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TAX INFORMATION
Bulletin

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Inland Revenue
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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly 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 a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe to receive regular email updates when we publish new draft items for comment.

Below is a selection of items we are working on as at the time of publication. If you would like a copy of an item please contact us as soon as possible to ensure your views are taken into account. You can get a copy of the draft from **www.ird.govt.nz/public-consultation/** or call the Team Manager, Technical Services Unit on 04 890 6143.

Ref	Draft type/title	Description/background information	Comment deadline
ED0120	Draft tax depreciation rates general determination: Test chambers – acquired during the 2009/2010 or subsequent income years	The Commissioner has been advised that the existing general economic depreciation rate for test chambers is not appropriate for newer assets. This draft depreciation determination sets a new rate that will apply to assets acquired during the 2009/2010 or subsequent income years.	29 January
ED0121	Draft tax depreciation rate provisional determination: Computer-controlled tablet dispensing systems	The Commissioner proposes to set a provisional depreciation rate for computer-controlled tablet dispensing systems. The draft depreciation determination will add the new asset class to the "Medical and Medical Laboratory" and "Pharmaceuticals" industry categories that will apply to assets acquired during the 2009/2010 and subsequent income years.	29 January
INS0057	Deductibility of business relocation costs	This interpretation statement considers the deductibility of business relocation costs incurred to carry out an overall business relocation within New Zealand under the general rules of deductibility in the Income Tax Act 2007. It replaces an earlier draft version of the statement that was released for external consultation on 16 February 2005. In the light of submissions received, the Commissioner has reconsidered the approach taken in the earlier version and, in some regards, has changed his view.	
INS0064	Residential rental properties – depreciation of items of depreciable property	This statement considers the depreciation of items in the context of a residential rental property. It sets out a three-step test that the Commissioner will apply to determine whether an item can be depreciated separately or whether it is properly depreciated as part of the building. It also includes an appendix with a number of common items (such as plumbing, electrical wiring, hot water cylinders, doors, and cupboards) and states the Commissioner's view on whether these are separately depreciable items or part of the building.	
XPB0020	Commissions received by life agents on their own policies and those of associated persons – income tax implications; and, Discounted premiums on life insurance policies provided to life agents and associated persons – fringe benefit tax implications	These rulings are reissues of BR Pub 00/01 and BR Pub 00/02, which expired on 31 December 2004. The rulings consider the income tax treatment of commissions received by life agents on their own life insurance policies and those of associated persons, and the fringe benefit tax treatment of discounted life insurance policies received by life agents and associated persons.	

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NEW LEGISLATION

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.

STUDENT LOAN SCHEME (REPAYMENT BONUS) AMENDMENT ACT 2009

Sections 45A to 45H of the Student Loan Scheme Act 1992

The Student Loan Scheme (Repayment Bonus) Amendment Bill was introduced into Parliament on 27 April 2009. The Bill had its first reading on 5 May 2009 and was considered by the Education and Science Committee, which reported the Bill back to the House on 3 August 2009. The Bill completed all remaining parliamentary stages on 17 September 2009 and received Royal assent on 22 September 2009.

The Act amends the Student Loan Scheme Act 1992 to provide a 10% bonus for borrowers who pay $500 or more in excess of their annual compulsory repayment obligation.

The bonus will not be of financial benefit to all borrowers. The Commissioner of Inland Revenue is unable to provide financial advice. Borrowers may therefore wish to seek independent advice before making excess repayments.

Background

The Act gives effect to a commitment given by the National Party in the lead-up to last year's election to introduce a bonus scheme for borrowers to encourage them to make voluntary repayments so their student loans are repaid more quickly.

Key features

A 10% bonus will be available for those who make excess repayments on their student loans on or after 1 April 2009. The bonus will be available to both New Zealand and overseas-based borrowers. Only repayments made to Inland Revenue will qualify for the bonus.

Excess repayments will be any repayments in respect of a tax year that exceed the borrower's compulsory repayment obligation for that tax year by $500 or more. The excess repayment can be made in a lump sum or by smaller contributions throughout the year.

The loan balance needs to be at least $550 at the beginning of the tax year for excess repayments to attract the bonus. If the loan balance was $550 or more at the start of the tax year, but between $500 and $549 at the time of the final repayment, the maximum bonus will be $49. Borrowers wishing to repay their loan in full will need to pay 10/11ths of their loan balance (provided all obligations are up to date).

Borrowers who are required to make interim instalments during the tax year will have until the third interim instalment date—7 May after the end of the tax year for most borrowers—to make repayments that will count towards the bonus.

For borrowers fully repaying their loan during the tax year, the bonus will be credited to the loan balance as at the date of the final repayment. Borrowers repaying in full before 31 March 2010 will have the bonus backdated to the date on which the final repayment was made.

For borrowers who do not repay in full, the bonus will be calculated after the end of the tax year and credited to their loan balance as at the following 1 April. This is because it is not until after the end of the tax year that a borrower's compulsory repayment obligation, which is income-contingent for New Zealand-based borrowers, and thus the amount of any excess repayments, can be established with certainty. Borrowers will generally not have to apply for the bonus. (The exception to this is PAYE errors which are discussed below.) After the end of the tax year, or at the time the final repayment is made, Inland Revenue will check borrowers' entitlements and apply the bonus accordingly.

Examples

Janis is a salary and wage earner who has asked her employer to deduct $20 extra from her fortnightly income and pay it to Inland Revenue for repayment of her student loan. After the end of the tax year, her compulsory repayment obligation is established at $700 and the total deductions from her salary are $1,220. Janis will be entitled to a bonus of $52 ($1,220 – $700 × 10%) and this will be credited to her loan account on 1 April of the next tax year.

Martin is a salary and wage earner who has just the standard deductions made from his weekly wages, and these total $2,560 for the year. When Martin heard about the bonus scheme in June 2009 he set up automatic repayments of $100 a month from his bank account and these repayments total $1,000 by 31 March 2010. Martin's compulsory repayment obligation for the 2009–10 tax year is assessed in May 2010 at $2,550. A bonus of $101 ($2,560 + $1,000 – $2,550 × 10%) is credited to Martin's loan account as at 1 April 2010.

Paula is currently at home looking after her children and, as her income is under the repayment threshold, does not have any compulsory repayment obligation. Her parents decide to give her the money to fully repay her loan. Paula rings Inland Revenue at the end of April 2010 and is told that her loan balance is $11,000 and she will need to repay $10,000 to fully repay her loan. Her parents give her this amount and she pays it to Inland Revenue on 20 May 2010. Inland Revenue calculates her bonus at $1,000, credits it to Paula's loan balance as at 20 May 2010 and advises her that her loan has been fully repaid.

Dennis is working in the UK on 17 July 2010. He accesses his IR online services and establishes that his loan as at that day, including interest, is $24,453 and that, allowing for the bonus, he needs to pay $22,230. He calculates that this is equivalent to £8,900 and the following day arranges for his bank to transfer this amount to Inland Revenue. However, because of exchange fluctuations, the amount that Inland Revenue receives is actually $22,460. Inland Revenue credits a bonus of $2,223 and refunds $230 to Dennis.

Brendon is working in Australia on 1 September 2010. He accesses his IR online services and establishes that his loan as at that day, including interest, is $15,972 and that, allowing for the bonus, he needs to pay $14,520. However, Brendon does not actually make the payment until 15 October 2010. By that time his loan has increased to $16,106 because of interest charged since 1 September. To clear the loan balance Brendon would need to pay a further $122.

Margaret's loan was $2,300 at the start of the 2010–11 tax year. By 22 November 2010, repayment deductions made from her salary and wages have reduced this to $530. Margaret decides to pay off the loan in full before she heads off overseas and sends Inland Revenue a cheque for $500. Inland Revenue applies this and a bonus of $30 to Margaret's loan balance and advises her that her loan is now fully repaid.

Small inaccuracies may arise in the repayment deductions that are made from salary and wages during the tax year. In addition, employers sometimes make errors in the amount of these deductions. The Commissioner has therefore been given the ability to allow the bonus if the Commissioner considers that the borrower did make a voluntary repayment(s) of $500 or more, but the end-of-year excess was less than this because the shortfall arises under the PAYE system and is:

- less than $20;
- due to the borrower starting or ceasing employment; or
- due to the employer's error.

Inland Revenue has no way of automatically identifying whether one of these events has occurred and it will be necessary for any affected borrower to bring this to Inland Revenue's attention.

Example

Gary tells his employer that he has a student loan, but his employer overlooks deducting the $165 that should have been deducted for April 2009. In March 2010, Gary receives a bonus and decides to use $500 of it towards repayment of his student loan, which he pays directly to Inland Revenue. Gary's repayment obligation for the 2009–10 tax year is $2,000 and his repayment deductions for the year are $1,830. His excess repayment is therefore $330 and no bonus is initially allowed. Gary contacts Inland Revenue and points out his employer's error. Inland Revenue checks this out and then allows Gary a bonus of $50.

The bonus will not apply to any excess repayment for which a refund is subsequently requested or to any repayment that needs to be applied to another liability, such as an amount in respect of an earlier tax year.

Examples

Miriam made excess repayments of $3,000 and was credited with a $300 bonus. However, shortly after receiving notice of this, she decides that she wishes to have $1,000 refunded to cover an unexpected bill. Inland Revenue makes the refund and reduces Miriam's bonus to $200.

Grant made excess repayments of $2,000 and was credited with a $200 bonus. He subsequently decides that he would be better off using this money to reduce his mortgage and asks for the full amount to be refunded. Inland Revenue makes the refund and reduces Grant's bonus to zero.

Brent's repayments for the 2009–10 tax year exceeded his repayment obligation for that year by $650. However, his terminal repayment obligation for the 2008–09 tax year of $210, which was due on 7 February 2010 has not been paid. After crediting $210 to the 2008–09 tax year, the excess repayment amount is less than $500 and no bonus is allowed.

Application date

The Act comes into force on 1 April 2010, but the bonus will apply to excess repayments made on or after 1 April 2009.

GUIDANCE ON A "REASONABLE DAILY TRAVELLING DISTANCE"

This item provides further detail on recently enacted legislation relating to work-related relocation payments.

One of the requirements of a "work-related relocation"[1] is that the relocation of the place where an employee lives is required because the employee's workplace is not within reasonable daily travelling distance of the employee's residence.

"Reasonable daily travelling distance" is not defined in the legislation. A number of submissions during consultation on the development of the policy and legislation in relation to the tax treatment of relocation payments asked for guidelines from Inland Revenue on what is meant by "reasonable travelling distance".

The information provided here is a guideline only. It is ultimately up to the taxpayer to form a view on what he or she considers to be reasonable. The guideline is based on the assumed time it would take the average person to drive the distance to and from work. There may be special circumstances surrounding why an employee or employer might consider a lesser distance or time to be a reasonable cut-off, such as if the person had a physical disability that limited their scope to drive long distances. The guideline also assumes that the employee will choose the most efficient route to work. Usually this will be the shortest route, but this may not always be so; a longer route may be quicker because of lighter traffic flows. An employee might also have a range of transport options, such as travelling by car, rail, bus or ferry. The guideline should be applied using the mode of transport, or reasonable combination of modes, that is quickest and most feasible in the circumstances.

The two key practical constraints on the daily travelling distance to and from work are the actual distance itself and the time it takes to travel that distance. Traffic density at normal travel times to and from work, for example, is a factor in limiting the distance that could be reasonably travelled because it extends the time taken to travel the distance. Traffic density should, however, be less of an issue if there is an adequate public transport alternative. Employees may be prepared to commute longer distances outside of the main centres because the roads are less congested at the time they travel.

