Vol 22 No 11 December 2010

TAX INFORMATION Bulletin

CONTENTS

Inland Revenue
Te Tari Taake

ISSN 0114–7161 (Print)
ISSN 1177–620X (Online)

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
INS0089	Meaning of "obsolescence" in section EE 63 of the Income Tax Act 2007	This draft interpretation statement sets out the Commissioner's view on the meaning of the term "obsolescence" in section EE 63 of the Income Tax Act 2007. Section EE 63 provides that certain factors must be taken into account when determining the estimated useful life of an item. One of these factors is "obsolescence". Obsolescence involves a reduction in the usefulness (and so the value) of an item, for reasons other than physical deterioration or wear and tear, such as economic, technological or other external causes that affect the estimated useful life of the item. The estimated useful life of an item is relevant when the Commissioner sets a depreciation rate, or considers applications for special or provisional depreciation rates.

IN SUMMARY

BINDING RULINGS

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

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

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

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

INTEREST DEDUCTIBILITY – *ROBERTS AND SMITH* – BORROWING TO REPLACE AND REPAY AMOUNTS INVESTED IN AN INCOME EARNING ACTIVITY OR BUSINESS

Note (not part of rulings): Rulings BR Pub 10/14–10/19 ("the Rulings") are a reissue of public rulings BR Pub 07/04 – BR Pub 07/09. BR Pub 07/04 – BR Pub 07/09 were published in *Tax Information Bulletin* Vol 19, No 6 (July 2007), and applied for the period beginning on 22 May 2007 and ending on 22 May 2010.

The Rulings, and accompanying commentary, are essentially the same as BR Pub 07/04 – BR Pub 07/09 and commentary. However, BR Pub 07/04 – BR Pub 07/09 were issued when the Income Tax Act 2004 was in force. The Rulings and commentary have been updated to reflect the repeal of the Income Tax Act 2004 and the enactment of the Income Tax Act 2007. In addition:

- the commentary has been updated to reflect subsequent case law; and
- minor changes have been made to the Rulings and commentary to improve their precision and to assist readers' understanding.

These changes do not result in the Rulings differing to BR Pub 07/04 – BR Pub 07/09 as to the scope of the Arrangements to which they apply, or in their conclusions on the application of the taxation laws to those Arrangements.

PUBLIC RULING BR PUB 10/14: INTEREST DEDUCTIBILITY – FUNDS BORROWED BY A PARTNERSHIP TO RETURN CAPITAL CONTRIBUTIONS

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a partnership to return capital to partners who previously invested that capital.

The Arrangement includes only:

- a partnership carrying on a business for the purpose of deriving assessable and excluded income both at the time the partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Any partner's share of the interest will be deductible by that partner to the extent that the partner's capital contribution was used directly in the partnership's business, or used to repay borrowed funds on which the interest was deductible.
- Any partner's share of the interest will not be deductible by that partner under the *Roberts and Smith* replacement

and repayment principle to the extent that the borrowed funds are used by the partnership to pay current year income to the partner, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/15: INTEREST DEDUCTIBILITY – FUNDS BORROWED BY A PARTNERSHIP TO RETURN PROFITS

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a partnership to pay profits to partners.

The Arrangement includes only:

- a partnership carrying on a business for the purpose of deriving assessable or excluded income both at the time the partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Any partner's share of the interest will be deductible by that partner to the extent that the profits are past years' profits that were used directly in the partnership's business or used to repay borrowed funds on which the interest was deductible.
- Any partner's share of the interest will not be deductible by that partner under the *Roberts and Smith* replacement and repayment principle to the extent that the borrowed funds are used by the partnership to pay current year income to the partner, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/16: INTEREST DEDUCTIBILITY – FUNDS BORROWED BY A COMPANY TO REPURCHASE SHARES

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to repurchase shares from its shareholders as authorised by the Companies Act 1993.

The Arrangement includes only:

- a company carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the company borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible in the circumstances described in the Arrangement to the extent that the borrowed funds are used to repurchase shares funded by capital contributed by the shareholders or past years' profits. The contributed capital or past years' profits must have been used directly in the company's assessable or excluded income earning activity or business, or used to repay borrowed funds on which the interest was deductible.
- Interest will not be deductible to the extent that the borrowed funds are used by the company to pay current year income to a shareholder, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/17: INTEREST DEDUCTIBILITY – FUNDS BORROWED BY A COMPANY TO PAY DIVIDENDS

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to pay dividends to its shareholders.

The Arrangement includes only:

- a company carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the company borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible to the extent that the dividends are funded by past years' profits or contributed capital that was used directly in the company's assessable or excluded income earning activity or business, or used to repay borrowed funds on which the interest was deductible.
- Interest will not be deductible to the extent that the borrowed funds are used by the company to pay current year income to a shareholder, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/18 INTEREST DEDUCTIBILITY – FUNDS BORROWED TO REPAY DEBT

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a taxpayer or a partnership to repay borrowed funds to the person who invested those funds in the taxpayer or partnership.

The Arrangement includes only:

- a taxpayer or a partnership carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the taxpayer or partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

This Ruling is subject to Part FE of the Act. (The purpose of Part FE is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FE are commonly referred to as the "thin capitalisation rules".)

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible in the circumstances described in the Arrangement to the extent that the funds that are repaid:
  - were used directly in the taxpayer's or partnership's assessable or excluded income earning activity or business; or
  - were used by a company and the interest was deductible under section DB 7; or
  - were used by a company to purchase shares and the interest was deductible under section DB 8; or
  - were used for one of the Arrangements in Public Rulings BR Pub 10/14 – BR Pub 10/17, and met the requirements for interest deductibility in those Rulings; or
  - were used to retain income earning assets from sale and satisfied the elements of the *Public Trustee* case (*Public Trustee v CIR* [1938] NZLR 436) set out in the Commissioner's Interpretation Statement IS0082 *Tax Information Bulletin* Vol 18, No 6 (July 2006); or
  - themselves repaid, either directly or through a series of borrowings used to repay borrowings, other borrowed funds in respect of which the interest was deductible.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/19: INTEREST DEDUCTIBILITY – FUNDS BORROWED TO MAKE A PAYMENT TO A GROUP COMPANY

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

Taxation Law

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

This Ruling applies in respect of section DB 6 and section IC 5.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to make a payment under section IC 5 to another company that has a net loss.

The Arrangement does not include arrangements where the interest is deductible under section DB 7 (section DB 7 applies to companies).

For the avoidance of doubt, the Arrangement also does not include Arrangements where subpart BG of the Act applies to void the arrangement (subpart BG relates to tax avoidance arrangements).

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will not be deductible in the circumstances described in the Arrangement.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 23 May 2010 and ending on 23 May 2015.

This Ruling is signed by me on the 27th day of October 2010.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULINGS BR PUB 10/14–10/19

1. This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Rulings BR Pub 10/14–10/19 ("the Rulings").
2. The Rulings and commentary express the Commissioner's view of the principles relating to interest deductibility in the Australian Full Federal Court decision in *FC of T v Roberts; FC of T v Smith* 92 ATC 4 ("*Roberts and Smith*").
3. The commentary is organised under the following headings:
    - Summary
    - Legislation
    - How the sections of the Act, other than section DB 7, apply in relation to interest deductibility
    - Scope of the Rulings and commentary
    - Analysis of the *Roberts and Smith* case
    - Arrangements to which the replacement and repayment principle applies
    - When interest is not deductible under the replacement and repayment principle
    - Other matters.

