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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.

DETERMINATION – USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND

The following determination (FDR2007-04), concerning New Zealand resident investors' ability to use the fair dividend rate method to calculate foreign investment fund (FIF) income from a type of attributing interest in a FIF, was made by the Deputy Commissioner, Policy, Inland Revenue, under section 91AAO of the Tax Administration Act 1994 on 12 October 2007.

DETERMINATION

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the Deputy Commissioner, Policy, under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Units in a non-resident issuer to which this determination applies are an attributing interest in a FIF for New Zealand resident investors. New Zealand resident investors are required to apply the foreign investment fund rules to determine their tax liability in respect of their units in the non-resident issuer each year.

Due to the presence of specified lock-in thresholds, section EX 40(9) of the Act applies to units in the non-resident issuer and prevents use of the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

Despite the presence of specified lock-in thresholds, I consider that it is appropriate for New Zealand resident investors in this arrangement to use the fair dividend rate method. The overall arrangement (as described to me by the applicant) contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument that effectively provides guaranteed returns.

Scope of determination

The investments to which this determination applies are units in a non-resident issuer which:

(a) is one of the Credit Suisse PL100 series of trusts;

(b) is a unit trust constituted under New South Wales law;

(c) issues New Zealand dollar denominated units (not being fixed rate shares or non-participating redeemable shares) to New Zealand resident investors;

(d) indirectly offers New Zealand resident investors the benefit of capital protection and rising capital protection;

(e) invests proceeds from the issue of units in a physical basket of securities upon which dividends may be paid;

(f) converts any dividends derived from the physical basket of securities to New Zealand dollars and distributes such dividends to New Zealand resident investors from time to time; and

(g) enters into a specified call and put option arrangement in relation to a hedging portfolio.

Interpretation

In this determination, unless the context otherwise requires—

"Capital protection" means an arrangement under which an investor receives an amount from the issuer equal to the New Zealand dollar issue price for each unit held by the investor at maturity;

"Fixed rate share" means a fixed rate share under section LF 2(3) of the Act;

"Hedging portfolio" means a notional portfolio of shares and fixed income securities that requires 25% minimum participation in notional share investments at all times;

"Non-participating redeemable share" means a non-participating redeemable share under section CD 14(9) of the Act;

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Act;

"Physical basket of securities" means a portfolio of shares or other securities physically held by the issuer;

"Rising capital protection" means an arrangement under which an investor receives an amount from the issuer which exceeds the New Zealand dollar issue price for each unit held at maturity if any specified lock-in threshold is reached, irrespective of the value of the issuer's underlying investments at maturity;

"Specified call and put option arrangement" means an arrangement consisting of two separate option contracts entered into simultaneously by the issuer and a counterparty under which:

(a) the issuer is able to transfer the physical basket to the counterparty in exchange for an amount equal to the value of the hedging portfolio (in New Zealand dollars) if the value of the hedging portfolio at maturity (less a portfolio fee) is equal to or greater than the value of the physical basket; and

(b) the counterparty is able to require the issuer to pay the counterparty the shortfall in value between the physical basket and the hedging portfolio (in New Zealand dollars) if the value of the hedging portfolio at maturity (less a portfolio fee) is less than the value of the physical basket;

"Specified lock-in threshold" means the level of growth in value of the hedging portfolio (adjusted downwards for dividends paid to investors on their units), expressed as a percentage of the value of the hedging portfolio at the commencement of the investment term, which is determined by the issuer at the commencement of the investment term to be a specified lock-in threshold;

"The Act" means the Income Tax Act 2004.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2007–08 and subsequent income years.

Robin Oliver
Deputy Commissioner, Policy
Inland Revenue
12 October 2007

NOTICE

INCOME TAX ACT 2007

The Income Tax Act 2007 passed through its final stages late October, receiving Royal assent on 1 November 2007. The new Act contains the rewritten Income Tax Act from Part F to the end of the Act, including Schedules. It also enacts and consolidates Parts A to E and renumbers various sections contained in those Parts. The resulting Income Tax Act 2007 will apply to income derived from the 2008–09 income year. An article outlining the main features of the Act will be published here early in 2008.

STANDARD PRACTICE STATEMENTS

Correction

SPS 07/05 TRANSFER OF DEPRECIABLE PROPERTY BETWEEN ASSOCIATED PERSONS – SECTION EE 33 OF THE INCOME TAX ACT 2004

In the item published under the section "Standard Practice Statements" in the *Tax Information Bulletin*, Vol 19, No 9 (October 2007), pp 16-25, please note that the word "nephew" in the first paragraph under "Example 2: transfer between individual taxpayers" is incorrect and should be replaced with the word "grandson". The correct example is reproduced below:

Example 2: transfer between individual taxpayers

Jack, a 70-year-old sole trader operating a dairy decides to sell the business assets to his grandson, Johnny. Johnny will take over Jack's dairy business. Jack and Johnny enter into a sale and purchase agreement, whereby all the business assets in the dairy will be sold to Johnny at a price based on an independent valuation. The payment consists of an Acknowledgment of Debt for 75% of the transferred price and cash for the remaining 25%.