The condition of the roads may also affect the distance that can be covered in a given time. For example, in some parts of the country, roads may be more winding than in other areas.

In terms of travelling time, we note that many employees are prepared to commute for up to an hour each way between home and work.

Furthermore, an employee is likely to factor in the aggregate time and distance travelled to get to work and back again when considering whether it is reasonable. A substantially shorter time on one leg of the journey may, for example, compensate for the other leg taking a long time.

Given the range of factors involved in determining what is "a reasonable travelling distance", it is not possible to accommodate them all within a precise formula. Only a general rule of thumb can be provided. In these circumstances, a guideline incorporating the various factors would be whether, taking the two legs in combination, the employee has to, on the relevant day, travel more than two hours at the time the employee needs to travel to get from home to work and from work to home. If this were the case, the distance between home and work would not be considered a reasonable daily travelling distance. Generally this equates to between 50 kms and 80 kms for each leg of the journey or between 100 kms and 160 kms, taking both legs into account, depending on the time of day, state of the roads and the mode of transport.

Example

Jessica was previously employed by Fantastic Enterprises in its Papakura branch, which is a relatively short distance from where she lives near the town of Miranda. Fantastic Enterprises requires a new branch manager in Auckland Central and Jessica moves to a house in Waitakere. Fantastic Enterprises wants to pay Jessica's relocation costs tax-free. The issue is whether Miranda was within a "reasonable daily travelling distance" of the new work premises in Auckland Central. The distance from Miranda to Auckland Central via State Highway 2 is approximately 79 kms, and the travelling time for Jessica to start at 8.30 am is 1 hour 40 minutes. At night, Jessica usually works until 7 pm and her travelling time is about 55 minutes. Jessica has heard that some of her neighbours in Miranda travel the coastal route into Auckland which takes a shorter time, but is a longer distance.

[1] See section CW 17B(4) of the Income Tax Act 2007. Under section CW 17B, an amount that an employer pays to or on behalf of an employee in connection with the expenses of the employee in a work-related relocation is exempt income of the employee.

Fantastic Enterprises can pay Jessica's relocation costs tax-free because:

- the time it would have taken to travel the distance from Miranda to Auckland and back again using State Highway 2 would have been a combined 2 hours 35 minutes
- alternatively, if Jessica chooses the coastal route (where each leg of the journey is 90 kms but the travel time is only 65 minutes), the combination of the two legs would have also exceeded two hours
- similarly, if Jessica had used a combination of the two routes, her combined travel distance of 169 kms would take at least two hours.

ORDER IN COUNCIL

FORESTS (PAYMENT OF MONEY) ORDER 2009

A payment to landowners for permanently protecting native forest with high conservation values on their land can be exempted from income tax if the appropriate Order in Council is made.

An Order in Council, made under the Forests Amendment Act 2004 (see *Tax Information Bulletin* Vol 16, No 8, p19) grants an income tax exemption in relation to a payment made by the Nature Heritage Fund to the owners of a block of land in Waitutu Survey District. The payment made in April 2009 was in exchange for the owners entering into conservation covenants over the land.

The Order in Council, which came into effect on 27 October 2009, is part of the Government's SILNA (South Island Landless Natives Act 1906) Policy Package announced in 2002.

(Forests (Payment of Money) Order 2009 (2009/328))

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 DET 09/04: ELIGIBLE RELOCATION EXPENSES

This determination is made pursuant to section 91AAR of the Tax Administration Act 1994. It may be cited as "Determination DET 09/04: *Eligible relocation expenses*". Further commentary is provided in *Tax Information Bulletin* Vol 21, No 8 (October/November 2009) on the background and key features of the related legislation.

Application

This determination shall apply to relocation expenses incurred in respect of the 2002–2003 and subsequent income years.

In addition to being a listed eligible relocation expense, the other criteria under section CW 17B of the Income Tax Act 2007, (or section CW 13B of the Income Tax Act 2004, or section CB 12(1B) of the Income Tax Act 1994, as required) must also be met for a payment by an employer to cover an employee's relocation expenses to be exempt income of the employee.

This determination may be supplemented or amended from time to time by further determinations pursuant to subsection 91AAR(4) of the Tax Administration Act 1994.

The list of eligible relocation expenses are set out in the schedule to this determination.

Definitions

In this determination, unless the context otherwise requires, expressions used have the same meaning as those in sections CW 17B of the Income Tax Act 2007, CW 13B of the Income Tax Act 2004, CB 12(1B) of the Income Tax Act 1994, and section 91AAR of the Tax Administration Act 1994.

Amendments to determination

Amendments to this determination may be made by the Commissioner issuing supplementary determinations pursuant to subsection 91AAR(4) of the Tax Administration Act 1994. This determination provides a process for updating the list of eligible relocation expenses.

Amendments may include adding further expenditure items to those already listed or deleting items from the existing list. The Commissioner must give at least 30 days notice of the implementation date for any change to the determination.

If a taxpayer wishes to put forward a case for an additional expenditure item to be included in the list, they would need to make a written application. Applications for changes should include the following information:

1. the nature of the amendment to the determination being sought;
2. the applicant's details – this includes full name, IRD number (if applicable), address, landline telephone number, fax number, cell phone number and the contact person for enquiries; and
3. information to support the amendment requested.

Applications for changes to the determination should be sent to:

LTS Manager, Technical Standards
National Office
Inland Revenue
PO Box 2198
WELLINGTON 6140

This determination is made by me, acting under delegated authority from the Commissioner of Inland Revenue under section 7 of the Tax Administration Act 1994.

This determination is signed on the 28th day of October 2009.

Rob Wells
LTS Manager, Technical Standards

SCHEDULE TO DETERMINATION DET 09/04: LIST OF ELIGIBLE RELOCATION EXPENSES

This list sets out the types of expenditure that may be treated as exempt income when an employee is reimbursed, or the expenditure is paid on an employee's behalf, when the employee (including their immediate family) relocate their accommodation for employment purposes.

"Immediate family" includes the employee's partner, dependent children and any dependent adults that are part of the employee's household. A dependent adult might be a dependent parent of the employee or partner or a disabled relative for whom the employee or the employee's partner is the caregiver.

The costs should be reasonable in the circumstances and, where relevant, should be as if they had been calculated on an arms-length basis between third parties.

Where there is a time limit specified on an item, that limit will be assumed to have been met for payments made prior to the issue of this determination.

Furthermore, the time limit on a specific item is subject to the overall time limit set in the legislation (that is, expenditure must have been incurred by the end of the tax year following that in which the relocation occurred).

List of eligible relocation expenses

Preparatory
Engaging a relocation consultant
A familiarisation trip to the new location immediately prior to relocation, for a maximum of 7 days in the new location (this excludes travelling time between the old and new locations)
Obtaining immigration assistance
Immigration and emigration applications
Health checks, tests and immunisations necessary for immigration or emigration
Any documentation and police and other agency checks required as a result of the relocation
Obtaining advice on the taxation and superannuation implications of relocating and of obtaining assistance in meeting any additional tax reporting/return requirements that arise from relocating
Transportation
Removal and transport of household effects (including insurance, insurance excesses and taxes)
Moving "tools of trade" (including insurance, insurance excesses and taxes)
Moving other personal items such as cars, boats or trailers (including insurance, insurance excesses and taxes)
Cleaning and fumigation associated with the removal, transportation and storage of household effects
Excess baggage charges arising from the transportation of household and other personal effects and "tools of trade"
Customs' clearance and other costs associated with complying with New Zealand Customs regulations and other regulatory requirements that arise when transferring household and personal effects and "tools of trade" from the old to the new location
Transport to get to the new location (such as, but not limited to, air fares and car rental costs) using a direct route, and meals and accommodation en route
Relocating pets, including quarantining and boarding fees
Hiring a replacement vehicle while awaiting transportation and clearance of the employee's own vehicle to the new location. If the employee does not have a vehicle in transit, the cost is limited to a maximum of one month's hire
A trip to tidy up affairs after relocation

Property
Exiting or breaking existing accommodation leases and similar contracts
Selling an existing home and acquiring a new dwelling: • real estate commissions; • advertising and auctioning; • legal and conveyancing fees and disbursements; • loan application fees; • mortgage early repayment loan application fees; • valuation costs; • LIM and building reports (or similar); • any stamp duty; and • penalty interest charges for breaking a fixed term loan (but not any loss in capital value of the existing home)
Finding accommodation, whether to rent or to purchase, in the new location (but not bonds, refundable or otherwise)
Hiring household and/or personal effects for the new location, while awaiting transportation of related property to the new location
Storage of household or personal effects left at the old location, for (subject to the overall time limit) up to two years
Storage for household or personal effects once they have arrived in the new location, for up to three months, or until the employee finds a permanent home, whichever is sooner
Disposing of household/personal effects and similar assets at the previous location (but not capital losses)
Conversion of any electrical appliances because of voltage differences between the old and new locations
Disconnection and connection fees for, respectively, the old and new residences in relation to utilities (such as power and gas) and telecommunication services (such as telephone, internet and television)
Accommodation or value of employer provided accommodation once the employee has arrived in the new location, for up to three months after arrival
Cleaning and fumigation of old and new residences
Utility, rates, insurance and maintenance for the employee's previous residence for up to one year if, despite reasonable efforts, it cannot be sold or rented, or if the property is rented by the employee, it cannot feasibly be rented to someone else (for example, because the relocation is for a short period)
Individuals, dependants and miscellaneous
Language training for the employee necessary for the relocation (up to 12 months after relocation)
Redirecting mail
Disposal of investments, including superannuation and insurance policies, (but not any reduction in the value thereof), that cannot be held or continued because of the relocation
Charges for currency exchange on actual eligible relocation expenses incurred
Travel/health insurance while relocating
Additional childcare costs that arise as a result of a relocation giving rise to a temporary household rearrangement, for up to three months from the time of relocation
School uniform items that need to be replaced because of the relocation
Private school application fees if an employee's children were enrolled in private schools in the previous location or where there is no alternative to private schools in the new location
Cancelling professional and club memberships
Other costs directly arising from relocation, up to $500 in aggregate

INTERPRETATION STATEMENT

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.

IS 09/01: FINES AND PENALTIES – INCOME TAX DEDUCTIBILITY

All legislative references are to the Income Tax Act 2007, unless otherwise stated.

Application

1. This statement applies to fines and penalties imposed on a person under a statute or regulation.
2. This statement does not apply to:
   - fines and penalties imposed under a contract or as the result of a dispute between two commercial parties;
   - penalties for the late payment of an amount where the underlying amount payable is not payable as the result of a breach of statute or regulation; or
   - legal fees incurred in defending a fine or penalty.
3. Whether fines and penalties outside the scope of this statement are deductible will depend on the particular circumstances of the taxpayer and the nature of the fine or penalty. Where there is doubt as to the deductibility of such a fine or penalty, it may be necessary to obtain advice from a tax advisor.

Overview

4. In several decided cases, a deduction for fines and penalties has been denied—either for failing the statutory nexus test or on public policy grounds. This statement examines the leading cases on fines and penalties with a view to determining the correct test or tests that apply in a New Zealand context. In many situations it will be clear that the breach of law (and associated fine or penalty) is too remote from the income-earning process. However, the statement concludes that irrespective of whether the statutory nexus is met, fines and penalties are not deductible in New Zealand because of the application of public policy considerations.
5. Fines and penalties are not deductible in New Zealand irrespective of whether the:
   - infringement for which the fine or penalty is imposed forms part of criminal proceedings;
   - fine is imposed by the court or another body;
   - fine is imposed on the taxpayer, its employees, or a third party;
   - taxpayer intended to break the law; or
   - fine is imposed in respect of a strict liability offence.
6. The item "Deductibility of fines and levies paid by hotel licensees", *Tax Information Bulletin* Vol 6, No 13 (May 1995) sets out the Commissioner's view on the deductibility of certain expenditure incurred by hotel licensees. The discussion in the item that relates to the deductibility of fines paid by licensees does not reflect the law as it stands, so, to that extent, the item has been withdrawn effective from 15 October 2009 and taxpayers taking a taxpayer's tax position after that date should not rely on the May 1995 item. However, where a taxpayer has previously taken a tax position in reliance on the statement, the Commissioner will not be devoting staff time and resources to investigating and reassessing in such cases.

