However, the taxpayer was liable to pay a shortfall penalty for evasion for an income tax position taken on 1 June 2003.

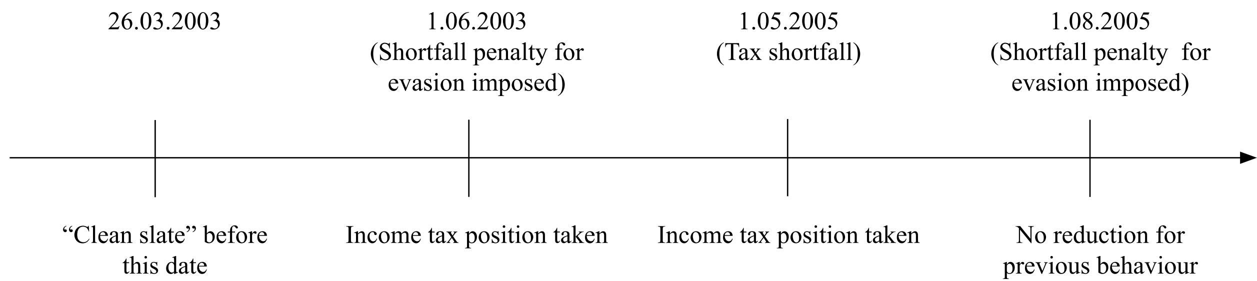
The shortfall penalty for evasion for the tax position taken on 1 June 2003 is a "disqualifying penalty" because:

(a) it is for the same tax type as the current penalty.

(b) it is not reduced for voluntary disclosure by the taxpayer.

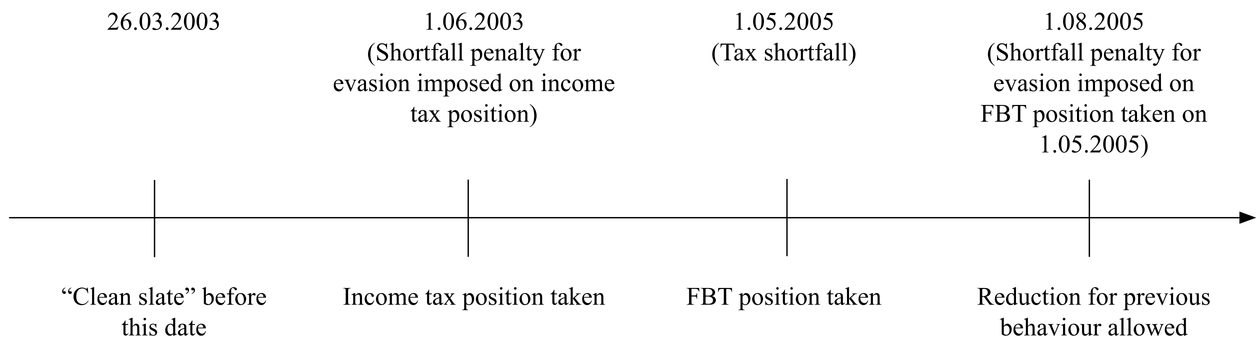
(c) it relates to a tax position taken after 26 March 2003 and before the date on which the taxpayer takes the tax position to which the current penalty relates, ie 1 May 2005.

The current penalty will not be reduced by 50% under section 141FB(1) because the taxpayer is liable to pay a "disqualifying penalty".