Jack retires after the transfer. Johnny carries on the dairy business. Jack helps out in the dairy occasionally but is not otherwise involved in the business. Jack forgives some of the debt annually. Johnny requests that the Commissioner exercises the discretion under section EE 33(4)(a)(ii).

Jack and Johnny are associated persons in accordance with the definition of "relative" in section OB 1.

The Commissioner will exercise the discretion under section EE 33(4)(a)(ii) to allow Johnny to claim tax depreciation on the basis of the assets' transferred price. This is because:

(a) The transaction is genuine: the transfer of the assets is the result of genuine negotiation between Jack and Johnny. Consideration has passed by Johnny to Jack for the transfer of business assets.

(b) The transferred price is at a fair market value: the transferred price does not exceed the fair market value of the business assets.

(c) The transfer of business assets is permanent: the parties to the transaction do not intend to lease or transfer the business assets of the dairy back to Jack.

(d) The transferor does not continue to benefit from the transferred property: Jack does not have any control over the transferred assets in the dairy. Johnny runs the dairy business by himself. Jack only helps out occasionally.

(e) The transfer is not tax driven: the main reasons for the transaction are to enable Jack to retire due to his old age and for succession planning.

However, Jack is required to calculate depreciation claw back or gain on disposal at the time of the transfer.

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.

SHARE TRANSACTIONS NOT TAXABLE

Case: Dowell & Ors as trustee for Estate Frank King, Brenda King & Ann King v The Commissioner of Inland Revenue

Decision date: 31 October 2007

Act: Income Tax Act 1994 & Income Tax Act 1976

Keywords: "in business", "dealing" and "purpose of disposal"

Summary

Taxpayers' share trading activities held to be on capital account.

Facts

This was an appeal from the High Court. The TRA case is *Case W43* (2004) 21 NZTC 11,403 and the High Court as *King v The Commissioner of Inland Revenue* (2006) 22 NZTC 19,691. An attempt by the taxpayer to recall the High Court judgment is reported at Estate of *King v The Commissioner of Inland Revenue* (2006) 22 NZTC 20,040. Judicial review proceedings were also part of this matter and are reported (at the High Court) as *Dowell v The Commissioner of Inland Revenue* (2006) 22 NZTC 19,681.

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

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

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

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

The Commissioner appealed the TRA decision regarding the share business or trading and the onus of proof issue. The taxpayers appealed the finding that there was a bare trust. On appeal to the High Court, the Commissioner was successful and the taxpayers unsuccessful.

The taxpayers appealed to the Court of Appeal.

In addition, the taxpayers sought to appeal the High Court's refusal to recall its substantive judgment in the tax case. The taxpayers argued that the Commissioner had in fact conceded his appeals in the course of the hearings and therefore should not have succeeded before the High Court. The taxpayers sought, unsuccessfully, recall of those decisions.

Finally, the taxpayer sought a judicial review. The assessments were made relying upon the Income Tax Act 1994 whereas the correct Act should have been the Income Tax Act 1976. The taxpayers sought, by judicial review, a declaration that the assessments were nullities and were void. This was unsuccessful at the High Court and the taxpayers appealed to the Court of Appeal

Decision

The Court of Appeal dismissed the appeals in the judicial review and recall application. In the judicial review the Court considered that section YB5(4) applied and answered the case, thus the taxpayer's arguments the assessments were nullities had no merit.[par 116-121]. In respect of the recall appeal the appeal was described

as "misguided" (as the Court doubted there was an oral judgment) and "pointless" as the substantive judgment was under appeal anyway: the recall appeal was "nonsensical" [par 125]

The Court allowed the tax appeal. Addressing each ground:

Share Dealing (first limb s 65(2)(e) ITA 1976): After reviewing the relevant cases and the peculiar facts of this case, the Court concluded:

> [66] Our conclusion is that this matter is very finely balanced. On the one hand, there was a reasonable high frequency and continuity of effort. Certainly, this was not a case of haphazard or unsystematic buying and selling. Rather, the portfolios were, in [taxpayer's witness'] words "actively managed". On the other hand, there are explanations, other than trading, for a considerable number of the transactions and for their timing. Furthermore, the overall approach was, as [taxpayers' counsel] suggested, a fairly conservative one with a focus on the preservation of capital.
>
> [67] Given the matter is finely balanced in these circumstances we consider that before taking a different view from the TRA, it was incumbent on the Judge to be satisfied that the TRA was wrong in its factual findings. We do not consider that this test was met….

In Business (section 65(2)(a) and *Grieve*): The Court noted the TRA's view that there was considerable overlap of this test with the share dealing test [69] and after reviewing the relevant cases and facts of this case the Court concluded:

> [78] Essentially for the reasons we have given in relation to the first limb of section 65(2)(e), we do not consider there was a basis for the High Court to take a different view from that in the TRA in this issue. The nature of the activity was investment. The scale and nature of the activity across the portfolios was not such as to meet the test for a business when the transactions are analysed taking into account [the taxpayer's witness'] explanation for them. It cannot be said the taxpayers' intention was to conduct a business.