Character of fine or penalty

7. This statement reviews the deductibility of payments that are in the nature of fines and penalties. When referring to fines or penalties, this statement is referring to forms of financial punishment imposed for carrying out some kind of prohibited activity and generally payable to the state or a representative of the public. The statement starts by reviewing the character or identifying features of fines and penalties. The relevant tests for deductibility are then applied with these characteristics in mind. The *Oxford English Dictionary* (11th ed, 2006) provides the following definitions:

   Fine: A certain sum of money imposed as the penalty for an offence ... A penalty of any kind ...

   Penalty: A punishment imposed for breach of law, rule, or

> contract; a loss or disadvantage of some kind, prescribed by law for an offence, or agreed upon by the parties concerned in the case of breach of contract; esp. the payment of a sum of money imposed in such a case, or the sum of money itself; a fine.

Statutory test of deductibility

8. Section DA 1(1) is the general deductibility provision. It provides:

> 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.

9. In short, under section DA 1(1) an amount is an allowable deduction if a sufficient relationship is established between the expenditure or loss incurred and the derivation of income: *CIR v Banks* (1978) 3 NZTC 61,236, 61,240; *Buckley and Young v CIR* (1978) 3 NZTC 61,271, 61,274.

10. However, in several decisions the courts have denied a deduction for fines and penalties, even in situations where it would appear that the required relationship has been established.

Deductibility of fines and penalties

United Kingdom

11. *IRC v Alexander von Glehn and Co Ltd* (1919) 12 TC 233 is a leading case on fines and penalties. It followed the principles in the earlier English case of *Strong v Woodifield* (Surveyor of Taxes) 5 TC 215 (which it acknowledged was in a different context) and was also consistent with the decision in *IRC v Warnes* [1919] KB 444. *Alexander von Glehn* involved a company that carried on an exporting business and was fined £3,000 for exporting goods to Russia without taking appropriate precautions to ensure their ultimate destination was not enemy territory. The company's claim to deduct that sum was rejected by the English Court of Appeal. In reaching its decision, the Court of Appeal considered that, because the fine was imposed on the company for breaking the law, the expense could not be connected with or arising out of the company's trade.

12. In *Mann v Nash* (1932) 16 TC 523, 529, Rowlatt J, referred to *Alexander von Glehn*, and observed that:

> the decision in the case was that payment of those penalties was nothing to do with the trade or business; it was not an expense for the earning of the profits, but it was an expense in the form of an inconvenience which supervened later when the profits were made, because illegality had been committed in the course of earning them.

13. The early United Kingdom decisions suggest that a deduction is denied on the basis that the required statutory connection or nexus between the fine or penalty and trading is absent.

14. More recently, the House of Lords in *McKnight (Her Majesty's Inspector of Taxes) v Sheppard* [1999] 3 All ER 491 discussed *Alexander von Glehn*. Lord Hoffmann had no doubt that *Alexander von Glehn* was correct. However, he observed (at p 485) that "the Court of Appeal was curiously inarticulate about why the fine was not money expended for the purposes of the trade". His Lordship considered (at p 496) that the reason a fine is not deductible is not found in "the broad general principle of what counts as an allowable deduction". Lord Hoffmann considered that the reason relates to the particular character of a fine or penalty. On this point, he said (at p 486):

> [A fine or penalty's] purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden of the rest of the community by deduction for the purposes of tax. This, I think, is what Lord Sterndale MR meant when he said that the fine was imposed 'upon the company personally'.

15. This reasoning as to why a deduction for a fine or penalty is denied is commonly referred to as the "public policy" reasons.

Australia

16. The Australian courts have approached this matter in a similar way. *Herald & Weekly Times Ltd v FCT* (1932) 2 ATD 169 is a case dealing with the deductibility of damages for libel. The High Court held that the damages in that case were deductible. However, in the course of its judgment the High Court referred to the deductibility of fines and penalties. Gavan Duffy CJ and Dixon J said in their joint judgment (at p 172):

> The penalty is imposed as a punishment on the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character as a trader.

17. Under this view, a fine or penalty is not incurred by an offender acting in the capacity of a trader because it fails to satisfy the requisite statutory connection as a relevant outgoing incurred in deriving assessable income.

18. *Magna Alloys and Research Pty Ltd v FCT* 80 ATC 4,542 considered whether the taxpayer was able to deduct legal costs in the defence of criminal proceedings. The court found that the payments were deductible. In the course of their judgment, Deane and Fisher JJ expressed unease as to the reasons given for denying deductibility in earlier cases on the deductibility of fines and penalties. Deane and Fisher JJ preferred to base the denial on public policy considerations. They said (at p 4,563):

> It is somewhat difficult to understand how it can be maintained, as an unqualified proposition, that the nature of a penalty severs it from the expenses of trading. Recurrent penalties for parking infringements incurred by a delivery man and per diem penalties for unlawfully using premises for business or commercial purposes in contravention of zoning requirements are not, for example, logically severed from the expenses of trading. The same can be said of fines imposed for actually engaging in some unlawful activities, such as illegal bookmaking or soliciting, the purposes of earning assessable income. If, when the matter directly arises for decision in the Australian courts, it is to be held that all fines and penalties are to be denied deductibility under the Act, **it would seem preferable that it be on the basis of some perceived overriding consideration of public policy which precludes deductibility**. Even in that event however, it would not necessarily follow that, as a matter of overriding principle, a deduction should be refused in respect of a taxpayer's costs of defending the proceedings in which the penalty was imposed upon him.
>
> [Emphasis added]

19. In *Mayne Nickless Ltd v FCT* (1984) 15 ATR 752 (Supreme Court of Victoria), the taxpayer, a transport operator who ran armoured cars, had incurred a multitude of fines and penalties related to a variety of motoring offences. Ormiston J examined all the relevant authorities and concluded that none of the outgoings was deductible.

20. In relation to the fines imposed directly on the company and paid by it, Ormiston J followed earlier High Court decisions and found that the payments were not deductible. Ormiston J also held amounts paid by the company for fines and penalties imposed on employees, independent contractors, or persons other than the taxpayer should be precluded on the grounds of public policy (at p 772):

> The critical feature of the fines and penalties are that they are imposed for purposes of the law in order to punish breaches thereof and that makes it undesirable that they should be deductible, whether for serious or minor regulatory offences and **whether they are imposed directly on the taxpayer or on its employees or third party contractors**. In the latter case the policy of the law ought not to differ whether or not the money was originally paid by, **or the original liability fell on, persons other than the taxpayer**.
>
> [Emphasis added]

21. In discussing public policy, Ormiston J continued (at p 772):

> Many aspects of public policy have been and remain controversial largely because the courts have attempted to express and apply policies which did not derive directly from the common law or statute, but were derived from what were said to be accepted social or economic beliefs at the time. These beliefs have not always remained constant, so that difficulties arise in determining whether 'public policy' can change or expand.

22. *Madad Pty Ltd v FCT* [1984] 15 ATR 1,118 was the first time this issue had come directly before the full Federal Court. *Madad* concerned the deductibility of a penalty imposed on the taxpayer under the Trade Practices Act 1974. The court considered that the penalty was not deductible (at p 1,124):

> We are of the view that the deductions claimed should not be allowed. We placed this decision on the basis of the acceptance in *Snowden and Willson* [99 CLR 431] ... of what was said in the cases we have referred to. The acceptance in the High Court, albeit by way of dicta, of the earlier dicta in England and in *Herald and Weekly Times* [(1932) 2 ATD 169] ... indicates in our view an approach to the construction of s 51(1) which we should follow.
>
> The approach may well have its origins in public policy. In any event, it has been of long standing, and having in mind the application it must have had over many years, we should not disturb it, for reasons similar to those stated by Dixon CJ in *Lunney's* case [100 CLR 478].

Canada

23. The Canadian courts initially denied deductions for fines or penalties on the basis of overriding public policy considerations. For example, in *King Grain and Seed Co Ltd v Minister of National Revenue* (1961) 26 Tax ABC 436, the taxpayer operated a fleet of trucks and sought to deduct a highway fine levied against it for overloading one of its trucks. The Tax Appeal Board disallowed the claim, stating (at p 439):

> [It] would be contrary to accepted principles if the present appellant, King Grain and Seed Company, was allowed to deduct the amount of this fine ... and thus be enabled to share with the public revenue the loss which it was condemned by reason of its own negligence.

24. Over time, however, the Canadian courts have modified their approach. *Day & Ross Ltd v The Queen* [1976] CTC 707 was a trucking case in which the taxpayer had incurred fines in excess of $70,000 over several years for the violation of various highway weight restrictions. The Federal Court held that the fines were deductible. This was followed in the Canadian Federal Court of Appeal in *Amway of Canada v The Queen* [1996] 2 CTC 162. In *Amway*, the Federal Court of Appeal recognised that:

> [t]here emerges in the jurisprudence and the literature a recognition of two possible criteria for deciding whether amounts expended for the payment of fines or penalties should be deductible as a business expense. The first test is whether it was an expense incurred for the purpose of earning income ...
>
> The second criterion sometimes invoked is that of public policy: that is, even if the expense was incurred to produce income would it be contrary to public policy to allow a taxpayer to reduce his net income, and thus save taxes, by virtue of having been obliged to pay a fine or penalty for some wrongdoing?

25. The court in *Amway* discussed *Alexander von Glehn* and continued (at p 171):

> An observation made by Lord Sterndale, M.R. is of interest given the later developments in Canadian jurisprudence. He stated:
>
> > Now what is the position here? This business could perfectly well be carried on without any infraction of the law at all. This penalty was imposed because of an infraction of the law and that does not seem to me to be, any more than the expense which had to be paid in the case of *Strong v. Woodifield* [(1906) 5 T.C. 215] appeared to Lord Davey to be, a disbursement or expense which was laid out or expended for the purpose of such trade, manufacture, adventure or concern; nor does it seem to me, though this is rather more questionable, to be a sum paid on account of a loss connected with or arising out of such trade, manufacture, adventure or concern.
>
> This concept of avoidability of a penalty, as a test of whether its payment amounts to a business expense, has been developed, I believe correctly, in decisions of the Federal Court Trial Division.