Example 4: disqualifying penalty for a different tax type

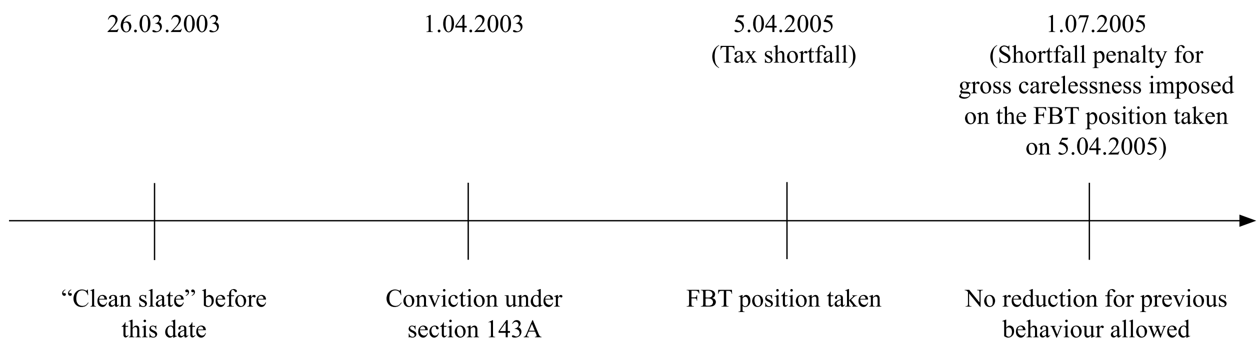
Applying the same facts as example 3 but the current penalty relates to an FBT shortfall. The current penalty will be reduced by 50% under section 141FB(1). The earlier shortfall penalty is not a "disqualifying penalty" because it relates to a different tax type from the tax shortfall relating to the current penalty.



Example 5: disqualifying offence and current penalty for gross carelessness

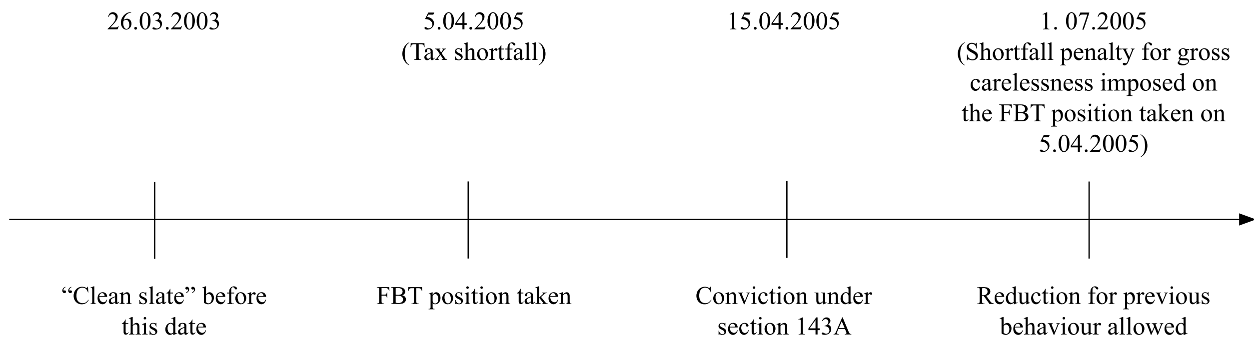
On 1 April 2003, a conviction is entered against a taxpayer for a knowledge offence under section 143A. Following an Inland Revenue investigation a current penalty for gross carelessness under section 141C is imposed for an FBT shortfall in relation to the tax position taken on 5 April 2005. The current penalty is imposed on 1 July 2005. The taxpayer is not liable for another shortfall penalty.

The current penalty will not be reduced by 50% pursuant to section 141FB(2) because the taxpayer is convicted of a "disqualifying offence" after 26 March 2003 and before the taxpayer has taken the tax position to which the current penalty relates, ie 5 April 2005. This is notwithstanding the fact that the conviction under section 143A was entered against the taxpayer over two years before the current penalty is considered. The "disqualifying offence" also means that the taxpayer will not be eligible for a 50% reduction of any later shortfall penalty for any tax type.



Example 6: disqualifying offence occurs after tax position taken

Applying the same facts as example 5 but a taxpayer pleads guilty to an offence on 1 April 2005 and a judge ratifies the guilty plea and enters conviction against the taxpayer for a knowledge offence under section 143A on 15 April 2005. The guilty plea on 1 April 2005 does not amount to a conviction. Therefore, there is no "disqualifying offence" because the conviction is entered (ie on 15 April 2005) after the taxpayer has taken the tax position to which the current penalty relates (ie 5 April 2005). The current penalty will be reduced by 50% pursuant to section 141FB(2).