Finally the Court considered whether the *shares were acquired for the purpose of resale* (section 65(2)(e) second limb). The parties accepted that this was a subjective test to be determined by reference to each individual instance of share acquisition [89]. However, in the absence of finding of fact on individual transactions (which the Court of Appeal would not usually make) and the Commissioner's decision not to seek the matter be remitted back to the TRA for it to make such findings of fact, the Court concluded the second limb of section 65(2)(e) was not met [90].

A minor issue in the tax case was whether the Jersey-based company which held the portfolios was a bare trustee for the taxpayers. The Court of Appeal agreed with the TRA and High Court that it was [91-114].

THE COMMISSIONER OBTAINS INTERIM CHARGING ORDER AND MAREVA INJUNCTION OVER TRUST ASSETS

Case:	The Commissioner of Inland Revenue v Joseph Colin Skudder, Willerton Investments Limited, Athena Professional Trustees Limited
Decision date:	11 October 2007
Act:	Judicature Act 1908
Keywords:	Mareva injunction, pre-judgment charging orders

Summary

The Commissioner obtained an interim mareva injunction and pre-judgment charging orders over assets held by a corporate trustee, which were prima facie beneficially owned by the taxpayer

Facts

The taxpayer is a successful property developer/speculator and the Commissioner has sued him for in excess of $3.5 million in unpaid tax debt. The substantive proceedings are currently before the Taxation Review Authority.

During the course of an investigation into the taxpayer's tax affairs it was identified that he generally operated behind the veil of trading trusts and/or limited liability companies. The taxpayer maintains full and unfettered control of these entities but does not own any significant assets in his own name. All entities which the taxpayer is associated with have an unsatisfactory compliance history in terms of their return filing and payment obligations. The taxpayer is the director and shareholder of Athena Professional Trustees Limited ("Athena"), a corporate trustee company, and settlor and final beneficiary of the CBD Properties Trust (CBD Trust"). A number of properties owned by Athena were actively being marketed by the taxpayer.

The Commissioner's case was that if those properties were sold before judgment is given against the taxpayer there may be no assets left against which the Commissioner could seek to recover the unpaid tax debt. Effectively, the taxpayer would be judgment proof.

The Commissioner sought a mareva injunction and pre-judgement charging orders over the properties held by Athena.

Decision

To obtain a pre-judgment charging order the burden of proof rests on the Commissioner to show that the taxpayer is making away with his property with the intent to defeat his creditors. For a mareva injunction all that needs to be shown is there is a real risk the properties are going to be sold with the intention to defeat the Commissioner as a creditor.

The Commissioner relied on evidence of the taxpayer's previous non-compliance with his tax obligations and the tax obligations of entities which he controlled. The Court accepted that previous behaviour was likely to evidence future such conduct and in that regard held:

> [20] Given the apparent level of revenue being generated by the properties and the fact that no income tax has ever been paid voluntarily it is difficult to resist the inference that the taxpayer has deliberately conducted his affairs over several years so as to avoid meeting tax obligations. It is reasonable to assume that he is likely to continue this pattern when it comes to the sale of the properties in question ie that he will act with the underlying intention of avoiding his tax obligations.

The Court then examined the question of whether or not the orders sought could be given in view of the fact that Athena was the registered proprietor of the properties over which the orders were sought. The Court stated that if a prima facie case could be made out showing beneficial ownership vested in the taxpayer, then the orders sought could be granted.

The Commissioner presented affidavit evidence showing the taxpayer dealt with the properties as if they were his personal property. In addition, the taxpayer was the director and shareholder of Athena, he was the settlor and final beneficiary of the CDB Trust. The Court accepted that the taxpayer via Athena and the CBD Trust had complete control of the assets and it was more likely than not that the taxpayer was the beneficial owner and held:

> [31] I am therefore satisfied that, at the least, there is an arguable case that the taxpayer is the beneficial owner of the properties. In fact, I think that the position is actually stronger than that and that it is more likely than not that he is the beneficial owner.

In the result the Court was satisfied that the Commissioner had discharged the onus for the Court to grant interim pre-judgement charging orders and mareva injuctions over the properties in question.

REGULAR FEATURES

DUE DATES REMINDER

December 2007

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

January 2008

15 GST return and payment due

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

28 GST return and payment due

February 2008

7 End-of-year income tax

2007 end-of-year income tax due for people and organisations with a March balance date and don't have an agent

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

28 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2007–2008*. This calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum.

This item has been added to this electronic version of *TIB* Vol 19, No 11 (December 2007) since the issue was printed.

RESEARCH & DEVELOPMENT TAX CREDIT GUIDE CONSULTATION

This month we expect to begin consulting on the Research & Development (R&D) Tax Credit Guide. The Taxation Annual Rates, Business Taxation, KiwiSaver and Remedial Matters Bill, which will introduce the R&D tax credit, is expected to be enacted in mid-December.

A consultation draft of the Guide will be available for consultation on the Inland Revenue website from mid-December 2007 to early-February 2008. We will notify you when the Guide is on the website.

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