26. The court in *Amway* continued (at p 172):

> With respect to the first criterion I believe that one legitimate test of whether fines should be deductible as a business expense is that of avoidability of the offences ... In adopting this test of avoidability of the offences leading to fines, and thus the avoidability of this particular type of expense, I do not purport to pronounce a more general rule concerning the deductibility of other types of expense. The question here is not: could the taxpayer have run his business more cheaply? It is: could the taxpayer have reasonably been expected to run his business in consistent conformity to this kind of law?
>
> ...
>
> Secondly, in my view it is contrary to public policy to allow the deduction of a fine or penalty as a business expense where that fine or penalty is imposed by law for the purpose of punishing and deterring those who through intention or a lack of reasonable care violate the laws. In a case such as the present the penalties are fixed by statute (albeit that the Minister first remitted about one third of the penalty and ultimately settled for less than one third of the total penalty owing under statute). It would frustrate the purposes of the penalties imposed by Parliament if after paying those penalties exigible by law a taxpayer were then able to share the cost of that penalty—and the higher his marginal rate of taxation the more he could share—with other taxpayers of Canada by treating it as a deductible expense and thus reducing his taxable income. Such a result would, I believe, clearly be contrary to public policy. Suggestions that instead a court imposing a penalty can augment it in anticipation of the accused being able to deduct the fine from his taxable income are not applicable to a situation such as this where the penalties are specifically defined by statute. Nor do I believe that sentencing courts should be required to anticipate the value of an income tax deduction to a penalized party. For this reason I think that the deductibility of penalties set by courts exercising their discretion should be subject to the same rules as I have elaborated above in respect of a penalty set by statute.

27. Under this approach, for a fine or penalty to be deductible, the taxpayer needs to satisfy two requirements. First, the fine or penalty must have been incurred for the purpose of producing income, and this condition is satisfied only where the incurring of the fine or penalty is considered to be an unavoidable incident of carrying on the business. In other words, could the taxpayer have been reasonably expected to run a business in consistent conformity to this kind of law? The focus is on whether the taxpayer could reasonably be expected to avoid breaking the law.

28. The second requirement requires an examination of the public policy concerns behind the particular fine or penalty. In the view of the Federal Court of Appeal in *Amway* (at p 173):

> it is contrary to public policy to allow the deduction of a fine or penalty as a business expense where that fine or penalty is imposed by law for the purpose of punishing and deterring those who through intention or a lack of reasonable care violate the laws.

29. Canada has since introduced legislation to prohibit the deductibility of fines and penalties.

New Zealand

30. Several cases in New Zealand have considered the deductibility of fines and penalties.

31. *Robinson v CIR* [1965] NZLR 246 considered whether fines imposed on the taxpayer by the New Zealand Law Society constituted a "loss exclusively incurred in the production of assessable income". Tompkins J considered whether the fines were similar to a penalty inflicted by a court for a breach of the law, which would preclude the deduction, or whether the fines were so different in character that they did not come within the prohibition. Tompkins J said (at p 250):

> **In my opinion there is no distinction in principle between a claim to be entitled to deduct from assessable income a fine imposed by the Disciplinary Committee and a fine imposed by a Court.** It seems to me that all the passages quoted from the cases of *Commissioners of Inland Revenue v Warnes*, *Commissioners of Inland Revenue v Von Glehn*, and *Herald and Weekly Times Ltd v Federal Commissioner of Taxation* … apply in principle to such a fine. It is inflicted on the offender as a penal liability; it is a fine imposed on the offender for professional misconduct; it is inflicted on the offender as a personal deterrent and a punishment.
>
> … a payment of damages for professional negligence is a loss which is in truth exclusively incurred as part of the operations reasonably incidental to the production of income because it is a loss arising directly out of and in the course of the practice of the profession; the risk of overlooking a time limit due to pressure of work or other negligent acts is one which must be necessarily incidental to the practice. **But the fine imposed for the negligent act is quite different from the payment of damages suffered by a client by reason thereof. It is a personal penalty imposed as a personal deterrent and punishment and not a loss incurred in the legal business.** It has no relation to what would be called a trading loss in an ordinary business. Whether it is a capital loss I am not called upon to decide. But I am clear that it is a loss which comes within s 110 of the Land and Income Tax Act 1954 and is not deductible.
>
> … Here it seems to me that the fines totalling £500 are certainly a loss in the sense that the appellant has had to pay the fine. They are, of course, incurred during the time that the income was being produced. It is noteworthy, however, that the fines were partly imposed because the appellant failed to answer letters from the Law Society relating to the complaint and that can have little to do with the production of income. But is it fairly incidental to the carrying of the appellant's profession that he should be guilty of professional misconduct so as to render him liable to fines? I think not. **They are a punishment imposed on him personally rather than a loss suffered in the practice of his profession.**
>
> [Emphasis added]

32. The taxpayer in *Case F126* (1984) 6 NZTC 60,174 was sentenced to imprisonment and fined in relation to dealing in illicit drugs. The Taxation Review Authority considered (at p 60,172) that this case did not seem to be "an appropriate one to endeavour to distinguish it from the principles laid down in *Robinson's* case".

33. However, the Taxation Review Authority suggested (at p 60,177) that, in certain circumstances, a fine and penalty may be treated as:

> akin to an operating cost of [the taxpayer's] business, in the nature of fines for parking infringements or loading offences as a business expense [provided] a sufficient and an appropriate relationship [can be found] between the gaining or producing of assessable income and the expenditure for the fine.

34. *Case K62* (1988) 10 NZTC 504 concerned a claim by a self-employed taxpayer for a deduction for the payment of three traffic fines. The Taxation Review Authority agreed with the Commissioner's submission that the classical position regarding the deductibility of fines and penalties is that no deduction is available for any penalty or fine paid for a breach of law. However, during the course of its determination, the Taxation Review Authority observed that (at p 506):

> it is conceivable that traffic fines could, in special circumstances, be deductible business expenditure even under New Zealand law. For instance, if a mail courier company is required by an important customer to urgently deliver a package to a downtown city office, it may reasonably be only able to carry out the instructions by double parking and (possibly) incurring a traffic infringement notice. In that situation, the traffic fine might well be deductible under sec 104 of the Income Tax Act 1976.

35. The taxpayer in *Case L15* (1989) 11 NZTC 1,113 was involved in an accident while driving home. He was subsequently convicted and fined and disqualified from holding a driver's licence for 12 months. The taxpayer claimed a deduction for the legal fees incurred in defending the prosecutions, the court fine and costs, and the repair costs of both cars.

36. The Taxation Review Authority referred to *Case K62* where it said that a deduction might be available in special circumstances. However, in this case no deduction was allowed because (at p 1,116):

> the objector had incurred the fine and Court costs because of criminal conduct. That activity was not conducted in the course of any income earning process. That expenditure was of a private character and could not be deductible. Such connection as there may be between the fine (and Court costs) and the income producing activity or process of the objector as a real estate agent is insufficient for tax deductibility. In any event, under my interpretation of New Zealand law, expenses resulting from a breach of the law are generally not deductible.

37. In *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213, a deduction was disallowed for fines imposed under the Trade and Industry Act 1956 as a result of a company importing goods in excess of its licence. In dealing with the general issue of the deductibility of fines Sinclair J said (at p 6,217):

> When one analyses the problem in light of the various decided cases ... any severance based on illegality is somewhat artificial and **it is preferable to rely upon public policy considerations which, in reality, form the basis of the earlier decisions**.
>
> [Emphasis added]

38. His Honour continued (at p 6,218):

> From an overall appreciation of all the decisions, I am of the view that where a fine or penalty is imposed by the Courts resulting from a breach of the law, no deduction ought to be allowed for to do so would be to prefer business lawbreakers over individuals as the business lawbreaker would obtain the benefit of deductibility of the amount of the fine or penalty whereas the individual would have to bear that particular expense personally. Additionally it would tend to allow, and encourage, lawbreaking and in some instances, to even treat it as a legitimate business option resulting in deductibility.

39. The most recent case to consider the deductibility of fines is *Case Z6* (2009) 24 NZTC 14,068. *Case Z6* involved the deductibility of fines imposed on a transport company for alleged overloading of its trucks. Barber DJ considered previous case law from New Zealand, Australia, the United Kingdom, and Canada and concluded the fines were not deductible. The conclusion was based on there being insufficient nexus and also public policy reasons:

> [109] However, it seems to me that a business should operate within the law. The disputant's business of carting logs on large trucks and trailers is able to comply with the law, but there is expense involved in weight-of-load compliance and such non-compliance can involve a relatively modest amount of annual fines. It seems to me to be illogical to seek to deduct fines relating to a breach of the law as if they were a business expense, because they relate to activities which do not confirm to the law and so are not within the permitted scope of the business. **I consider that a penalty/fine arising from a taxpayer's illegal activities** (i.e. transporting too-heavy a load) **cannot have a sufficient nexus with the taxpayer's income earning process so as to create deductibility for that cost of the fine.**
>
> ...
>
> [111] In any case, **under the doctrine of precedent** I am bound, by the 1989 High Court decision of *Nicholas Nathan Ltd and Anor v CIR* where Sinclair J held that **deductibility of fines should not be allowed on the grounds of public policy**. It would be contrary to public policy to allow such fines paid by logging transport companies to be deducted from their revenue earnings. It makes no difference to my reasoning whether the objector company incurred the fines or whether its drivers incurred them but the objector paid them. The public policy approach readily leads to a denial of deductibility for fines; but the nexus approach is not so easy to apply.
>
> [Emphasis added]

40. Barber DJ also distinguished (for deductibility purposes) illegal businesses from legal businesses that have fines imposed on them for breaches of the law:

> [110] I realise that there are activities which are illegal/criminal, e.g. drug dealing, types of gambling, dealing in stolen goods, and (until recently) prostitution, but which the IRD (in confidence) have treated as businesses and taxed after allowing appropriate deductions (but not for fines). At law, those activities seem to be businesses if there is a sufficient level of activity and the intention of profit. However, the present case is about the deductibility of fines imposed for breach of the law as distinct from assessibility of profits of a business activity which is illegal and allowable deductions when assessing that profit.

41. In the course of his judgment (and after considering relevant earlier case law), Barber DJ concluded that fines were not deductible irrespective of whether the:

- infringement for which the fine or penalty is imposed forms part of criminal proceedings;
- fine is imposed by the court or another body;
- fine is imposed on the taxpayer, its employees, or third party contractors;
- the taxpayer intended to break the law; and
- fine is imposed for a strict liability offence.

Summary of the judicial approaches to the non-deductibility of fines and penalties

42. From the above cases the following trends and principles can be extracted:

a) The courts of New Zealand, Australia, and United Kingdom all deny a deduction for any payment in the nature of a fine or penalty.

b) In reaching this conclusion, the two main strands of reasoning are that the payment fails to satisfy the requisite statutory deductibility test and overriding public policy considerations exist.

c) In the early cases, the United Kingdom and Australian courts considered that, because a fine or penalty is imposed for breaking the law or to punish an offender, it necessarily followed that the payments made lack sufficient connection with the expenses of trading, so were non-deductible.

d) In certain circumstances it is conceivable that the incurring of the fine or penalty has a strong connection with the derivation of income. Dicta in some cases suggest that a deduction may be available if a sufficient and an appropriate relationship can be found between the gaining or producing of assessable income and the expenditure for the fine (see, eg, *Case F126* and *Case K62*).

e) More recent Australian, United Kingdom, and New Zealand cases now support the public policy approach (*McKnight v Sheppard, Madad, Nicholas Nathan*).

f) *Robinson* makes it clear that there can be no distinction in principle between a claim to be entitled to deduct a fine imposed by a disciplinary committee and one imposed by a court.

g) Case law also supports the view that fines and penalties paid on behalf of an employee or independent contractor are not deductible to the party paying the fine (*Mayne Nickless, Nicholas Nathan, Case Z6*). While the cases acknowledge that nexus may be satisfied where a taxpayer (for commercial reasons) voluntarily pays fines imposed on an employee or contractor, it has nonetheless been consistently held that public policy considerations prohibit deductions in such cases. It is also noted that additional income tax implications (such as PAYE) could arise where a taxpayer pays a fine on behalf of a third party.

h) The Commissioner's view is that the prohibition on deductibility also applies to taxpayers paying fines on behalf of other third parties, irrespective of the relationship between the person incurring the fine and the person paying it (such as an advisor paying a fine on behalf of a client). It could be argued that the payment of a fine in such circumstances is more akin to a payment of damages and deductibility should not be denied. However, it is considered that the situation is analogous to payments of fines incurred by employees and contractors and the public policy considerations set out above would be defeated if any person was allowed a deduction. Further, Ormiston J arguably contemplated the extension of the prohibition to other third parties, when he noted "[in] the latter case the policy of the law ought not to differ whether or not the money was originally paid by, or the original liability fell on, persons other than the taxpayer".