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

Summary

4. The interest deductibility test is satisfied if there is a sufficient connection between interest incurred and assessable income. The sufficient connection is established if the borrowed funds on which interest is incurred are used in deriving assessable income or in a business carried on for the purpose of deriving assessable income.
5. In *Roberts and Smith* the borrowed funds were not used directly in deriving income, but the Court held that the interest is deductible.
6. *Roberts and Smith* is authority that there is a sufficient connection between interest and income when the interest is incurred on borrowed funds used to replace an amount previously invested in an income earning activity or business and to return the amount to the person who invested it. The link with income is through the new borrowings taking the place of funds that have a sufficient connection with assessable income or in respect of which interest was deductible through the operation of section DB 7 or section DB 8. Capital contributions, past years' profits and debt are all capable of being replaced.
7. The case applies only where the amount replaced and repaid is owed to a person separate to the income earning activity or business. It does not apply to sole traders.

Legislation

8. The relevant provisions of the Income Tax Act 2007 are sections DA 1, DA 2, DA 3, DB 1, DB 6, DB 7 and DB 8.

PART D DEDUCTIONS

Subpart DA General rules

DA 1 General permission

Nexus with income

(1) 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.

General permission

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

Avoidance arrangements

(3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

DA 2 General limitations

Capital limitation

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

Private limitation

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

Exempt income limitation

(3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

…

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

DA 3 Effect of specific rules on general rules

Supplements to general permission

(1) A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.

Express reference needed to supplement

(2) A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.

Relationship of general limitations to supplements to general permission

(3) Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.

Relationship between other specific provisions and general permission or general limitations

(4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.

Express reference needed to override

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

(a) it overrides the general permission or the relevant limitation; or

(b) the general permission or the relevant limitation does not apply.

Part E

(6) No provision in Part E (Timing and quantifying rules) supplements the general permission or overrides the general permission or a general limitation.

DB 1 Taxes, other than GST, and penalties

No deduction

(1) A person is denied a deduction for the following:

(a) income tax:

(b) a tax imposed in a country or territory outside New Zealand that is substantially the same as income tax:

(c) ancillary tax, unless listed in subsection (2):

(d) a civil penalty under Part 9 of the Tax Administration Act 1994:

(e) a tax, a penalty, or interest on unpaid tax that is—

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

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

Some ancillary tax excluded

(2) Subsection (1) does not apply to—

(a) pay-as-you-earn (PAYE):

(b) fringe benefit tax (FBT):

(c) employer's superannuation contribution tax (ESCT):

(d) resident withholding tax (RWT):

(e) non-resident withholding tax (NRWT).

Link with subpart DA

(3) This section overrides the general permission.

…

DB 6 Interest: not capital expenditure

Deduction

(1) A person is allowed a deduction for interest incurred.

Exclusion

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

…

Link with subpart DA

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

DB 7 Interest: most companies need no nexus with income

Deduction

(1) A company is allowed a deduction for interest incurred.

Exclusion: qualifying company

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

Exclusion: exempt income

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

(a) dividends; or

(b) income exempted under section CW 58 (Disposal of companies' own shares); or

(c) income exempted under section CW 60 (Stake money) and ancillary to the company's business of breeding.

Exclusion: non-resident company

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

Exclusion: interest related to tax

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

Consolidated groups

(6) Section FM 12 (Expenditure when deduction would be denied to consolidated group) may apply to allow a deduction under this section to a company that is part of a consolidated group.

…

Link with subpart DA

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

DB 8 Interest: money borrowed to acquire shares in group companies

Deduction: borrowing to acquire group company shares

(1) A company is allowed a deduction for interest incurred on money borrowed to acquire shares in another company that is part of the same group of companies.

Exclusion: group not in existence at year end

(2) Subsection (1) does not apply if the 2 companies are not part of the same group of companies at the end of the tax year that corresponds to the income year in which the deduction is allowed.

Deduction: interest after resident's restricted amalgamation

(3) A company is allowed a deduction for interest incurred on money borrowed to acquire shares in another company that has ended its existence on a resident's restricted amalgamation.

Exclusion: group not in existence immediately before resident's restricted amalgamation

(4) Subsection (3) does not apply if the 2 companies were not part of the same group of companies immediately before the resident's restricted amalgamation.

Application from income year of resident's restricted amalgamation

(5) Subsection (3) applies in the income year in which the resident's restricted amalgamation occurs and in later income years.

Consolidated groups

(6) Section FM 12 (Expenditure when deduction would be denied to consolidated group) may apply to allow a deduction under this section to a company that is part of a consolidated group.

…

Link with subpart DA

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

Roberts and Smith *principle not relevant to section DB 7 deductions*

9. The interest deductibility legislation distinguishes between companies and other taxpayers. Interest incurred by companies is automatically deductible—that is, there is no requirement to satisfy a nexus test—except for certain exceptions. The effect of this is that most companies seeking interest deductions will obtain them under section DB 7, rather than by applying *Roberts and Smith*. *Roberts and Smith* may apply to companies that do not come within section DB 7.

10. Under section DB 7, interest incurred by a company is automatically deductible, provided the statutory exceptions in sections DB 7(2)–(5) do not apply. The exceptions are:

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

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

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

12. The following paragraphs provide an overview of the relevant deductibility provisions, and their relationship with each other.

13. Section DB 6(1) provides that:

> A person is allowed a deduction for interest incurred.

14. Section DB 6(3) states that:

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

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

> **DA 1 General permission**
>
> *Nexus with income*
>
> (1) 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.
>
> *General permission*
>
> (2) Subsection (1) is called the **general permission**.

16. Consequently, in considering the application of the Act to interest expense, a person must satisfy the test under the general permission that the expenditure (interest in this case) is incurred in deriving assessable income (or excluded income) or incurred in carrying on a business for the purpose of deriving assessable (or excluded income). This test is the same in all relevant respects to the tests under the Income Tax Act 1994 and the Income Tax Act 2004.

17. The concept of "excluded income" requires some comment in relation to how it is dealt with in this commentary. "Excluded income" is defined and specified to include, for example, GST, fringe benefits, certain life insurance premiums or claims derived by persons carrying on the business of life insurance, and other specific classes of income (see sections YA 1 and BD 1(3) and subparts CX and CZ). The addition of the reference to "excluded income" in the general permission does not alter the principles applying to the deductibility of interest. The same principles apply to excluded income. However, because the concept of "excluded income" is a statutory mechanism used to deal with certain types of income, and does not affect the principles of interest deductibility, for ease of reference "excluded income" is not referred to further in this commentary.

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

> **DA 2 General limitations**
>
> *Capital limitation*
>
> (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.
>
> *Private limitation*
>
> (2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.
>
> …
>
> *Relationship of general limitations to general permission*
>
> (7) Each of the general limitations in this section overrides the general permission.

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

> **DA 3 Effect of specific rules on general rules**
>
> …
>
> *Relationship between other specific provisions and general permission or general limitations*
>
> (4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
>
> *Express reference needed to override*
>
> (5) A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states that—
>
> (a) it overrides the general permission or the relevant limitation; or
>
> (b) the general permission or the relevant limitation does not apply.
>
> …

20. The capital limitation is expressly overridden in relation to interest by section DB 6(4) (section DB 6(1) is reproduced to give context):

> **DB 6 Interest: not capital expenditure**
>
> *Deduction*
>
> (1) A person is allowed a deduction for interest incurred.
>
> …
>
> *Link with subpart DA*
>
> (4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

Summary of the legislation relating to interest deductions

21. In summary, the legislation provides the following general rules relating to interest deductibility:
    - Interest incurred by companies is usually automatically deductible.
    - For other taxpayers, interest is deductible if it is incurred in deriving assessable income or incurred in carrying on a business for the purpose of deriving assessable income.
    - Interest is not deductible if it is private or domestic in nature.
    - Being capital in nature will not, on its own, mean that interest is non-deductible.

Scope of the Rulings and commentary

22. Except for BR Pub 10/19, the Rulings and commentary only consider deductibility under the *Roberts and Smith* principle. The scope of BR Pub 10/19 (and related commentary) is wider: it states that interest on borrowed funds used to make subvention payments is not deductible under the general permission on any basis.