Example 7: disqualifying penalty and current penalty for gross carelessness

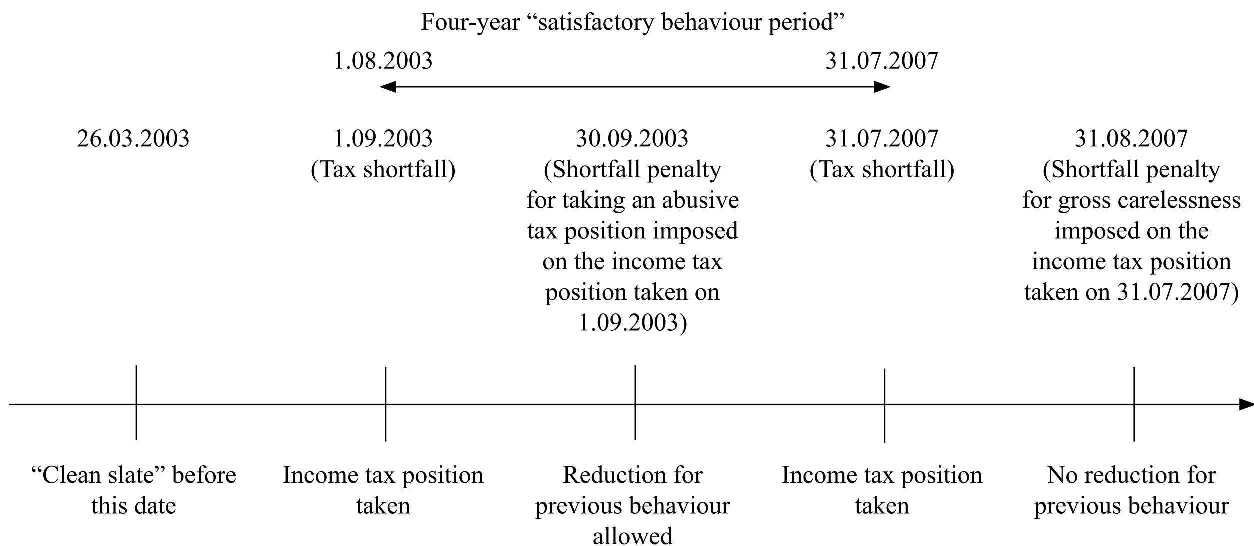
A taxpayer takes an income tax position on 31 July 2007 and a current penalty for gross carelessness under section 141C is imposed on 31 August 2007. Following a previous Inland Revenue investigation the taxpayer is liable to pay a shortfall penalty for taking an abusive tax position imposed under section 141D on 30 September 2003 for an income tax position taken on 1 September 2003. The shortfall penalty was not reduced for voluntary disclosure but was reduced for previous behaviour. The taxpayer is not convicted of a "disqualifying offence".

The shortfall penalty for taking an abusive tax position is a "disqualifying penalty" because:

(a) it is for the same tax type as the current penalty

(b) it is not reduced for voluntary disclosure by the taxpayer

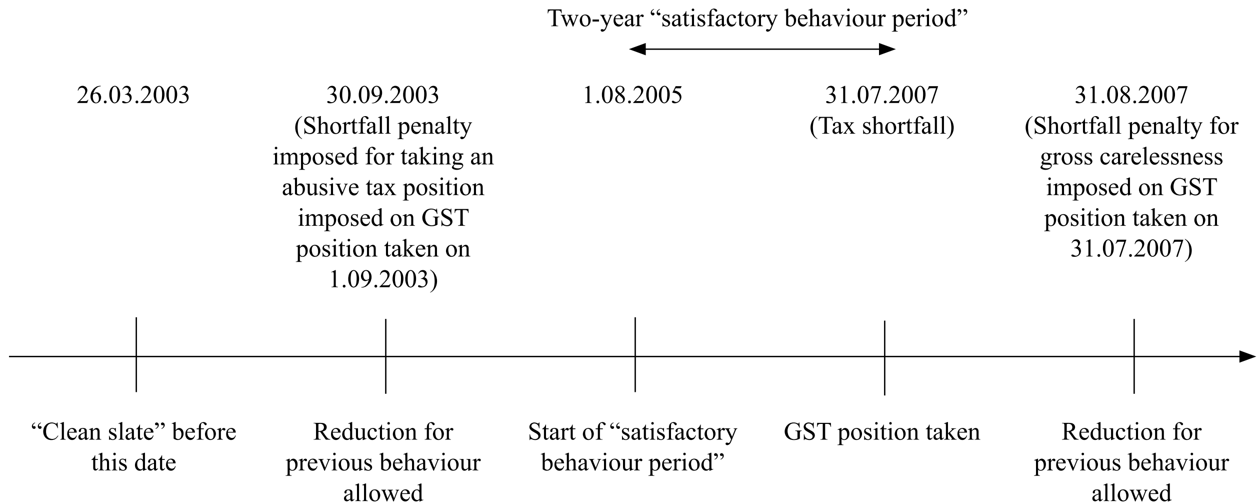
(c) it relates to a tax position taken after 26 March 2003, within the four-year "satisfactory behaviour period" (1 August 2003 to 31 July 2007) and before the date of the taxpayer's tax position to which the current penalty relates, ie 31 July 2007.