ROLE OF PUBLIC POLICY

43. Public policy is based on the premise that the law should serve the public interest. It assists judges in the concurrent development of the common law and statutory interpretation.

44. Public policy is never static: it evolves over time. This evolution is due to the constant change in the wide sphere of interest that constitutes the public interest. For example, changes in society's economic needs, social costs, customs, and moral aspirations can affect the public interest. Although public policy may change in response to signals from any part of society at any time, changes usually occur incrementally.

45. This functional aspect separates public policy from rules of law. Public policy is a collection of principles that judges consider the law has a duty to uphold. This distinction is important because, although a rule of law binds, a principle merely guides. If an Act incorporates a rule, that rule is binding for the purposes of the Act. In contrast, as a principle is not binding, it leaves scope for more flexible application depending on the circumstances of a particular case. However, while there is flexibility in the application of judicial principles, it is expected that judges take heed of the principles in relevant cases.

Nature of public policy in the context of fines and penalties

46. The following statements are representative of judicial statements in relation to the public policy reasons why fines and penalties should not be deductible. Ormiston J in *Mayne Nickless* said (at p773):

> Fines and penalties are imposed for purposes of the law to punish breaches. This deterrent aspect makes it undesirable for a fine to be deductible. To allow such deductions is seen as frustrating the legislative intent, as the punishment imposed will be seen to be, diminished or lightened.

47. Sinclair J in *Nicholas Nathan* said (at p 6,218):

> From an overall appreciation of all the decisions, I am of the view that where a fine or penalty is imposed by the Courts resulting from a breach of the law, no deduction ought to be allowed for to do so would be to prefer business lawbreakers over individuals as the business lawbreaker would obtain the benefit of deductibility of the amount of the fine or penalty whereas the individual would have to bear that particular expense personally. Additionally it would tend to allow, and encourage, lawbreaking and in some instances, to even treat it as a legitimate business option resulting in deductibility.

48. In both *Mayne Nickless* and *Nicholas Nathan*, the courts considered that the public interest is not served by providing a corresponding tax saving to taxpayers for fines and penalties imposed on them for breaches of the law. In particular, it is considered that allowing deductibility would diminish the punitive nature of fines and penalties, treat business lawbreakers more favourably than non-business lawbreakers, and encourage lawbreaking as a legitimate business option.

Departures, in similar contexts, from the public policy approach

49. Public policy plays an important role in relation to the tax deductibility of fines and penalties. From the perspective of serving the public interest, the general aim of the public policy approach to fines and penalties is understandable. It is interesting to note that the approach to deny deductibility has not been adopted in cases involving illegality or damages. This is because the public policy focus is not on the unlawful conduct but on the fine itself and the reason it was imposed. For example, the public policy approach is not invoked to deny deductibility in three areas: for expenses legally incurred by an illegal business, illegal expenses incurred by legal businesses, and damages for civil wrongs.

Expenses legally incurred by an illegal business

50. The Act does not discriminate between legal and illegal activities (*Ministry of Finance v Smith* [1927] AC193 and Case Z6). The connection between the expense and the income-earning activity is relevant, not the legality of the activity. In *Nicholas Nathan*, the Commissioner submitted that the legal expenses the taxpayer incurred should be disallowed because they were incurred by the taxpayer illegally importing goods rather than for carrying on its business. The court rejected this submission. However, the court considered that as the necessity for "legal advice", after the illegal acts, was commercially prudent and an exercise of damage control, the legal costs were connected with the income-earning process. Additionally, the court was in no doubt that if the taxpayer had taken legal advice before importing the goods, the cost would have been allowed as a deductible expense.

Illegal expenses incurred by legal businesses

51. A taxpayer carrying on a lawful business that incurs illegal expenses may deduct the cost of the illegal expenses, but not the fines levied because of the outlay. For example, no issue arose in *Magna Alloys* as to the deductibility of the illegal commissions paid to employees of its customers.

Damages for civil wrongs

52. Damages are a loss suffered because of an activity prohibited or punishable by the common law but, as held in *Herald and Weekly Times*, they may be deductible.

Summary of the New Zealand approach

53. In the Commissioner's view, no income tax deduction is available in New Zealand for any fine or penalty to which this statement applies (see paragraphs 1 and 2). Irrespective of whether the statutory nexus is met, fines and penalties are not deductible in New Zealand because of the application of public policy considerations. This is the case irrespective of whether the:

- infringement for which the fine or penalty is imposed forms part of criminal proceedings;
- fine is imposed by the court or another body;
- fine is imposed on the taxpayer, its employees, or a third party;
- taxpayer intended to break the law; or
- fine is imposed for a strict liability offence.

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.

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.

SECOND HIGH COURT DECISION CONFIRMS STRUCTURED FINANCE TRANSACTIONS AS TAX AVOIDANCE

Case	Westpac Banking Corporation v Commissioner of Inland Revenue
Decision date	7 October 2009
Act	Income Tax Act 1994
Keywords	Tax avoidance, structured finance, financial arrangements

Summary

Between 1998 and 2000 Westpac entered into a number of structured finance transactions with foreign counterparties. The Commissioner considered the transactions constituted tax avoidance, and issued amended assessments to Westpac. The High Court upheld the Commissioner's assessments.

Impact of decision

This judgment represents a helpful example of the practical implementation of the "tandem approach" to considering avoidance which is required by *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, where both the specific provisions and the general anti-avoidance provisions are given equal weight.

Facts

Between 1998 and 2002 Westpac entered into a number of structured finance transactions with foreign counterparties. The Commissioner issued amended assessments in relation to nine of the transactions, on the grounds that (a) the transactions were part of tax avoidance arrangement, and (b) Westpac was not entitled to deductions for guarantee procurement fees paid as part of the arrangement.

By order of the Court, four of the nine transactions were litigated. The remaining five are stayed until further court order.

Westpac had previously received a binding ruling in relation to a similar transaction. The Court of Appeal ruled prior to this hearing that the existence of that binding ruling was irrelevant and that Westpac was not entitled to place any reliance on it.

The Judgment is lengthy, reflecting the amount of evidence adduced. This summary does not attempt to traverse the facts in detail. The Judgment contains a useful summary of one of the transactions from paragraph [120].

In summary (and generally):

a) Westpac and the counterparty's subsidiary entered into a Sale and Repurchase Agreement in respect of redeemable preference shares ("RPS") carrying a fixed dividend. That dividend was exempt income, and was also relived from foreign dividend withholding payment ("FDWP") under the conduit tax relief regime. The dividend was calculated to share the tax benefits arising from the transaction. (One of the transactions used the Foreign Tax Credit ("FTC") regime instead of the conduit regime.)

b) Westpac agreed to pay a guarantee procurement fee ("GPF") to the subsidiary for the procurement of a guarantee from the counterparty. The guarantee was in respect of the subsidiary's obligations to repurchase the shares at the conclusion of the transaction.

c) Westpac and the subsidiary entered into a swap, whereby Westpac paid a fixed interest rate and received a floating interest rate.

d) Westpac funded the transaction by borrowing funds from the market.

e) Westpac claimed deductions for the funding costs, as well as the GPF. Its costs were greater than the fixed dividend received, but as the dividend was exempt the transactions were profitable on an after-tax basis.

Decision

The Commissioner won on all counts.

Deductibility of the GPF

This issue is covered in the judgment at paragraphs [252] to [315]: the Financial Arrangement ("FA") deductibility at [254] to [295]; Gross income at [296] to [315].

His Honour agreed with the Commissioner that the GPF was paid for the service of procuring the guarantee, not for the guarantee itself. The parties had deliberately structured the arrangement in that way to avoid the possible application of withholding tax payable if it was a guarantee fee. The Court agreed that it is the legal structures implemented by the parties which are relevant at this "black letter" stage of analysis; it was not open to Westpac to argue on economic substance grounds that the fee was really paid for the guarantee itself. As it was paid for the service of procurement, in this case it did not fall within the definition of an FA.

Westpac argued the RPS were held on revenue account, and that as the guarantee was in respect of the subsidiary's repurchase obligations, the GPF was paid to preserve the value of a revenue asset, and therefore there was a nexus with gross income.

On the facts, His Honour decided that the RPS were on capital account. Further, while Westpac clearly had an intention of reselling the shares, the resale was not the purpose of acquiring them. Purpose was not necessarily synonymous with intention, and in this case the purpose was to derive the dividends. Therefore, because the shares were held on capital account and were not purchased for the purpose of resale, the guarantee was not over a revenue asset. This meant there was no nexus between the GPF and gross income.

Tax avoidance

The avoidance analysis of the transactions at issue is discussed at paragraphs [316]–[620]. The recent decisions of the Supreme Court in *Ben Nevis* and *Glenharrow Holdings Ltd V the Commissioner of Inland Revenue* [2009] 2 NZLR 359 are discussed at paragraphs [170]–[201]. The following is merely a brief summary of the key findings.

In respect of the *Ben Nevis* and *Glenharrow* decisions, His Honour:

a) Agreed with the decision of Wild J in the recent BNZ structured finance decision (*BNZ Investments & Ors v CIR* HC WN CIV 2004-485-1059 15 July 2009) that the *Ben Nevis* and *Glenharrow* decisions render analysis of previous avoidance case law unnecessary (at paragraph [170]).

b) Accepted the Commissioner's submission that the cases are not a restatement of existing law, and represent a rejection of Richardson J's juristic scheme and purpose approach in *Challenge* (at paragraphs [174]–[183]).

c) Disagreed with the Commissioner's submission that the avoidance provisions only bite once the Court is satisfied that the specific provisions have been complied with.

d) Referred to the factors for consideration listed at paragraphs [108]–[109] of *Ben Nevis* and stated at paragraphs [193]–[196]:

   i) *Ben Nevis* represents "a significant shift in identifying the principles to be applied when construing s BG 1, mandating a broader inquiry than was previously required".

   ii) "The previous constraints imposed by a legalistic focus, to the exclusion of economic realism, have gone".

   iii) *Ben Nevis* prescribes "a combined form and substance test".

   iv) The ratio of *Ben Nevis* at paragraphs [107] and [108] is "designed to prescribe the permissible scope of the substance inquiry".

e) Noted *Glenharrow's* emphasis that anti-avoidance provisions are concerned with the purpose of the arrangement, not the purpose of the parties. Subjective intention may be relevant to the issue of whether there was (for example) a business purpose for a scheme.

The avoidance analysis of the transactions at issue is extensive, and as much turns on the facts of each arrangement, it is not useful to reproduce that analysis in any detail here. However, a useful summary of the factors His Honour considered is at paragraph [317]:

> Broadly stated, the question is whether by using all of the specific provisions – both the conduit and FTC regimes for income and the interest deductibility provisions for expenditure – Westpac crossed the line and changed the character of the transactions from lawful to unlawful. That inquiry will take into account:
>
> (1) The nature of the contractual relationship between Westpac and the counterparty and the legal effects of the documents;
>
> (2) The economic substance of the transaction (investment or loan);
>
> (3) The structure of the transaction and whether Westpac obtained the benefit of the specific provisions in an artificial or contrived way including but not limited to:
>
> (a) the existence and amount of the GPF, the circumstances in which it was agreed, and its objective value – that is, whether it was at a market or commercial rate;

(b) the use of a pricing mechanism to fix the dividend rate and in particular whether it provided for the parties to share all of Westpac's taxation benefits – that is, both cross-border and domestic asymmetries;

(c) the cost of funds to Westpac and the profitability of the transaction (both pre and post-tax);

(d) the relationship between a transaction and the relevant level of Westpac's tax shelter or estimated tax ratio;

(e) the use of currency and interest swaps (both internal and external); and

(f) the financial consequences of the transaction.