Analysis of the *Roberts and Smith* case

Introduction

23. Courts have established that the general test for interest deductibility requires a sufficient connection between the interest incurred on borrowed funds and the derivation of income. This sufficient connection depends on the use to which the assets provided with the borrowed funds are put (see *Eggers v CIR* (1988) 10 NZTC 5,153, per Richardson J, and *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146; per Cooke P at p 5,148, per Richardson J at pp 5,151–5,152 and per Somers J at p 5,155). In most cases, the test is satisfied when the borrowed funds are used directly in an income earning activity or business in that they are used to acquire income earning assets.

24. In a limited number of cases, notably *Roberts and Smith* and *Public Trustee v CIR* [1938] NZLR 436, the courts have held that the borrowed funds were used in relation to the income earning assets, and that the connection was sufficient for deductibility, even though the funds were deployed outside the income earning activity or business. The application of *Roberts and Smith* is discussed in this commentary, and the application of *Public Trustee* is discussed in Interpretation Statement IS0082: *Interest Deductibility—Public Trustee v CIR*[1].

The facts of Roberts and Smith

25. The Australian decision in *Roberts and Smith* concerned the deductibility of interest incurred by a partnership that borrowed in order to repay partners part of their capital contributions. Judgment was given on two appeals heard together.

26. The facts were that new partners were to join the partnership, but the cost of contributing an amount equal to the capital of the existing partners was too high. To make it easier for the new partners to join the partnership, the partners decided to decrease the amount of the existing partners' capital by borrowing to repay partners their capital contributions. The Australian Full Federal Court held that the interest on this borrowing was deductible.

27. Hill J, who delivered the leading judgment, considered that the deduction was limited to the extent that the borrowed funds replaced the amount of partnership capital contributed by partners. His Honour explained (at p 4,390):

> The provision of funds to the partners in circumstances where that **provision is not a replacement of funds invested in the business**, lacks the essential connection with the income producing activities of the partnership business.
>
> [Emphasis added]

28. Hill J explained his reasoning in the following passage (at p 4,390):

> Let it be assumed that the original partnership capital in the Lord Lindley sense [i.e. contributed capital] was $10 and that the balance in the account designated as "the capital account" of the partnership was $125,000, which included goodwill. That would mean that the equity of each partner in the partnership, assuming five partners, was $25,000. But it could not be said that each partner had invested funds totalling $25,000 as capital in the partnership. A cheque for $25,000 drawn on the partnership bank account would not operate to repay the partner any funds invested. The partnership capital would remain as $10, and all that would happen is that there would be a borrowing which was used to

[1] *Tax Information Bulletin* Vol 18, No 6 (July 2006).

> pay the partner $25,000. That borrowing would reduce the partner's equity in the partnership, but it could not represent a replacement of capital invested. The partnership assets would remain constant. The goodwill would still be worth $125,000; it would not have been distributed to the partners, nor could it be.
>
> On these facts, there could be no question of there being a refund of a pre-existing capital contribution. Rather, looking at the facts objectively, the only purpose of the borrowing would be the provision of funds to the partners to which they were not entitled during the currency of the partnership (save of course by agreement among themselves). The provision of funds to the partners in circumstances where that provision is not a replacement of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or, in other words, the partnership business.
>
> … If at least $125,000 of the amount in that account represents partnership capital in the Lord Lindley sense, undrawn profit distributions, advances by partners **or other funds which have actually been invested in the partnership** and which the partners were entitled to withdraw in June 1984, then in my view the taxpayer is entitled to succeed.
>
> [Emphasis added]

29. His Honour considered that interest is deductible in this type of situation only if the borrowed funds replace amounts that have actually been invested in the partnership. The reason for this is that the borrowed funds take on the character of the funds they are replacing only if in fact they have the effect of replacing funds used in the business. Capital contributions can be replaced by borrowings that are used to pay out these contributions to partners. Hill J explains that goodwill is not an amount invested in an income earning activity, and so it cannot be repaid to anyone, and therefore borrowed funds cannot take the place of that goodwill. Similarly, with asset revaluations, the revalued portion of the asset is not an amount that has been invested so it cannot be repaid to anyone.

30. Therefore, *Roberts and Smith* applies if an amount is able to be replaced by borrowed funds and if the amount replaced is then returned to the person who invested it. The link with income comes through the new borrowings taking the place of funds that have a sufficient connection with assessable income. Capital contributions, undrawn profits and advances are all capable of being replaced.

31. This principle from *Roberts and Smith* is referred to in this commentary as the "replacement and repayment principle".

Whether the borrowed funds are used in an income earning activity

32. In Hill J's view, in the circumstances of *Roberts and Smith* the borrowings replaced the capital that had been paid in by the partners. A question might be raised as to how borrowings can be said to replace funds invested in an income earning activity or business, when the borrowings were actually paid direct to the partners and were never paid into the partnership. The "replacement" occurs in the books of the partnership in that equity is reduced and debt increased. There might seem to be some difficulty in understanding how one debt, with its own parties, conditions, and direct use can inherit the deductibility status of a completely different debt. A basic principle of deductibility would seem to be that deductibility of any item should depend on the circumstances in which it is incurred. A further issue is that if the direct use of the borrowed funds is a private use, for example the private use of partners in a partnership, then it might be argued that the prohibition against deductions of a private nature in section DA 2(2) might apply.

33. Hill J supports his reasoning by saying that interest on a debt that replaces a debt is deductible. But that statement is not an explanation, and it is not clear that a debt replacing a debt inherits its deductibility status. A contrary approach was taken in the Canadian decision in *Interior Breweries Ltd v Minister of National Revenue* [1955] CTC 143; 55 DTC 1090. In that case Cameron J of the Exchequer Court held that interest was not deductible where the borrowed funds were used to pay a bank loan. Cameron J considered that the borrowed money was not used to earn income, but was "used entirely to pay off the bank loan …" (at p 148).

34. However, *Interior Breweries* does not appear to have been applied in any later cases. In Canada, the reason is that legislation was introduced to reverse its effect. It seems likely that the decision may not be accepted in New Zealand or Australia if it were argued. Although New Zealand and Australian courts have been cautious about allowing deductions relating to indirect uses of borrowed funds (particularly in the lower courts in regard to cases where there has been private use of funds), they have not taken as strict an approach as the Canadian courts have taken. *Roberts and Smith* is an Australian example of acceptance by a court that interest may, in some situations, be deductible when the borrowed funds are not used directly to derive income.

Approach to identifying the use of borrowed funds in New Zealand

35. In New Zealand, as in Australia and Canada, the interest deductibility test involves considering the use of the borrowed funds and the connection between the funds and the derivation of income. However, the New Zealand courts have held that the use of funds encompasses not only the direct use of the funds, but also the outcome of that use. In *Public Trustee* the borrowed funds were applied in payment of death duties. It was argued that the funds were used to retain assets. The dissenting judge in *Public Trustee*, Northcroft J, had the following view about how the borrowed funds were used (at p 459):

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

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

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

37. This definition involves two aspects: deployment (ie, application) and outcome. A similar conclusion was reached in *Pacific Rendezvous*. The use of the funds was held to be in acquiring assets for the motel business and in augmenting the company's capital. *Pacific Rendezvous* therefore established that if borrowed funds are used in deriving assessable income, and the sufficient connection is established, it does not matter that the funds are also used to achieve a non-taxable outcome. In the Commissioner's opinion, this same reasoning applies to the *Roberts and Smith* situation. If the sufficient connection is established through the use of the borrowed funds, that connection is not lost if there is a second, non-income-related outcome. In *Roberts and Smith*, the two outcomes were the replacement of funds that had a sufficient connection with the derivation of assessable income, and the use of the funds by partners for non-partnership and possibly private uses.