Example 8: shortfall penalty outside satisfactory behaviour period

Applying the same facts as example 7 but the current penalty and earlier shortfall penalty relate to a GST position. In

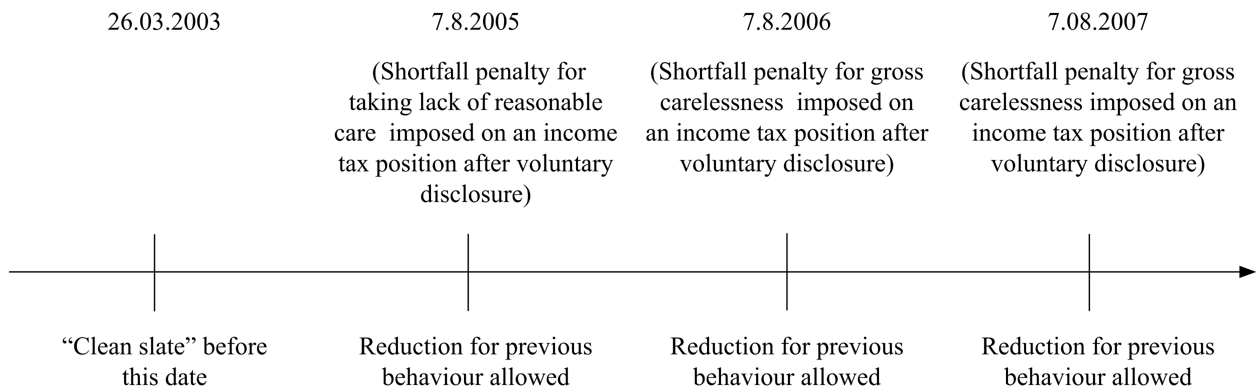
does not fall within the two-year "satisfactory behaviour period" (1 August 2005 to 31 July 2007). The current penalty will also be reduced by 50% pursuant to section 141FB(2).



Example 9: voluntary disclosure by the taxpayer

A taxpayer files an income tax return and omits income from a particular source. After filing the return, the taxpayer voluntarily discloses the income omission and a shortfall penalty for lack of reasonable care is imposed on 7 August 2005 which is reduced by 75% for the voluntary disclosure and a further 50% for previous behaviour.

In the next two returns the taxpayer omits income and later discloses the omission. On both occasions the shortfall penalty for gross carelessness under section 141C is reduced by 75% for the voluntary disclosure and a further 50% for previous behaviour. As the shortfall penalties imposed on 7 August 2005 and 7 August 2006 are both reduced for voluntary disclosure, neither penalty is a "disqualifying penalty" and the additional 50% previous behaviour reduction is available for both the shortfall penalties imposed on 7 August 2006 and 7 August 2007 respectively. It is also noted that the shortfall penalty for taking lack of reasonable care imposed on 7 August 2005 cannot be a "disqualifying penalty", where the current penalty is for gross carelessness.