Some key findings by His Honour were:

a) There was a commercial purpose to the transactions (paragraph [590]) but the main purpose was generating deductible expenses and altering the incidence of income tax (eg paragraphs [598] and [605]).

b) There was never any prospect of profit, and the tax benefits were significant (eg paragraphs [586]–[587]).

c) There was no commercial justification for the GPF; its function was to generate a statutory deduction for an expense which appeared genuine but was in truth a contrivance (eg paragraphs [593]–[600]).

d) Aspects of the structure (such as the GPF) were artificial. While taxpayers are free to structure their affairs in the most tax effective way, and to take post-tax consequences into account when deciding whether to proceed with a transaction, that is premised on the assumption that the transaction has an independently justifiable commercial rationale (paragraphs [603]–[604]). Further, this was not a case of a taxpayer choosing between "two means of carrying out an economically rational transaction, one of which would result in less tax being payable than the other" (paragraph [617]).

His Honour discusses the use of the specific provisions (the conduit and foreign tax credit regimes) as part of the arrangement at [605]–[618].

At [577]–[582] His Honour identifies (and rejects as irrelevant) what he describes as "tangential factors" which the Commissioner had submitted amounted to indicia of tax avoidance. These included the social cost of the transactions, the novelty of the transactions, and the use of a formula to determine pricing. His Honour accepted that circularity is relevant, but held that there was no circularity in the transactions at issue.

Reconstruction

Reconstruction is discussed at paragraphs [621]–[667].

The Commissioner did not reconstruct the arrangements in this case; he merely disallowed the deductions claimed in relation to them. The Court observed at [624] that the Commissioner may have had grounds for disallowing an exemption [of income] at least for that amount of Westpac's income attributable to the GPF equivalent of the dividend rate.

Westpac's arguments, which were all rejected on the facts, were that:

a) the Commissioner failed to identify the tax advantages accruing to the bank ([637]–[641]);

b) incorrectly disallowed deductions for the cost of funds ([642]–[648]);

c) failed to limit reconstruction to the extent to which the GPFs exceeded the market value ([649]–[667]).

BACKDATED ACC COMPENSATION NOT DOUBLE TAXED

Case	Claire Avon Hollis v the Commissioner of Inland Revenue
Decision date	30 October 2009
Act	Income Tax Act 1994, Tax Administration Act 1994
Keywords	Income tested benefit, PAYE, ACC, backdated compensation

Summary

The plaintiff received a taxable income-tested benefit and non-taxable supplementary benefits comprising disability and accommodation allowances from Work and Income New Zealand (now Ministry of Social Development and referred to below for convenience as "MSD") for a period for which she was later determined to be entitled to weekly compensation from the Accident Compensation Corporation ("ACC").

The dispute between the parties arose out of what took place when the change-over from MSD to ACC as the paying agency occurred and the effect of that for tax purposes in the 2004 income year.

Impact of decision

The Court found that the backdated compensation paid by lump sum was not properly characterised as an "extra emolument" for tax purposes and should be adjusted by the Commissioner.

Facts

This is an appeal from the TRA decision *Case Z9* (2009) NZTC 141,000.

Between 1994 and 2004 the plaintiff received an income-tested benefit and non-taxable supplementary benefits comprising of disability and accommodation allowances from the MSD. During that time, MSD had on behalf of the plaintiff, paid PAYE to Inland Revenue on the income-tested benefits.

In August 2001 the plaintiff made a written application to the ACC for weekly compensation backdated to 1998. In 2003 her claim was accepted under the Accident Rehabilitation Compensation Insurance Act 1992 ("ARCI Act") and backdated to cover the period from November 1998 to April 2003.

During the 2004 income tax year, ACC paid the plaintiff two lump sum payments of backdated ACC weekly compensation in relation to the 1999 to 2004 income tax years as well as ongoing weekly compensation from 28 April 2003.

The plaintiff was no longer entitled to the income-tested and supplementary benefits she had previously received from MSD, therefore MSD required reimbursement of the net amounts she had received in the 1999 to 2004 income tax years.

The plaintiff claims that ACC should have deducted from her back-dated weekly compensation only the net amount of her income-tested benefit, which was refunded to MSD, and that double taxation has resulted due to ACC also deducting an amount equal to PAYE on the income-tested benefit.

Decision

Whether the Taxation Review Authority ("TRA") was correct to find that the amount of income tested benefit and the non-taxable supplementary benefits received from MSD are deemed to be weekly compensation

The hearing before the TRA proceeded on the basis that section 78(2) of the ARCI Act applied, as this Act was in force from 1 July 1992 until 1 July 1999 covering the period for which the plaintiff's claim for weekly compensation was accepted.

However, in light of the High Court decision of *Buis v Accident Compensation Corporation* (HC AK CIV 2007-404-004703 6 March 2009) the Court proceeded on the basis that the Injury Prevention, Rehabilitation and Compensation Act 2001 (the "IPRC Act") was the applicable Act. The plaintiff's entitlement to compensation was established in April 2003 by which time the 1998 Act had been repealed and the IPRC Act.

The Court agreed with the TRA, that the payments made by ACC were correctly made and that the treatment of the amount of the excess benefit payment as having been paid as weekly compensation arises by operation of law.

At paragraph [19] the Court said:

> If Ms Hollis were correct that she did not have to pay tax on the lump sum entitlement from ACC because of the tax paid on the benefit received from MSD, she would effectively gain an advantage (ie a grossed-up payment) meant only for beneficiaries of MSD, despite not being entitled to a benefit. Additionally, she would obtain an advantage over and above that of other ACC recipients who did not first (erroneously) obtain a benefit from MSD.

Whether the TRA was correct to find that the plaintiff was not overtaxed in the 2004 income tax year

The Court agreed with the TRA that under the IPRC Act, section CC 1(1)(bc) of the Income Tax Act 1994 applies and that the amount equivalent to the income-tested benefit and the residual weekly compensation are both part of the plaintiff's gross income for the purpose of the Act. The income-tested benefit is deemed by section 252 of the IPRC Act to be weekly compensation and the residual sum is weekly compensation from the outset.

The Court found that it is settled law that in cases involving backdated ACC payments, the taxpayer derives the income when it is received and it cannot be spread back to earlier years to which the computation of the income relates.

The Court did not accept the Commissioner's argument that the residual of the backdated weekly compensation should be taxed at the extra emolument rate. The Commissioner relied on the definition of extra emolument contained in section CC(1) (a)(ii) as a "retrospective increase in salary and wages":

> I am not satisfied that the back-dated compensation paid by way of lump sum to Ms Hollis is properly characterised as an "extra emolument" for tax purposes. The lump sum did not amount to an increase in compensation ("wages") she was then receiving for the current period. Rather, it was a payment of the amount to which she was entitled by way of compensation for the prior years i.e. from the date of her accident until the date ACC cover was established. It could not therefore be characterised as an extra payment over and above her ordinary entitlement for the "pay period" in question. I am satisfied that a lump sum payment of back-dated compensation does not fall within the definition of "extra emolument" unless it is a payment additional to the "employee's" ordinary entitlement for the relevant "pay period". An extra emolument is usually a discretionary payment rather than one to which the "employee" has a statutory or contractual entitlement.

The rate of taxation payable in terms of section NC 2 ITA may still be higher than the rate payable if the lump sums had been received in the appropriate years but is likely to be less than the extra emolument rates. The rate payable will have to be assessed by the Commissioner and adjusted accordingly.

Whether the TRA was correct to find that the plaintiff was not entitled to deduct certain expenses from her assessable income in the 2004 income tax year

The Court agreed with the TRA that the expenses claimed by the plaintiff could not be deducted because the dispute was concerned solely with the 2004 income tax year and the expenses had not been incurred in that year.

The Court recommended that Inland Revenue Department provide a full account summary to the plaintiff in relation to her tax affairs over the period from the date of her accident in 1992 until the present time.

DISPOSAL DEEMED AT MARKET VALUE

Case	Foodstuffs (Wellington) Co-operative Society Limited v the Commissioner of Inland Revenue
Decision date	28 October 2009
Act	Tax Administration Act 1994, Income Tax Act 1994
Keywords	Shares, amalgamation, disposal, no consideration, deemed market value

Summary

The plaintiff acquired 100% of the shares in a company and amalgamated that company with three others into one unit. As a result of the amalgamation the newly acquired shares were cancelled.

The plaintiff claimed as a deduction the purchase price of the shares. The Commissioner disallowed the deduction and deemed the disposal of the shares to be at market value.

Impact of decision

This decision is of limited application as the wording of the Income Tax Act 2007 requires both a transferee and a transferor.

Facts

The plaintiff acquired 100% of the shares in North Island Dairy Company Holdings Limited for $2.3 million. It did so intending to amalgamate that company with three others into one unit. As a result of the amalgamation, Kapiti Fine Foods Limited emerged as the new entity and the newly acquired shares were cancelled.

The plaintiff took the position that its purchase of the shares fell within section CD 4 of the Income Tax Act 1994 (the "ITA 1994") as it had bought the shares in order to dispose of them by way of the amalgamation process. This position had the effect of making the shares "trading stock" and "revenue account property".

In its tax return for the year ended March 2004, the plaintiff claimed as a deduction the purchase price of this trading stock, being $2.3 million. It did not have an equivalent income entry attaching to the disposal of the shares by amalgamation.

The Commissioner considered section GD(1) of the ITA 1994 applied to the disposal of the shares so as to deem the plaintiff to have received as income the value of the shares. The Commissioner assessed the market value of the shares to be $2.3 million. The Commissioner also imposed a 20% penalty for an unreasonable tax position.

The plaintiff argued section GD1 did not apply as the section required both a transferor and transferee. The Commissioner argued that this was not a requirement of the ITA 1994.

Decision

GD1

Section GD 1(1) states:

> (1) Subject to subsection (2), where any trading stock is sold or otherwise disposed of without consideration in money or money's worth or for a consideration that is less than the market price ... of the trading stock at the date of the sale or other disposition,—
>
> (a) the trading stock is, for the purpose of this Act, treated as having been sold at and realised at its market price on the date of the sale or other disposition:
>
> (b) The price which under this section the trading stock is deemed to have realised shall be treated as gross income of the person selling or otherwise disposing of the trading stock;
>
> (c) The person acquiring the trading stock shall be deemed to have purchased the trading stock at the price which under this section the trading stock is deemed to have realised.

The Court held that it did not matter that the shares were not disposed of to a purchaser or transferee. The Court acknowledged that in many of these situations the transaction is analysed in terms of creating a transferor and transferee. The Court found that not every situation must be capable of such analysis to properly come within section GD1 of the ITA 1994.

The Court found that a purchaser is irrelevant to the need to adjust the accounts of the owner of the trading stock who has disposed of his property. The plaintiff bought the shares, chose to treat them as trading stock, chose to bring them within its "revenue account property" and claimed the deduction for the purchase price. When the plaintiff then chooses to dispose of the trading stock, there must be an adjustment to its tax position regardless of whether the method of disposal has further implications for a different plaintiff.