38. Following Hill J's judgment, and applying the understanding of "use" that New Zealand courts have taken, the Commissioner's opinion is that borrowings used to replace and repay amounts invested in an income earning activity or business will have a sufficient connection with income. In those circumstances, the new borrowings take on the character of the money they replace, and the interest will be deductible if the original funds were used directly in the income earning process. Deductibility will not be affected by a concurrent non-income earning use of the borrowed funds.

Requirement of the replacement and repayment principle – the funds must return to their owners

39. An element of the *Roberts and Smith* replacement and repayment principle is that the repaid funds are returned to the person who originally paid them. The principle stated by Hill J in *Roberts and Smith* is as follows (at p 4,390):

> The provision of funds to the partners in circumstances where that provision is not a replacement of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or in other words, the partnership business.

40. When the borrowed funds are used to enable funds invested in income earning activities to be repaid to the person who invested them, the borrowed funds have the necessary connection with the income earning activity of the partnership or business. This connection arises because the borrowed funds, in effect, replace the repaid funds. As a result, the borrowed funds take the place of the repaid funds and so take on the deductibility nexus of the replaced funds. By contrast, *Roberts and Smith* does not apply when the borrowed funds are paid to a person who did not invest funds into the income earning activity. In this situation, even though the borrowed funds would be recorded as a liability against the assets, there is no necessary connection between the borrowed funds and the income earning activity. This is because the borrowed funds do not replace any funds invested in the income earning activity.

41. This distinction can be understood from a statutory interpretive point of view. If the *Roberts and Smith* principle extended to borrowings used to replace any amounts in an income earning activity or business, then interest on those funds would in most cases be

deductible. That result would be inconsistent with the presence of a statutory test for deductibility that requires a sufficient connection between interest and income. For example, a business might borrow and use the funds for a non-income use, such as to make a nil interest loan to a sister company, to invest in a company that was barred from making distributions, or to pay criminal fines. The argument might be made that as the borrowing would be reflected in the business' liabilities, it was used in the income earning activity. However, borrowed funds used in that way are not connected with the income earning activity of the business. No amount is repaid, and therefore the borrowings cannot inherit any connection with income.

42. Professor Ross Parsons discussed this issue in his paper "Roberts and Smith: Principles of Interest Deductibility".[2] He argued that the *Roberts and Smith* principle should not be simply that a borrowing inherits the deductibility status of the original borrowing. If that were the rule, then there "would be opened a means of obtaining deductions for interest in respect of money borrowed that is used for private non-income producing purposes". In the Commissioner's opinion, an interpretation of the deductibility provision that would lead to all interest being deductible, in the context of a provision that the Courts have said requires a sufficient connection and apportionment where that connection is not established, cannot be correct.

43. Therefore, in the Commissioner's view, the *Roberts and Smith* principle requires that funds repaid are returned to the person who invested or advanced them.

New Zealand cases relevant to Roberts and Smith

Case P56

44. The approach of the Taxation Review Authority in *Case P56* (1992) 14 NZTC 4,386 is similar to the Commissioner's interpretation of *Roberts and Smith*. In this decision, partners borrowed to draw out more than they had invested in the partnership. The interest was held to be non-deductible. Willy DJ said that if the partners had replaced capital investments, they would have been entitled to interest deductions (at p 4,396).

Case M127

45. *Roberts and Smith* appears to be inconsistent with *Case M127* (1990) 12 NZTC 2,817. *Case M127* concerned a husband and wife operating a coffee lounge business. They had $76,000 of their own equity invested in the business. There was little available cash. They wished to buy a new dwelling house, and had some cash outside of the business, but were $70,000 short. The partnership paid $70,000 to the husband and wife as individuals. This put the partnership account into overdraft. The partnership then borrowed to repay the overdraft, leaving it with a credit balance of $2,304. In summary, the borrowed funds were used by the partnership to pay back a loan to the bank, which had been taken out to repay partners their capital so that they could buy a house. The effect on the partnership's balance sheet was that the capital contributed by the partners was replaced by the loan.

46. The objectors argued that the borrowed money was used in the production of income. It does not appear from the judgment that they specifically argued that the loans replaced their equity. The case was heard before *Roberts and Smith* was decided, so the taxpayers did not have that case available as a precedent.

47. It is helpful to consider *Case M127* in the context of the general principles of interest deductibility. The direct test for interest deductibility, followed in *Pacific Rendezvous v CIR and CIR v Brierley* (1990) 12 NZTC 7,184, requires borrowed funds to be traced to a use that derives income. *Roberts and Smith* is authority that a strict tracing is not required if the borrowing replaces funds and the replacement involves a replacement of money actually invested. The direct use of the borrowed funds in *Roberts and Smith* was to pay capital out to partners, who may have used the funds for private use. Hill J said (at p 4,388):

> A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production of the partnership of assessable income.

48. In *Case M127*, if a strict tracing approach is applied, the loan was used to pay off a business overdraft. That overdraft loan can be traced to private use by the partners. If *Roberts and Smith* is applied to the facts, the second loan can be seen as replacing the overdraft, which in turn replaced the equity. The equity was used directly to fund the partnership's business, and therefore, there is a sufficient connection with income such that the interest is deductible. This reasoning was not argued, or applied by Bathgate DJ. Bathgate DJ held that the interest was not deductible. The case is,

[2] Professor Ross Parsons "Roberts and Smith: Principles of Interest Deductibility" (1993) 1 *Taxation in Australia (Red Edition)* 261 at p 266.

therefore, incompatible with *Roberts and Smith*. The objectors might have still failed on the facts, had they argued *Roberts and Smith*, because a large proportion of the $76,000 appears to have been made up of goodwill.

49. In the absence of *Roberts and Smith*, Bathgate DJ held in *Case M127* that the borrowed funds were used for private purposes. His Honour considered that the first loan by way of overdraft was used to buy the house, that the second loan paid back the overdraft, and that neither loan was used in producing partnership income. Instead, the loans were used to purchase the house for the objectors. The interest incurred by the partners was private in nature.

50. The decision in *Case M127* is therefore inconsistent with the decision in *Roberts and Smith*. Although *Case M127* is from the New Zealand jurisdiction, a decision of the Full Federal Court of Australia has precedent value. In the circumstances of this issue the Commissioner considers that a higher New Zealand court would follow *Roberts and Smith* rather than the Taxation Review Authority's decision in *Case M127*.

Arrangements to which the replacement and repayment principle applies

Introduction

51. Paragraphs 52–109 below explain the Commissioner's position on when interest will be deductible under the *Roberts and Smith* replacement and repayment principle. These paragraphs are organised under the following headings:
    - Returns of capital to partners: BR Pub 10/14
    - Payments of past years' profits to partners: BR Pub 10/14 and BR Pub 10/15
    - Payments of current year income to partners: BR Pub 10/14 and BR Pub 10/15
    - Share repurchases: BR Pub 10/16
    - Payments of dividends: BR Pub 10/17
    - Replacement of debt: BR Pub 10/18.

Returns of capital to partners: BR Pub 10/14

52. BR Pub 10/14 applies to interest on borrowed funds used by a partnership to return capital to partners who invested that capital into the partnership.

53. The *Roberts and Smith* replacement and repayment principle applies to borrowed funds used to repay partners their capital contributions to the partnership. Interest is deductible on borrowings used to repay capital to partners, to the extent that the capital that was repaid was used in earning assessable income.

54. This view is based on the conclusion that a partnership can transfer property to a partner. However, a partnership is not a legal entity. A partnership consists of a collection of rights and obligations between the partners, and ownership of partnership assets is vested in the partners, not the partnership. It could be argued, therefore, that a partnership cannot repay partnership property to a partner, because the partner already owns that property.