Example 10: Inland Revenue's investigation subsequent to the taxpayer's voluntary disclosure

A taxpayer files an income tax return and omits income from a particular source. After filing the return, the taxpayer voluntarily discloses the income omission and a shortfall penalty for lack of reasonable care is imposed on 7 August 2004 which is reduced by 75% for the voluntary disclosure and 50% for previous behaviour.

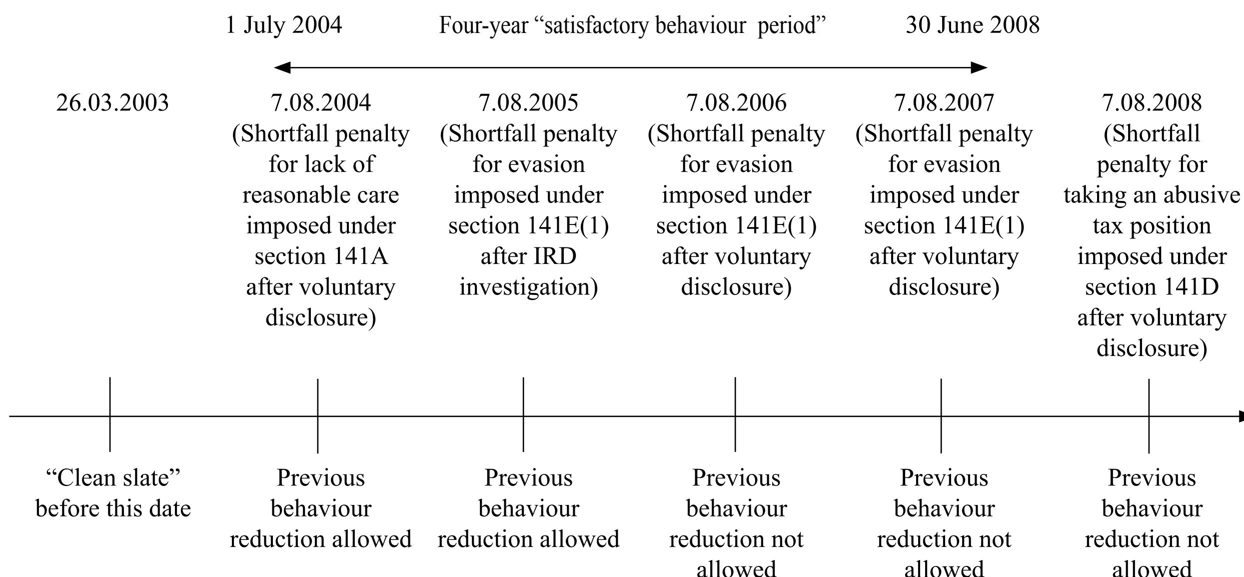
Inland Revenue decides to investigate the period following the first voluntary disclosure and a current penalty for evasion is imposed on 7 August 2005. This current penalty is reduced by 50% for previous behaviour under section 141FB(1), as the previous shortfall penalty was reduced for voluntary disclosure by the taxpayer and also was not imposed for evasion or a similar act. Therefore, the previous shortfall penalty is not a "disqualifying penalty".

On 7 August 2006, the taxpayer makes a voluntary disclosure of an income tax shortfall and the shortfall penalty is reduced by 75%. This shortfall penalty is not reduced for previous behaviour, as the previous shortfall penalty for evasion imposed on 7 August 2005 is a "disqualifying penalty". The previous shortfall penalty for evasion related to income tax and was not reduced for voluntary disclosure.

The following year, Inland Revenue again investigates the period following the voluntary disclosure and a shortfall penalty for evasion is imposed on 7 August 2007. This shortfall penalty will not be reduced for previous behaviour under section 141FB(1), as the previous shortfall penalty for evasion imposed on 7 August 2005 is a "disqualifying penalty". The previous shortfall penalty for evasion related to income tax and was not reduced for voluntary disclosure.

Note: the "satisfactory behaviour period" does not apply to the "disqualifying penalty" for the purpose of section 141FB(1).