The plaintiff argued that at the time of disposition, the shares had nil value, because the amalgamation decision and process required them to be cancelled without consideration being given. The Court rejected this argument and reiterated the Commissioner's analysis that the correct method at which the market value should be assessed is prior to the change in value effected by the disposition. Once cancelled, the shares of course had no value, but prior to the cancellation they were worth $2.3 million and could have been sold.

Shortfall penalties

In relation to the imposition of a shortfall penalty, the Court noted that the scope of section GD1 of the ITA 1994 is far from settled and that the plaintiff advanced a tenable argument.

The Court also took account of the fact that the Income Tax Act 2007 is consistent with the plaintiff's position. Accordingly it considered that a shortfall penalty should not be imposed.

> I cannot ignore that the wording of the 2007 Act either means I am wrong in my conclusions, or the drafters made the same mistake that the taxpayer has. In such circumstances I consider it incorrect to impose a penalty and accordingly I quash the penalty.

OWN-HOME LAQC WAS TAX AVOIDANCE ARRANGEMENT

Case	TRA Decision No 16/2009
Decision date	23 October 2009
Act	Income Tax Act 1994 and Income Tax Act 2004
Keywords	Loss attributing qualifying company ("LAQC"), tax avoidance

Summary

The Court held that because Mrs. B rented her residential home from an LAQC in which she was the sole shareholder there was a tax avoidance arrangement.

Impact of decision

This is the first "own-home LAQC" case to be considered by the Courts.

This case provides clear authority that a taxpayer cannot use an LAQC structure to claim deductions for expenditure that would otherwise be of a private or domestic nature.

This judgment is consistent with the Department's published view in various publications such as Revenue Alerts RA07/01, the Smart Tax Weekly Bulletin 20 July 2004 and 4 December 2007, and an Inland Revenue media release on 19 July 2004, to inform taxpayers and tax advisors that the Commissioner considers such an arrangement could constitute a tax avoidance arrangement.

Facts

Mrs B settled a family trust on 23 November 2002. Mrs B was trustee of the family trust along with her accountant. Mrs B was also a discretionary beneficiary under the trust along with Mrs B's daughter.

An LAQC was incorporated on 7 November 2002 with Mrs B as its sole shareholder and the accountant as its sole director. LAQC status was granted with effect from 31 March 2003.

The LAQC became the registered proprietor of a residential property. The purchase price of $290,000 was financed by a $292,000 loan from the family trust (with interest). The trust financed that loan by borrowing $292,000 from Mrs B. Mrs B had borrowed $160,000 from the Public Trust. The Pubic Trust loan is repayable by Mrs B over 20 years. The LAQC provided security by a mortgage over the residential property to the Public Trustee. (There is no clear evidence as to how Mrs B obtained the further $132,000 to make up the loan from her to the trust.)

The LAQC entered into a tenancy agreement with Mrs B. Mrs B pays $300 per week to the Public Trust Office for

payments due on her borrowings. This $300 is treated by the LAQC as rent paid by Mrs B to it. Neither the LAQC nor the family trust has bank accounts.

As a result of the residential activity, the LAQC has returned losses for the four years ended 31 March 2003 to 2006 inclusive. The losses were attributed to Mrs B by the LAQC and allowed Mrs B to reduce the amount of income tax she would otherwise have had to pay.

The Commissioner formed the opinion that the above facts constitute a tax avoidance arrangement for the purposes of sections BG 1 of the Income Tax Act 1994 and the Income Tax Act 2004. As such, the Commissioner can counteract any tax advantage obtained under section GB 1 of the relevant Acts.

Decision

The parties agreed that there was an arrangement [paragraph 62] but the disputant denied that it was a tax avoidance arrangement. Judge Barber went on to determine whether or not the arrangement should be void for tax avoidance.

At paragraph 44, Judge Barber said that the main judgment of the Supreme Court in *Ben Nevis* constitutes a comprehensive statement of law of income tax avoidance in New Zealand.

Judge Barber applied the *Ben Nevis Forestry Ventures Limited and Ors v CIR* [2008] NZSC 115; [2009] 2 NZLR 289; [2009] 24 NZTC 23,188 (SC) two-step approach. He agreed with the Commissioner that when looked at in isolation, each of the component parts of the arrangement entered into by the disputant falls within the ambit of the specific black letter taxing provisions and regimes [paragraph 63]. Judge Barber also agreed with the Commissioner that when viewed as a whole, the arrangement entered into by the disputant is not of a kind that would conceivably have been contemplated by Parliament when enacting the LAQC and deduction provisions [paragraph 65].

Judge Barber agreed with the Commissioner that the arrangement was artificial and contrived [paragraph 69].

Judge Barber found that the arrangement allowed for deductions that would otherwise be private or domestic expenditure and not deductible [paragraph 72].

Judge Barber held that there is a tax avoidance arrangement and the whole arrangement is void. As a consequence Judge Barber held that section GB 1 should be applied to counteract the tax advantage obtained.

NO CONTEMPT OF COURT BY COMMISSIONER

Case	Chesterfields v the Commissioner of Inland Revenue
Decision date	14 October 2009
Act	Tax Administration Act 1994
Keywords	Contempt of Court, section 17 notices

Summary

The Commissioner's use of section 17 notices, while unwise in the circumstances, was not a contempt of Court. Contempt of Court does not protect private rights but is to protect the administration of justice.

Impact of decision

The particular facts and allegations—that the Commissioner was in contempt of a specific order of the High Court not to use section 17—means this judgment is confined to circumstances similar to those facts.

Facts

The plaintiffs and Commissioner have been involved in lengthy litigation.

In the course of that litigation the plaintiffs alleged the Commissioner had used section 17 in breach of an order by Justice Fogarty prohibiting the use of section 17 and that the use of section 17 was a contempt of Court. The Commissioner denied that any such an order had been made. But if such an order had been made (or had been intended) by the Court then he apologised for inadvertently breaching the order but denied there had been a deliberate contempt of the Court.

The matter was referred to another High Court Judge (Justice Chisholm) to determine if a formal hearing on the matter was necessary.

Decision

Justice Chisholm concluded that, on the facts, there was no clear order of the court warning the Commissioner against the use of section 17 thus there was no factual basis to find a contempt of court. The matter was dismissed. However the Court did note the Commissioner had—in the circumstances—been exceedingly unwise to use section 17 without getting a direction from the Court first.

The Judge outlined the points to be satisfied before a contempt of Court could be established:

> [21] Before the Court could find that the Commissioner, or any of his officers, had committed a contempt it would need to be satisfied that:
>
> (a) the Court had directed that section17 notices were not to be issued;
>
> (b) such direction was clear and unambiguous: *Wilson v Davis* (High Court, Rotorua Registry, CIV 2006 463 000921, 12 June 2007, Fogarty J) at [11]; and
>
> (c) the direction was wilfully disobeyed in the sense that the section17 notices were issued deliberately: *Siemer v Stiassny* [2008] 1 NZLR 150 (CA) at [10].
>
> Notwithstanding the civil context, each of these elements would have to be proved beyond reasonable doubt: *Siemer v Stiassny* at [11].

The Judge determined that, on the facts, steps (a) and (b) above could not be satisfied. He did not address point (c). He also reminded the plaintiffs that:

> It needs to be kept in mind that the underlying purpose of contempt is not to protect the private rights of parties to litigation, but to prevent interference with the administration of justice. (at paragraph [25])

As such Justice Chisholm doubted, if contempt could be established (which he also doubted), that any penalty would be imposed.

As a consequence, to proceed with the contempt matter would serve no useful purpose.

Conclusion

The plaintiffs' contempt matter is at an end.

STANDARD PRACTICE STATEMENT

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

SPS 09/03: EXTENSION OF TIME APPLICATIONS FROM TAXPAYERS WITHOUT TAX AGENTS

Introduction

1. This Standard Practice Statement ("SPS") sets out the practice that the Commissioner of Inland Revenue ("the Commissioner") will apply when considering applications for an extension of time to file an income tax return from taxpayers who are not represented by a tax agent.
2. All references to legislation in this SPS are to the Tax Administration Act 1994 ("TAA") unless specified otherwise.

Application

3. This SPS applies from 13 October 2009 and replaces SPS RDC-1: *Extension of time applications from taxpayers without tax agents* originally published in December 1997.
4. This SPS affects the following:
   - a taxpayer who is not represented by a tax agent; or
   - a taxpayer whose tax agent no longer qualifies as a tax agent.

Definitions

5. The following terms are used throughout this SPS:

   Tax agent: A person who is eligible to be a tax agent under section 34B(2) and who is listed by the Commissioner as a tax agent and not later removed by the Commissioner from the list of tax agents.

   A person is eligible to be a tax agent under section 34B(2) when they prepare income tax returns for 10 or more taxpayers, and is one of the following:

   (a) a practitioner carrying on a professional public practice; or

   (b) a person carrying on a business or occupation in which returns of income are prepared; or

   (c) the Māori Trustee.

   Due date: The date by which an annual income tax return must be filed as prescribed by section 37(1).

   Extension of time or extension of time arrangement: An arrangement by which the Commissioner extends the due date for filing an annual income tax return to a date set by the Commissioner.

Summary

6. A taxpayer without a tax agent may request for an extension of time to file their annual income tax return. The request can be made by contacting Inland Revenue either by phone or in writing (including secure email).
7. Taxpayers who do not file a return by the due date may be liable for a late filing penalty. Therefore any requests for an extension of time should be made before the due date for filing the return, or the expiry of an existing extension of time arrangement.
8. In deciding whether to grant an extension of time, the Commissioner will take into account the following:
   - the reasons for requesting an extension of time;
   - the taxpayer's filing history; and
   - if previous extension of time arrangements had been adhered to.
9. An extension period that is appropriate to that particular taxpayer's circumstances may be granted.
10. The taxpayer will be notified in writing of the Commissioner's decision whether or not an extension of time is granted.
11. A taxpayer whose tax agent no longer qualifies as a tax agent is entitled to the same extension of time that previously applied to their tax agent.

Legislation

12. The relevant legislative provisions are sections 37, 183A, and 183D:

    Section 37 Dates by which annual returns to be furnished

    (1) Dates for furnishing annual returns The annual returns of income required under this Act shall be furnished to the Commissioner as follows:

    (a) *(Repealed)*

    (b) in the case of any taxpayer with a late balance date, not later than the 7th of the month which is the 4th month after the end of the taxpayer's corresponding income year:

(c) in all other cases, not later than 7 July in each year.

(2) Public Notice

...

(3) Extension of time Subject to subsection (5), where any taxpayer satisfies the Commissioner that the taxpayer is unable to furnish the required return by the due date required under this section, the Commissioner, upon application by or on behalf of the taxpayer on or before that date, or within such further period as the Commissioner may allow in any case or class of cases, may extend the time for furnishing the required return to such date as the Commissioner thinks proper in the circumstances.

(4) Extension of tax agent's time for furnishing return of income Subject to subsection (5), the Commissioner may extend a tax agent's time for furnishing a return of income for any taxpayer to a date the Commissioner thinks proper in the circumstances, if the Commissioner is satisfied that—

(a) the tax agent is unable to furnish the return of income on or before the date set by subsection (1); or

(b) it would be unreasonable, having regard to the circumstances of the tax agent preparing the return, to require the return to be furnished on or before the date set by subsection (1).