55. A key concept of partnership law is that partners do not have individual rights to partnership property. This point was made in *Hadlee & Sydney Bridge Nominees Ltd v CIR* (1993) 15 NZTC 10,106 (PC). Delivering the judgment of the Privy Council, Lord Jauncey stated (at para 5):

> First of all as a matter of general law, to quote the words of Richardson J [in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8, 116 (CA)] he "does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership. (*Lindley on Partnership* 15th Edition, page 516)". He can enforce this interest against his co-partners to the extent of seeing that the partnership assets are used for the benefit of the partnership but he cannot assign it to a non-partner. This beneficial interest, expressed in terms of its realisability, is in the nature of a future interest taking effect in possession on (and not before) the determination of the partnership (*Lindley and Banks on Partnership*, 16th Edition, p 457).

56. Lord Jauncey referred to Richardson J's judgment in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8, 116 (CA). In his judgment, Richardson J stated:

> A share in a partnership is a chose in action. It is a fractional interest in the future profits of the partnership business and in a surplus of assets over liabilities on a winding up. The partner does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership (*Lindley on Partnership* 15th ed, 516; *Maw v Maw* [1981] 1 NZLR 25).

57. In *CIR v Boanas* (2008) 22 NZTC 22,046, the High Court referred (at para 64) to this passage from Richardson J's judgment. In *Boanas*, Dobson J noted (at para 65) that Richardson J's judgment was consistent with the Partnership Act 1908, in particular section 23(1):

> All property and rights and interests in property … must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.

Dobson J held (at para 67) that the "application of substantive partnership law" meant that none of the partners could deal with any portion of the whole of the partnership property as if it were their own.

58. Molloy says in *Principles of the Law of Partnership* that a receipt received by a partnership remains a receipt of the partnership alone, which is to say by the partners jointly[3]. He says that if an amount is partnership property, it is not an individual entitlement of any particular partner. The individual partner does not derive several income (ie each partner's individual allocation of income) until it has been ascertained whether the overall result for the relevant fiscal period has been that the firm has derived any net assessable income.

59. The point was made in *Crowe v Commissioner of Taxation* (1958) 100 CLR 532 that there is a distinction between partnership property and each partner's individual property. The case was concerned with an expense, rather than income, but is relevant because it makes the point that partnership property is not the same as the individual entitlements of the partners. In *Crowe* a partnership took out a policy on each of the lives of its four partners. Each policy was for the benefit of all four partners. The premiums were paid by the firm and the policy was in the name of the firm. A provision of the Australian Commonwealth income tax legislation permitted the deduction of "amounts paid by the taxpayer as premiums or sums for insurance on the life of the taxpayer." Fullagar J said that if any of the partners were to have:

> … effected an insurance on her own life, and the partnership had paid a premium on the policy at her request and debited the amount to an advance account in its books, I should have said that she ought to be held to have "paid" the premium, although no money or money's worth passed from her hand to the hand of the insurer.

60. The issue in *Crowe* was whether payment by the firm, of the premium on a policy that the firm itself had taken out, had been payment by the taxpayer. Fullagar J answered the question in the negative:

> [T]hat a partnership has, in English law, no legal personality distinct from those of the individual partners … does not mean that there is not a very real difference between a right or obligation of a partnership (or partners as such) and a right or obligation of an individual member of a partnership.

The insurance contracts were taken out in the name of the firm, and the firm (and not each individual partner) paid the premiums. The premiums were paid by the partners jointly. It was therefore not a payment made by any one of the individual partners.

61. Similarly, in the Commissioner's view, income of a firm is derived by the partners jointly, and not individually by each partner. This is consistent with Richardson J's judgment in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (CA). In this decision, his Honour observed that the statutory regime for the taxation of partnership income, among other things, treated partnership income as derived by the partners jointly:

> New Zealand tax legislation does not isolate partnership income as a separate source of income. In New Zealand law a partnership is not a separate tax entity. It is not a "taxpayer" and partners make a return of partnership income only for the purpose of providing information on which their separate incomes are calculated. **The gross income is derived by the partners jointly** and the partners severally claim the deductions to which they are entitled as taxpayers in terms of the legislation. All that is reflected in sec 10 and various general provisions of the [Income Tax Act] 1976 …
>
> [Emphasis added]

62. Richardson J referred to section 10(1) of the Income Tax Act 1976 as reflecting the principle that gross income is derived by partners jointly. Section 10(1) has since been replaced by section 42 of the Tax Administration Act 1994. Section 42 largely resembles section 10(1) and also reflects the principle that gross income is derived by partners jointly:

> **Returns by joint venturers, partners and partnerships**
>
> (1) This section applies when 2 or more people derive income jointly or have deductions jointly.
>
> …
>
> (3) In the case of partners,—
>
> (a) if the partnership of the partner is a limited partnership registered under the Limited Partnerships Act 2008 or is a partnership that would carry on a business in New Zealand ignoring section HG 2 of the Income Tax Act 2007, then the partners must make a joint return of income that includes—
>
> (i) the total amount of income derived by the partners as members of the partnership; and
>
> (ii) the partners' partnership shares in the income; and
>
> (iii) a summary of the deductions of each partner:
>
> (b) there is no joint assessment, but each partner must make a separate return of income under section 33, including the income derived by the partner as a member of the partnership, and the partner's deductions. Each partner is separately assessed.
>
> (4) In any other case, each person shall make a separate return taking into account that person's share of the joint income and deductions. Each person is separately assessed.

63. In 2007, after the Rulings were originally issued, section HG 2(1) was enacted. When the original Rulings were issued there was no equivalent legislative provision. Section HG 2(1) provides that partnerships

[3] *Principles of the Law of Partnership*, Webb and Molloy (Butterworths, Wellington, 6th edition, 1996) para 11.235.

are transparent for income tax purposes unless the context otherwise requires. This means that, for the purposes of calculating their obligations and liabilities under the Act, the partners (and not the partnership) are generally treated as:

- carrying on activities and having the status, intention and purpose of the partnership; and
- holding property that a partnership holds, being parties to an arrangement to which the partnership is party, and doing or being entitled to a thing that the partnership does or is entitled to, in proportion to their partnership share.

64. Section HG 2(1) does not alter the principle that partnership income is derived by the partners jointly, and that partnership property is owned jointly, and not individually by each partner. The words "[f]or the purposes of a partner's liabilities and obligations under the Act" make clear that section HG 2(1) applies only in respect of the calculation of a partner's tax obligations and liabilities. Accordingly section HG 2 does not affect the partners' individual rights to partnership property under general law as developed in the case law discussed above.

65. In summary, partners own an undivided interest in partnership property, and do not have individual title to any particular items of partnership property. Consequently, there can be a valid legal transfer of property from a partnership to a partner, because the nature of the legal ownership changes from joint ownership to ownership by a single person. Therefore, the *Roberts and Smith* principle can apply to partnerships. The *Roberts and Smith* case of course involved a partnership, and so is authority for this point.

66. It should be noted that a return of capital, whether by a partnership or a company, is not connected with income simply because it is an ordinary part of running a business. A return of capital is not part of the income earning activity, it is a transaction relating to the structure of the business. However, there is a sufficient connection with income in this arrangement because, following *Roberts and Smith*, borrowing to return capital has the effect of replacing and repaying the funding of the income earning activity. In these circumstances, the borrowed funds continue the connection the repaid funds had with income.

Payments of past years' profits to partners: BR Pub 10/15

Introduction

67. BR Pub 10/15 states that:

- interest **is** deductible to the extent that the borrowed funds are used to repay past years' profits to the partners if those profits are used by the partnership in its income earning activities; and
- interest **is not** deductible to the extent that the borrowed funds are used to pay current year income to partners, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The following paragraphs explain the Commissioner's reason for distinguishing between past years' profits and current year income. BR Pub 10/14 also denies interest deductions where borrowed funds are used to pay current year income to partners. The Commissioner's position on unrealised asset revaluations and internally generated goodwill is discussed later: see paragraphs 111–116.