In a later period (on 7 August 2008) the taxpayer voluntarily discloses omitted income and a shortfall penalty for taking an abusive tax position is imposed under section 141D. The voluntary disclosure relates to an income tax position taken on 30 June 2008. This shortfall penalty will not be reduced for previous behaviour under section 141FB(2). The previous shortfall penalty for evasion imposed on 7 August 2005 is a "disqualifying penalty" because it is not reduced for voluntary disclosure and relates to an income tax position taken on a date falling within the four-year "satisfactory behaviour period" for the current penalty (ie 1 July 2004 to 30 June 2008).



Example 11: tax shortfalls arising from a single investigation

Separate shortfall penalties for gross carelessness are imposed in respect of a bad debt deduction and a depreciation claim respectively. The tax shortfalls are identified in a single investigation. Both tax positions are taken on the same date. The taxpayer is not liable for a previous shortfall penalty. Under section 141FB(5), in considering whether the current penalties can be reduced for previous behaviour, each penalty would be determined as if the taxpayer was not liable for the other penalty.

This Standard Practice Statement is signed on 8 June 2006.

Graham Tubb
National Manager, Technical Standards

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.

VALUATION AND HINDSIGHT

Case:	TRA Number 145/04, Decision Number 006/2006
Decision date:	1 May 2006
Act:	District Court Rules, Tax Administration Act 1994
Keywords:	Discovery, hindsight, valuation, sham, avoidance

Summary

When a purported valuation is subject to review, evidence of events that have occurred post that valuation date can be relied upon to help determine whether a valuation made was reasonable and justified at the time.

Facts

This was an interlocutory application by the Disputant seeking an order limiting the scope of discovery.

In 1997 the Disputant transferred its registered office to New Zealand from Luxembourg and became a New Zealand resident company. Once resident in New Zealand the Disputant began depreciating the rights to particular software using a straight line method and taking NZ$76,125,375 as the cost price for depreciation purposes.

The Commissioner disallowed the depreciation deductions on the basis that the sale price was a sham (as at December 1994), that the sale price is part of a tax avoidance arrangement and that the so-called price (as at December 1997) cannot properly form the basis of the depreciation claim by the Disputant.

The Commissioner sought discovery by the Disputant of all documents including those evidencing sales and licensing of the software post December 1997.

The Disputant applied for an order that discovery be restricted so that information relating to the Disputant's sales and licensing of the relevant software post December 1997 not be required; or, alternatively, that events after December 1997 not be subject to discovery as irrelevant to the substantive issues.

The Commissioner opposed that application and claimed neither order was warranted or necessary because:

1. The Disputant mischaracterises the case as one of valuation alone. In fact it is a case involving allegations of sham, tax avoidance and technical arguments as to the correct depreciation basis of the copyright.
2. In tax cases where sham and tax avoidance and valuation have been in issue the Court has accepted as relevant any evidence both pre and post the transaction date.
3. The sales history from 1 January 1998 is relevant to the sham argument, the tax avoidance argument and the technical argument about the correct depreciation basis.
4. Even in a strict valuation context, which this is not, evidence post dating the transaction is admissible.

Decision

For the reasons advanced by the Commissioner (as set out above) His Honour agreed that neither order sought by the Disputant was warranted or necessary. He concluded that the sales history of the software after December 1997 and up to the date of the substantive hearing would be relevant and important to the issues and therefore discoverable.

In regards to the sham and tax avoidance issues, His Honour stated that in his view the law was clear that the Courts would allow evidence to be called of events which occurred after the transaction in question. His Honour cited *Glenharrow Holdings Ltd v The Commissioner of Inland Revenue* (2006) 22 NZTC 19,319 as an example of where the High Court allowed evidence of events occurring post transaction where sham was in issue.

His Honour noted that sales post-December 1997 could well be relevant to the intentions of the parties at the material times and certainly to their credibility. His Honour

went on to explain those figures could well show quite some disparity between predictions on which the Disputant wishes to rely as compared to what actually happened and what might be thought to have actually happened.

In the context of valuation His Honour stated the law provided for the admission of evidence post valuation date (hindsight), where the purpose was to determine the proper weight to attach to the circumstances relied upon at the valuation date, see *Brian Russell Gilfoyle v Patrica Joan Gilfoyle* unreported judgment of Laurenson J, 3 September 2001, High Court, Auckland, and *Wood v Wood* [1984] FRNZ 576 at 581.