(4A) Cancellation of extension of time If a tax agent has not furnished for a tax year the required number of tax returns by the dates specified by the Commissioner, the Commissioner may:

(a) refuse to grant an extension of time under subsection (4) for furnishing one or more tax returns that are linked to the tax agent; and

(b) cancel any existing extension of time arrangement granted under subsection (4) for the tax years for which the tax agent has not furnished the required number of tax returns by the dates specified by the Commissioner; and

(c) cancel any existing extension of time arrangement granted under subsection (4) for one or more returns, but not necessarily all returns, for the tax years for which the tax agent has not furnished the required number of tax returns by the dates specified by the Commissioner.

(4B) Date of extension of time for tax agents If the Commissioner extends under subsection (4) the time for a person listed as a tax agent to furnish a return of income for a taxpayer and the person ceases to be a tax agent before the extension of time would have expired, the Commissioner must extend the taxpayer's time for furnishing the return to a date of 31 March on or after the date that would have applied if the person had continued to be a tax agent.

(5) Final dates For the purposes of subsections (3) and (4),—

(a) where the return required to be furnished by any taxpayer is a return for a year ending on 31 March, the time for furnishing that return shall not be extended or further extended to a time later than the 31 March that immediately succeeds that 31 March:

(b) where the return required to be furnished by any taxpayer is, by consent of the Commissioner under section 38, a return for a year ending with the date of the annual balance of the accounts of the taxpayer, the time for furnishing that return shall,—

(i) where that date is between 30 September and the next succeeding 31 March, not be extended or further extended to a time later than the 31 March next succeeding the 31 March that immediately succeeds that date:

(ii) where that date is between 31 March and the next succeeding 1 October, not be extended or further extended to a time later than the 31 March that immediately succeeds that date.

Section 183A Remission for reasonable cause

(1) Application of section This section applies to—

(a) a late filing penalty:

(b) a non-electronic filing penalty:

(c) a late payment penalty:

(d) imputation penalty tax imposed by section 140B:

(e) FDP penalty tax imposed by section 140C:

(f) Māori authority distribution penalty tax imposed by section 140CB:

(g) a shortfall penalty imposed by section 141AA.

(h) a civil penalty imposed under section 215 of the KiwiSaver Act 2006:

(i) a penalty for not paying employer monthly schedule amount imposed by section 141ED.

(1A) Grounds for remission The Commissioner may remit the penalty if the Commissioner is satisfied that—

(a) a penalty to which this section applies arises as a result of an event or circumstance beyond the control of a taxpayer; and

(b) as a consequence of that event or circumstance the taxpayer has a reasonable justification or excuse for not furnishing the tax return or an employer monthly schedule, or not furnishing an employer monthly schedule in a prescribed electronic format, or not paying the tax on time; and

(c) the taxpayer corrected the failure to comply as soon as practicable.

(2) Meaning of "event or circumstance" Without limiting the Commissioner's discretion under subsection (1), an event or circumstance may include—

(a) an accident or a disaster; or

(b) illness or emotional or mental distress.

(3) Exclusions from "event or circumstance" An event or circumstance does not include—

(a) an act or omission of an agent of a taxpayer, unless the Commissioner is satisfied that the act or omission was caused by an event or circumstance beyond the control of the agent—

(i) that could not have been anticipated; and

(ii) the effect of which could not have been avoided by compliance with accepted standards of business organisation and professional conduct; or

(b) a taxpayer's financial position.

Section 183D Remission consistent with collection of highest net revenue over time

(1) Remission to be consistent with Commissioner's duty The Commissioner may remit—

(a) a late filing penalty; and

(aa) a non-electronic filing penalty; and

(b) a late payment penalty; and

(bb) a shortfall penalty imposed by section 141AA; and

(bc) a civil penalty imposed under section 215 of the KiwiSaver Act 2006; and

(bd) a penalty for not paying employer monthly schedule amount imposed by section 141ED; and

(c) interest under Part VII—

payable by a taxpayer if the Commissioner is satisfied that the remission is consistent with the Commissioner's duty to collect over time the highest net revenue that is practicable within the law.

(2) Importance of promoting compliance In the application of this section, the Commissioner must have regard to the importance of the penalty, and interest under Part 7, in promoting compliance, especially voluntary compliance, by all taxpayers and other persons with the Inland Revenue Acts.

(3) Remission not available on basis of taxpayer's financial position The Commissioner must not consider a taxpayer's financial position when applying this section.

Discussion

13. Taxpayers who are required to file an annual income tax return must file it by the due date as prescribed by section 37(1). For taxpayers who have a late balance date, the due date is on the 7th day of the 4th month after the end of the taxpayer's income year. For all other taxpayers, including those taxpayers with an early balance date, the due date is 7 July of each year.

14. A taxpayer may apply for an extension of time to file their income tax return and the Commissioner may agree to extend the date for filing the return, where he is satisfied that the taxpayer is unable to file the return by the prescribed due date.

15. Inland Revenue has recognised that it may be difficult for tax agents to prepare all of their clients' returns by the due date. Therefore tax agents are generally granted an extension of time. In most cases the clients of a tax agent will automatically acquire the same extension of time status as their tax agent.

16. To ensure those taxpayers who are not represented by a tax agent are not disadvantaged, Inland Revenue will consider applications for an extension of time on a case by case basis. The particular circumstances of the taxpayer will be taken into consideration as far as the law permits.

17. In 2007, section 37(4B) was inserted into the TAA. This section applies to those taxpayers who had an automatic extension of time through their tax agent, but their agent ceases to be a tax agent before the extension of time expires. The provision requires the Commissioner to extend those taxpayers' filing date to 31 March on or after the original extension date.

18. The due date for filing an income tax return for all taxpayers, with or without a tax agent, cannot be extended beyond 31 March of the following year.

19. Taxpayers who do not file a return by the due date may be liable to a late filing penalty. Therefore taxpayers are encouraged to request an extension of time before the due date, or before an existing extension of time arrangement expires.

STANDARD PRACTICE

Request for an extension of time arrangement

20. Taxpayers can make a request for an extension of time in the following ways:
    (a) by phoning Inland Revenue;
    (b) in writing; or
    (c) by secure email.
21. Inland Revenue provides secure online services where taxpayers can complete a range of tasks online, including communicating with Inland Revenue electronically about their tax affairs via the "Send and receive mail" service at **www.ird.govt.nz** "Get it done online".
22. To use the secure email service, taxpayers must first register on the Inland Revenue website **www.ird.govt.nz**, Secure online services, "Register now". By registering for the "Send and receive mail" service, both taxpayers and Inland Revenue agree to correspond with each other electronically.
23. Taxpayers may use this secure email service to request an extension of time.
24. When making a request, taxpayers should state clearly that they are requesting an extension of time.
25. To ensure that Inland Revenue is able to consider the request for an extension of time, the following information should be provided:
    (a) the taxpayer's name and IRD number;
    (b) the type of return required to be filed (eg IR 3);
    (c) the return period to which the extension applies;
    (d) the length of the extension of time required; and
    (e) the reasons for requesting an extension of time.

Timing

26. A request for an extension of time should be made on or before the due date for filing the return. However, the legislation confers a discretionary power to the Commissioner to accept applications after the due date in some cases, or class of cases.

The Commissioner's consideration

27. An extension of time may be granted if the Commissioner is satisfied that the taxpayer will be unable to file a tax return by the due date. Each request for an extension of time will be considered on a case by case basis. Reasonable consideration will be given to the circumstances of the taxpayer and whether an extension of time is appropriate for that taxpayer.
28. In determining whether it is appropriate to grant an extension of time, the Commissioner will consider the following:
    (a) the reasons for requesting an extension;
    (b) the taxpayer's return filing history; and
    (c) if previous extension of time arrangements had been adhered to.

Reasons for requesting an extension

29. Examples of circumstances that the Commissioner may consider appropriate for granting an extension of time include:
    (a) The taxpayer is unable to obtain the necessary information to file the return. For example, the taxpayer is waiting to receive a Summary of Earnings from Inland Revenue.
    (b) The taxpayer has been overseas and needs more time to prepare the return. This is dependent on the dates of departure and return to the country and whether the taxpayer was able to file the return before departure.
    (c) Ill health, hospitalisation or injury of the taxpayer or a member of the taxpayer's family (eg, partner or dependent).
    (d) The taxpayer is awaiting the finalisation of accounts for a related taxpayer or entity.
30. These are merely some examples of circumstances in which the Commissioner may grant an extension of time. There may be other situations under which an extension of time may be appropriate.

Return filing history

31. The Commissioner will also take into account the taxpayer's return filing history in considering whether to grant an extension of time.
32. If the taxpayer has other outstanding returns it is unlikely that an extension of time will be granted for the current year's return, unless there are legitimate reasons for not filing the outstanding returns for the previous years.
33. It should be noted that any extension of time agreed to would only apply to the current year's return and not to the other outstanding returns. The prescribed maximum period for an extension relating to the previous years' returns would have elapsed in most cases and the Commissioner cannot grant an extension beyond that prescribed date. (Refer to "Period of extension" in paragraphs 35 to 37.)

Previous extension of time arrangements

34. Where a taxpayer has previously been granted an extension of time but has failed to adhere to that arrangement, it is unlikely that the Commissioner will agree to a further extension of time unless there are legitimate reasons for the taxpayer's failure to adhere to the earlier arrangement.

Period of extension

35. The maximum period for an extension of time that can be granted to any taxpayer is 31 March of the following year. This applies to taxpayers with a standard balance date and a non-standard balance date. For example, the final extension date that the Commissioner may grant to file a return relating to the 2009–10 income year is 31 March 2011.
36. The Commissioner will not necessarily agree to the maximum extension period in every case. The period of extension will be set after giving reasonable consideration to the reasons for the delay and the circumstances of the taxpayer.
37. Where an extension of time has been granted and the taxpayer is subsequently unable to meet the new due date, they should contact Inland Revenue before the expiry of the extension to request a further extension of time to avoid a late filing penalty. Again, there must be legitimate reasons for a further extension of time to be granted.

Taxpayers whose tax agent no longer qualifies as a tax agent

38. In most cases taxpayers who are represented by a tax agent will automatically acquire the same extension of time given to their tax agent. However, if that tax agent ceases to be a tax agent before the extension of time expires, the Commissioner is required to extend the filing date for those taxpayers to 31 March on or after the original extension date.
39. For example, a tax agent has an extension of time to file their client's tax returns by 31 March 2010. The tax agent is removed as a tax agent on 30 November 2009 and their clients are now required to file their own returns. Those taxpayers will be granted an extension of time to file their tax returns by 31 March 2010.

Notification and confirmation – extension of time granted or declined

40. Taxpayers requesting an extension of time over the telephone will usually be notified immediately whether an extension is granted or declined.
41. Requests made by secure email will receive a response via email.
42. In all cases, once a decision has been made, Inland Revenue will write to the taxpayer confirming the granting or declining of an extension of time.

Late filing penalties

43. A late filing penalty may be imposed if a return is not filed by the due date, or by the date agreed to in an extension of time arrangement.
44. Should the taxpayer fail to file the return by the due date, or the agreed date, the Commissioner will first give the taxpayer 30 days notice of an intention to impose a late filing penalty.
45. The late filing penalty will generally not be reversed if it has been imposed before an extension of time was granted.
46. However, the late filing penalty may be remitted in certain circumstances. The criteria for remitting late filing penalties are contained in sections 183A and 183D.
47. Remission applications under sections 183A and 183D will only be considered when the return relevant to the remission request has been filed and any tax due has been paid.
48. For more information on late filing penalties and remission of penalties, see SPS 05/01: *Late filing penalty* and SPS 05/10: *Remission of penalties and interest* (or any subsequent replacements of these SPSs).

This Standard Practice Statement is signed on the 13th day of October 2009.

Rob Wells

LTS Manager, LTS Technical Standards

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding pulic rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as the Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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