68. Past years' profits in a partnership, which Hill J in *Roberts and Smith* refers to as undrawn profit distributions, can be viewed as amounts contributed by partners. If a partner does not withdraw profits, they are allocated to partners equally, or in accordance with the divisions in the partnership agreement (*Principles of the Law of Partnership*).[4] The accounting treatment might be to carry profits to the credit of the partner's respective current accounts by book entry calculated at the end of the accounting period. Although there may not be any active reinvestment by the partners themselves, this process can reasonably be seen as an investment of capital.

69. Therefore, in the Commissioner's view, past years' profits can be seen as reinvestments by partners in the partnership and the replacement and repayment principle may apply. Interest is deductible on borrowings used to repay past years' profits to partners, to the extent that those profits were used in earning assessable income or in the partnership business.

Payments of current year income to partners: BR Pub 10/14 and BR Pub 10/15

70. The Commissioner's opinion is that the principle from *Roberts and Smith* does not extend to borrowings purporting to return the current year income that has not yet been identified as profits. The reason is that current year income is not an amount that has been invested in the partnership by the partners, and so cannot be repaid to partners.

71. The principle from *Roberts and Smith* is that interest may be deductible if borrowed funds repay funds invested in an income-earning activity or business carried on to derive income. The issue with current year income is whether it is an amount that can be repaid. To be repayable, it must have been paid

[4] *Ibid* paragraphs 2.48 and 4.109.

into the partnership by someone. The amount can only have been paid in if someone other than the partnership has had an entitlement to it at some time. Therefore, the issue is to decide whether partners can be said to have become individually entitled to current year income at some time before any purported replacement.

72. To consider this question, the legal nature of current year income is examined. If current year partnership income is owned by individual partners at any point during the year, it could in theory be invested by partners in the partnership business.

Whether current year income is partnership property or property of individual partners

73. The conclusion has already been reached that there is a distinction between partnership property and property belonging to individual partners. In considering the application of *Roberts and Smith* to current year income, the next step is to ascertain whether it is partnership property, or property of individual partners.

74. The Partnership Act 1908 is silent on the treatment of current year income. It provides for the division of profits in section 27:

> **27. Rules as to interests and duties of partners**
>
> The interests of partners in the partnership property, and their rights and duties in relation to the partnership, shall be determined, subject to any agreement (express or implied) between the partners, by the following rules:
>
> (a) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm:
>
> …
>
> (d) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him:

75. Under section 27, partners are entitled to share in any profits, subject to any agreement to the contrary. The concept of "profits" is not defined. There is no particular guidance in the Partnership Act as to when the division and allocation of profits occurs.

76. It has been held in Australia that, for tax purposes, the amount that forms part of each partner's individual income is only ascertainable once partnership accounts have been prepared, and that this would normally be at year end. In *FC of T v Galland* 86 ATC 4885 the High Court of Australia held that in the absence of an agreement stating a different balance date, accounts of the partnership would be required to be taken each year as at 30 June and a partner's share of the partnership income would be distributed to the partner as at that date. The High Court said:

> … although a partner is not usually entitled to call for a distribution of profits or net income until accounts have been prepared, he has an individual interest in the net income of the partnership, notwithstanding that the precise amount of his interest cannot be determined until the accounts are prepared for the relevant period.

77. The High Court's view is that partners are not (usually) entitled to current year income. The partners have an individual interest in the net income of the partnership, but not an immediate entitlement to the current year income. *Galland* was quoted by Hill J in *Roberts and Smith* as authority for the proposition that a partner's share of the partnership income is derived by the partner only once annual accounts of the partnership have been prepared. Hill J said:

> In the absence of agreement, accounts for the partnership would be required to be taken each year as at 30 June and a partner's share of the partnership income would be derived by him as at that date: *FC of T v Galland*.

78. Further, it is in the nature of profits that they have to be identified before anyone can become entitled to them. Fletcher Moulton LJ provided a definition of "profits" in *Re Spanish Prospecting Co. Ltd* [1911] 1 Ch 92 at 98–99[5] (cited in *Galland*):

> The word "profits" has, in my opinion, a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general practice, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respect from this fundamental signification. "Profits" implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at two dates … We start therefore with this fundamental definition of profits, namely, if the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

79. As Fletcher Moulton LJ points out, as a matter of logic, profits can be known only once they are calculated. They can be calculated only when the amounts of income and expenses for the relevant fiscal period are known. Although amounts will come in that will in due course form profits, until the fiscal period has ended, the amount of profits cannot be known.

[5] This definition was adopted by Williams J in *Dalgety v Commissioner of Taxes* [1912] NZLR 260 at 261–262, and discussed in Higgins & Fletcher *The Law of Partnership in Australia and New Zealand* (LBC Information Services, Pyrmont, NSW, 8th ed, 2001.

It follows, in the Commissioner's opinion, that an entitlement cannot arise until the amount can be known, and it can be known only at the end of the fiscal period. This period, as Fletcher Moulton LJ says, is generally annual.

80. Therefore, the Commissioner's opinion is that a partner does not have an individual entitlement to current year income. Current year income is owned by all of the partners jointly. Individual partners have an ownership interest in it in common with the other partners, but not an entitlement to their potential individual share until profits have been calculated and allocated for a fiscal period.

Discussion of current year income in Roberts and Smith

81. In applying the law to the case he was considering, Hill J in *Roberts and Smith* explained that it was necessary to identify whether the partners received a refund of capital, or whether they received amounts in excess of their capital. Hill J considered capital to be the aggregate amounts contributed by the partners for the purpose of commencing or carrying on the partnership business (at p 4,389). The partnership accounts he was considering did not separate out the contributed capital from other items. He thought that it was possible that the amount of capital represented in the partnership accounts included (at p 4,390):

- contributed capital;
- internally generated goodwill;
- undrawn distributions;
- profits of the year not yet distributed; and
- asset revaluations.

In Hill J's view, the items that could be replaced with a deductible result were (at p 4,390):

- contributed capital;
- undrawn profit distributions;
- advances made by partners; and
- other funds that have actually been invested in the partnership and which the partners were entitled to withdraw.

82. Hill J did not include "internally generated goodwill", "asset revaluations" and "profits of the year not yet distributed" (ie current year income) as amounts able to be replaced. Internally generated goodwill and asset revaluations are discussed later: see paragraphs 111–116 below. Hill J's view was that the types of amounts that could be replaced with a deductible result were funds that had actually been invested in the partnership and which the partners were entitled to withdraw at the time of the borrowing.

83. In contrast, Hill J considered that undrawn distributions that have been allocated to partners, but not paid out (ie past years' profits) can be replaced with borrowings and the interest would be deductible.

Application of the Roberts and Smith *principle and the law on partnerships to current year income*

84. Partners do not have rights to current year income as it arises during the year, because it is partnership property. Profits are generally determined at the end of the year and, until this happens, the partners are not entitled to current year income. This means that any drawings taken from the partnership's current year income can only be a partner's anticipated share of the profits. Current year income cannot, therefore, be an amount invested in the partnership by the partners. As it is, in the Commissioner's opinion, essential for the *Roberts and Smith* replacement and repayment principle that the funds must be repaid to someone, there must be someone who has had an entitlement to them. Therefore, to be repayable, someone must have invested the funds in the income earning activity or business. Current year income has not been invested so the *Roberts and Smith* principle does not apply to it.

Difference between current year income and past years' profits

85. Past years' profits can be distinguished from current year income because partners have become entitled to them, either at a time specified under the partnership agreement or, in the absence of a partnership agreement, when the partnership accounts are required to be taken (*FC of T v Galland*) and they have been notionally allocated to partners. Their status is then as advances to the partnership or new investments of capital. Hill J considered that past years' profits could be viewed as amounts invested, and that they could be repaid with a deductible result.