In the present case the Disputant's sales projections are alleged by the Commissioner to have been too optimistic. Evidence of actual sales since 1994 through to the present will be relevant to assessing the reasonableness of those assumptions.

His Honour concluded that in this pre-trial context, the information in issue was both relevant and reasonably necessary for the purpose of discovery. His Honour also referred to the question of weight and noted that that was different to the question of relevance for the purpose of discovery. His Honour however noted that weight of the evidence must be determined at trial and not at this preliminary stage.

Although His Honour did not accept the Disputant's submission that requiring discovery of material covering 12 years would be excessive he was prepared to reserve leave for the Disputant to apply from time to time regarding any particular aspect of the discovery which may seem to be unduly onerous. His Honour however, noted that in general, the discovery should not be onerous on the Disputant.

TAXPAYER SUCCESSFULLY OPPOSES COMMISSIONER'S APPLICATION TO ADDUCE NEW EVIDENCE

Case:	TRA003/003 Decision Number 7/2006
Decision date:	3 May 2006
Act:	Tax Administration Act 1994
Keywords:	Evidence exclusion rule

Summary

The Commissioner was unsuccessful in his attempt, under section 138G(2) TAA, to adduce new evidence which section 138G(1) excluded.

Facts

This ruling is about the admission of evidence.

The Commissioner had assessed the Disputant for the income previously accounted for in partnership returns for the period 1996 to 2005. At the time of the dispute and making the resultant assessments, the partner companies of the partnership were thought to have not filed tax returns of their own.

The partner companies filed tax returns after the issue of the Commissioner's Statement of Position to the Disputant. It also was discovered that for the tax years 1998 and 1999 one of the partner companies had filed returns prior to the issue of the Commissioner's Statement of Position.

The Commissioner applied to raise new evidence in challenge proceedings pursuant to sestion 138G(2) of the Tax Administration Act 1994 (the Act).

The grounds on which the Commissioner pleaded in the application were:

- At the time of delivery of the Commissioner's Statement of Position and Disclosure Notice dated 6 July 2001, the Commissioner could not have, with due diligence, discovered that evidence.
- Apart from the tax returns, which were lodged with the Inland Revenue Department on 27 March 2001, all returns were filed well after 6 July 2001.
- Such evidence was relevant to the issues in the challenge proceedings and having regard to the provisions of section 89A of the Act and the conduct of the parties, the admission of this evidence is necessary to avoid injustice to the defendant and the disputant.

A Notice of Opposition was filed by the Disputant on the grounds that:

- The returns for the 1998 and 1999 years were filed prior to the date of the Commissioner's Statement of Position and so are not new facts and evidence, the Commissioner had these documents and could have discovered them by simply referring to the file;
- Any details required from the tax returns could be confirmed in the Statement of Agreed Facts;
- Tax returns of the entities were not relevant to the disputant's assessments;
- The quantum of the partnership's income could be amended if the Commissioner chose to change his claim because it was different to those returns for those years;
- There is no nexus between the partnership's returns and the returns and assessments in the challenge proceedings; and
- The additional years requested do not meet the statutory criteria and are not relevant.

Decision

Judge Barber accepted there were three essential matters to consider when faced with an application under section 138G(2):

1. The evidence to be introduced must be evidence of a type described in the Commissioner's Statement of Position;
2. That the evidence could not have been, with due diligence discovered prior to the issue of the Statement of Position; and
3. Having regard to section 89A and the parties, that admission is necessary to avoid a manifest injustice.

The Judge agreed with the disputant that for the partner company which filed its 1998 and 1999 returns before the issue of the Commissioner's Statement of Position those returns could not be regarded as new facts and evidence [para 62].

The Judge also agreed (though reserved the right to change his mind when the substantive case had commenced) that the material sought to be admitted is so relevant that its exclusion would result in a manifest injustice, though it is possibly seen as helpful and has some relevance for the substantive case [para 63 to 64].

The judge noted his wide powers to ensure the assessments are correct [par 66]. Another factor that was important was the Disputant's opposition to the adducing of the evidence (even though it benefited the Disputant), suggesting it was not manifestly unjust not to exclude it [para 64].

In this instance it was not considered appropriate to admit the evidence under section 138G(2).

Judge Barber went on to discuss the case in general terms and against the background of certain template litigation raising his concerns with both parties' position [para 71 to 76]. He expressed dissatisfaction with the current proceedings saying "this matter cries out for a negotiated settlement of a unique problem" [at para 77] and inviting the parties to consider a Judicial Settlement Conference prior to the matter proceeding any further [para 78 to 80].

NEW GROUND OF ASSESSMENT ON APPEAL

Case: The Commissioner of Inland Revenue v Zentrum Holdings Ltd

Decision date: 23 May 2006

Act: Tax Administration Act 1994

Keywords: Disputes procedure, challenge, new ground of assessment, appeal

Summary

In circumstances where the evidence exclusion rule did not apply the Commissioner was held to be allowed to raise a ground to justify an assessment on appeal which had not been included in the Notice of Proposed Adjustment or raised in the Taxation Review Authority.

Facts

On 31 July 2001 the Commissioner issued a Notice of Proposed Adjustment against the disputant on the basis of tax avoidance. The disputant issued a Notice of Response on 28 September 2001. In March 2003 a second Notice of Proposed Adjustment was issued which was replied to by a second Notice of Response. In this case the disputes procedure was not completed, the Commissioner having issued an assessment before the disputant filed its second Notice of Response. No disclosure notice was issued. The assessment was issued on the basis of the general anti-avoidance provision (BG 1).

The disputant filed a challenge to the assessment in the TRA. The Commissioner defended the assessment on the basis of tax avoidance. The TRA overturned the assessment holding that there was no tax avoidance. The Commissioner appealed to the High Court.

In the course of preparing for the appeal the Commissioner formed the view that, as well as being a tax avoidance arrangement, the transactions were shams and gave notice that he wished to raise the additional argument of sham on appeal. The disputant brought an interlocutory application for an order limiting the Commissioner to the ground of assessment raised in the TRA. The High Court granted the order and held that the Commissioner was not allowed to raise the new argument of sham on appeal. The Commissioner appealed that decision.

Decision

The Appeal Court distinguished the earlier cases of *Farnsworth and Duval* and held that the legislative scheme, in circumstances where a disclosure notice is not issued, does not confine the parties to the positions formerly taken in their Notices of Proposed Adjustment and Notices of Response.

The Appeal Court held that points which could have been argued before the TRA are able to be advanced on appeal in the High Court, subject to the usual principles as to the circumstances in which new arguments may be advanced on appeal.

Further, that as the new ground of assessment did not increase the amount assessed the time bar in section 108 of the TAA was not applicable and did not prevent the new ground being raised on appeal.

The appeal was allowed and the case remitted to the High Court for the appeal to be heard.

REGULAR FEATURES

DUE DATES REMINDER

July 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

August 2006

21 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 2006–2007*. This calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum.

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

This page shows the draft binding rulings, interpretation statements, standard practice statements and other items that we now have available for your review. You can get a copy and give us your comments in these ways.

By internet: Visit **www.ird.govt.nz**
On the homepage, click on "Public consultation" in the right-hand navigation bar. Here you will find links to drafts presently available for comment. You can send in your comments by the internet.

By post: Tick the drafts you want below, fill in your name and address, and return this page to the address below. We'll send you the drafts by return post. Please send any comments in writing, to the address below. We don't have facilities to deal with your comments by phone or at our other offices.

Name ______________________________

Address ______________________________

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	Draft questions we've been asked	*Comment deadline*
☐	QB0048: GST treatment of funding provided to Treaty of Waitangi claimants by the Crown through the Office of Treaty Settlements	28 July 2006
☐	QB0052: GST and land transferred as a condition of subdivision consent pursuant to section 220 of the Resources Management Act 1991 in return for payment	28 July 2006
☐	QB0053: GST and works provided as a condition of resource consent pursuant to section 108 of the Resources Management Act 1991	28 July 2006

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