Share repurchases: BR Pub 10/16

86. BR Pub 10/16 applies to interest on borrowed funds that are used by a company to repurchase shares from its shareholders (as authorised by the Companies Act 1993).

87. A repurchase of shares by a company involves a payment by a company to its shareholders of amounts previously contributed by shareholders. The repurchase of bonus share issues that were funded by past years' profits can also be seen as involving a payment by a company to its shareholders of amounts previously contributed by shareholders. The effect of the payment by the company is a diminishment of the shareholder's capital holding in the company. This arrangement is analogous to a return of capital or past years' profits to partners in a partnership.

88. Therefore, in the Commissioner's view, the replacement and repayment principle may apply to share repurchases (including repurchases of bonus issue shares). Interest is deductible on borrowings used to repay share capital or past years' profits to shareholders, to the extent that the capital or profits were used in deriving the company's assessable income.

89. It should be noted that interest incurred by companies will generally be deductible under section DB 7, the provision that gives companies in most situations an automatic deduction for interest, and that *Roberts and Smith* would be an alternative basis for deductibility for interest incurred on borrowed funds used to repurchase shares.

Payments of dividends: BR Pub 10/17

90. BR Pub 10/17 applies to interest on borrowed funds used by a company to pay dividends to its shareholders.

91. The *Roberts and Smith* replacement and repayment principle applies to borrowings used to pay dividends sourced from past year profits, usually described as retained earnings, to shareholders. There is, however, some conceptual difficulty in bringing a company's retained earnings within this principle. The difficulty is in analysing retained earnings as amounts contributed by shareholders. Company profits are not allocated to shareholders at the end of each year. Retained earnings are added to the existing retained earnings. Directors may decide to distribute some of these as dividends or they may decide not to. Shareholders are not immediately entitled to retained earnings in the way that partners are entitled to partnership profits.

92. There are, however, similarities between a partnership's past years' profits and a company's retained earnings. They share the characteristic that the amount has been finally settled for the year, and the theoretical amount each shareholder (or partner) is entitled to can be established. They can, in a sense, be seen as the amount a shareholder or partner has invested into the business. The features of partnership profits that do not suggest they have been invested by partners are also shared by retained earnings. Both retained earnings and partnership profits are at the disposal of the business until the decision is made to pay them out. Just as partners may not necessarily make any active decision to reinvest past profits, shareholders would not usually make any decision to reinvest profits in the business. For these reasons, the Commissioner's opinion is that payment of dividends from retained earnings can be viewed as sufficiently analogous to payments to partners of partnership past years' profits, such that both should be treated the same in determining interest deductibility.

93. Therefore, in the Commissioner's view, retained earnings can be treated as notional reinvestments by shareholders in the company and the replacement and repayment principle should apply. Interest is deductible on borrowings used to pay dividends to shareholders, to the extent that those profits were used in income earning.

94. The Commissioner considers that the *Roberts and Smith* principle does not apply where the borrowed funds are used to pay current year income to a shareholder. In paragraphs 70–85 above, it was concluded that the *Roberts and Smith* principle cannot apply where a partnership uses borrowed funds to replace current year income. The basis for this conclusion was that individual partners do not have an immediate entitlement to current year income, and therefore they cannot be considered to have invested the income into the partnership. Similarly, shareholders in a company do not have an immediate entitlement to the company's current year income, and therefore they cannot be considered to have invested that income into the company.

95. If company profits are distributed as bonus issues, then similarly the amount represented by the shares can be seen as capital able to be replaced under the replacement and repayment principle.

96. As already mentioned, interest incurred by companies will generally be deductible under section DB 7, the provision that gives companies in most situations an automatic deduction for interest, and that *Roberts and Smith* would be an alternative basis for deductibility for interest incurred on borrowed funds used to pay dividends.

Replacement of debt: BR Pub 10/18

97. BR Pub 10/18 applies where borrowed funds are used to replace and repay funds to the person who lent them to the taxpayer or partnership.

98. Borrowings used to repay borrowings used in an income earning activity or business are within the *Roberts and Smith* principle. Hill J in *Roberts and Smith* said that where a loan is taken out and used to repay a debt that was used directly in an income earning process or business, the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. In Hill J's mind, there is no difference in terms of interest deductibility between repaying one debt with another and borrowing to return capital, and both situations should be similarly treated.

99. If the first refinancing takes on the character of the debt it replaces, then logically, subsequent refinancing should also inherit that character. Therefore, the Commissioner's opinion is that interest is deductible on borrowings used to repay other borrowings, to the extent those other borrowings can be traced to a use that gave rise to deductible interest.

100. Three issues can arise where the borrowed funds are used to repay funds to the person who lent them to the taxpayer or partnership. These issues are whether the *Roberts and Smith* replacement and repayment principle applies:

- where the original, replaced, funds were deductible under a statutory nexus other than the general permission (for example, section DB 7)
- where the lender's right is assigned to another person
- only if there is direct tracing between the original, replaced, funds and the borrowed funds.

These issues are considered in the following paragraphs.

Continuation of a statutory nexus

101. The general rule from *Roberts and Smith* is that borrowings may inherit the deductibility status of funds they repay. In some situations, the repaid funds may be deductible by the operation of a specified statutory nexus, rather than the general rule that requires as a question of fact a sufficient connection with income. One relevant nexus is in section DB 7, which provides for automatic deductions for most companies, and the other is in section DB 8, which provides for deductions for companies investing in shares in a group company.

102. The nexus in each of these two sections is different in nature from the nexus in *Roberts and Smith*, where the replaced funds achieved the nexus by being used to derive income. Nevertheless, the Commissioner considers that the deductibility status should also be inheritable when deductibility is established through a statutory nexus. If it were not, and refinancing meant interest that had been deductible as a matter of law rather than fact was no longer deductible, Parliament's intention for sections DB 7 and DB 8 would be defeated. Therefore, the Commissioner's opinion is that *Roberts and Smith* applies to replacement and repayment of borrowed funds in respect of which deductibility is established under sections DB 7 and DB 8.

Application of Roberts and Smith *where the lender's right is assigned*

103. The Commissioner's view is that the principle from *Roberts and Smith* is that funds may be replaced with borrowed funds and the interest will be deductible, if the repaid funds are returned to their owners. The exception is the replacement and repayment of a debt, where the right to receive the amount advanced has been assigned to someone else. Interest would still be deductible under the principle, because in those circumstances there is still a repayment of funds invested, as the amount can be traced back to the original investor through the assignee.

Whether direct tracing is required

104. The replacement and repayment principle requires identifying how the original funds were used, and identifying the use of the new debt to repay those original funds. Therefore, under the principle, the use of funds needs to be identified or "traced".

105. Given the compliance costs that may arise in some circumstances, consideration has been given to whether tracing is essential to the replacement and repayment principle. It is recognised that for some taxpayers, who have daily changes to their borrowings, the requirement may be difficult to fulfil.

106. One approach would be to allow a deduction if the refinancing loan is taken out and the first loan paid back about the same time. However, it seems likely that this "around the same time" requirement would not in practice operate to limit deductibility to arrangements within the principle, and would result in interest on any borrowing qualifying for deductibility.

107. An alternative is that the Commissioner would accept that a loan is a replacement unless it is used solely for a private or exempt use. However, that approach would, in the Commissioner's view, be too wide to be consistent with the statutory requirements, as any use of borrowings would satisfy the test (apart from sole private and exempt uses). The test would not be limited to replacement of funds that are returned to their owners. Without the element of replacement, there would not be a sufficient nexus with income. Uses of funds that would qualify would be those uses that would not seem to be within the intent of the interest deductibility provision such as nil interest loans to sister companies, investments in companies prohibited from making distributions, and so on.

108. Therefore, the Commissioner takes the view that the replacement and repayment principle requires that borrowings should be traced to replacement of funds that satisfy the statutory nexus for deductibility. Taxpayers with few borrowings should usually be able to trace money. Taxpayers with more complicated borrowing practices will, in most case, be companies, for which interest will be deductible under section DB 7, without the need to satisfy the *Roberts and Smith* principle.

109. It should be remembered that all debt is subject to a tracing test. In several cases that considered the direct test of interest deductibility, the courts have held that the use of funds must be traced: for example, *Pacific Rendezvous Ltd* and *Brierley*.

When interest is not deductible under the *Roberts and Smith* principle

Introduction

110. Paragraphs 111–128 below discuss the situations where interest is not deductible under the *Roberts and Smith* replacement and repayment principle. These paragraphs are organised under the following headings:

- Goodwill and asset revaluations: BR Pub 10/14; BR Pub 10/15; BR Pub 10/16; BR Pub 10/17; BR Pub 10/18
- Subvention payments: BR Pub 10/19
- Sole traders
- Private use.

Goodwill and asset revaluations: BR Pub 10/14; BR Pub 10/15; BR Pub 10/16; BR Pub 10/17; BR Pub 10/18

111. BR Pub 10/14 to BR Pub 10/18 state that interest on borrowed funds will not be deductible under the *Roberts and Smith* replacement and repayment principle to the extent that the borrowed funds are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

112. As mentioned in paragraphs 81 and 82 above, in *Roberts and Smith* Hill J singled out internally generated goodwill as an amount in the partnership capital account that could not be replaced and repaid to partners, because it is not an amount that has been invested by someone in the business. Hill J explained that a payment of goodwill is not a "refund of a pre-existing capital contribution" (at p 4,390).

113. Glazebrook and James[6] have explained that goodwill cannot be distributed because after a purported distribution, it would still remain. Therefore, internally generated goodwill is not an amount that can be replaced and repaid to partners or shareholders with borrowed funds with a deductible result.

114. However, the situation will be different if goodwill is purchased. In that situation, funds, either equity or debt, are used to purchase the goodwill. These funds can be replaced with borrowed funds and the interest would be deductible.

115. If purchased goodwill is revalued internally, the extent of the internal revaluation is not represented by an amount invested in the business that can be replaced and repaid. Therefore, interest on an amount borrowed purporting to replace goodwill to the extent that it is internally generated and to repay it to partners or shareholders, will not be deductible.

116. Similarly, amounts that are attributable to asset revaluations cannot be replaced and repaid and therefore are not within the *Roberts and Smith* principle.

Subvention payments: BR Pub 10/19

117. BR Pub 10/19 applies to interest on borrowed funds used to make a payment under section IC 5 to another company.

118. A company may use borrowed funds to make a payment under section IC 5 to another company that has a net loss and is in the same group of companies. This payment is commonly referred to as a "subvention payment". An issue arises as to whether the interest incurred on borrowed funds used to make subvention payments will be deductible in accordance with the replacement and repayment principle.

119. In many cases, this issue will not arise in practice. Interest incurred by companies is generally deductible under section DB 7. Therefore, interest incurred by a company on borrowed funds used to make a subvention payment will generally be deductible under that section.

120. However, if section DB 7 does not apply, then the application or not of *Roberts and Smith* becomes relevant. The replacement and repayment principle is that interest is deductible on borrowings repaying funds paid into the business or income earning process. A subvention payment is a payment between companies in a group to reduce the overall tax burden of the group. It is not a replacement of an amount previously advanced by the recipient company, or an amount repaid to shareholders for amounts they invested in the paying company.

121. Therefore, in the Commissioner's view, the use of borrowed funds to pay a subvention payment does not satisfy the replacement and repayment principle from *Roberts and Smith*, and interest incurred on borrowed funds used to pay a subvention payment is not deductible under that principle.

122. BR Pub 10/19 states that interest on borrowed funds used to make a subvention payment will not be deductible under the general permission on any basis. In the Commissioner's view, a subvention payment

[6] "Taxation Implications of Company Law Reform" by Susan Glazebrook and Jan James, New Zealand (1995) 1 NZJTLP 132 at p 157.

does not have a sufficient connection with the income earning activities of the company making the payment. The payment is made after the derivation of income by the company and when its annual profits are determined. The subvention payment reduces the tax liability of the company, thereby minimising the overall tax liability of the group of companies.

Sole traders

123. The principle in *Roberts and Smith* is that interest is deductible on borrowed funds used to repay funds to investors in an income earning activity or business. This principle applies where an entity—whether a partnership or a company—borrows money and uses it to return amounts invested in the partnership or company. Individuals with an income earning activity or business but who do not operate through a company or any other structure (referred to as a "sole trader"), do not have a separate entity in which to invest their money. If an individual invests money used for private purposes into a business or activity they carry on as a sole trader, there has been no change in ownership of that money. It is artificial to describe a transaction with oneself as a replacement and repayment of funds. Therefore, in the Commissioner's opinion, the replacement and repayment principle cannot apply to sole traders arguing that borrowing funds have the effect of returning their capital or past years' profits.

124. Although a partnership is not a separate legal entity from its partners, as discussed above, there is a distinction between property owned by a partnership and property owned by individual partners. Therefore, in contrast to sole traders, there can be a valid legal transfer of property from a partnership to a partner, and the *Roberts and Smith* principle can apply to partnerships.

125. Professor Parsons raised some arguments that support applying the *Roberts and Smith* principle to individuals in "Roberts and Smith: Principles of Interest Deductibility".[7] He said that separate accounting records may personify a separate entity. Secondly, he argued that the legislation recognises a sole trader in business as separate from the sole trader in a private capacity, because the deductibility provisions distinguish between individuals in business and individuals not in business. However, he considered that these arguments may be tenuous, and that it will be difficult for a sole trader to establish that interest on borrowings used to withdraw capital is not prohibited as private. Also, Professor Parsons considered these arguments in the context of an interpretation of *Roberts and Smith* that is much broader than the interpretation taken by the Commissioner.

126. Although an individual cannot replace capital, an individual can, however, deduct interest incurred in using borrowed funds to replace a debt owed to a third party, where the amount first borrowed was used directly in the individual's income earning activity or business. As the borrowed funds replaced are repaid to a separate entity, the third party lender, the funds are able to be repaid, and so the *Roberts and Smith* principle can apply.

Private use

127. The Commissioner's view is that when borrowings are used to return partners' capital, the interest may be deductible despite the fact that the direct use of the borrowed funds may be for the private use of the taxpayer. The reason is that the borrowed funds are also used for a concurrent income-related use—the replacement of funds used in deriving income.

128. That situation compares with the one where the borrowed funds replace borrowed funds that are being used solely for private use. In that situation, the interest on the replacing funds will not be deductible.

Other matters

Australian Tax Office's view on Roberts and Smith

129. The Australian Tax Office has issued a ruling on its interpretation of *Roberts and Smith*. The Australian Tax Office's view is similar to the Commissioner's view; see TR 95/25 *Income Tax: deductions for interest under subsection 51(1) of the Income Tax Assessment Act 1936 following FC of T v Roberts; FC of T v Smith*, issued 29 June 1995. Two addenda have been added to TR 95/25, primarily to update the references in the ruling to the Australian Income Tax Assessment Act 1997. A consistent interpretation of *Roberts and Smith* was applied in TR 2005/12 *Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with payments of distributions to beneficiaries*, issued 6 July 2005. TR 2005/12 relates to borrowings used to repay amounts to beneficiaries.

Applicability of Roberts and Smith *to the refinancing of investments in QCs, CFCs and FIFs*

130. If interest on funds invested in qualifying companies, controlled foreign companies or foreign investment funds is deductible then, applying *Roberts and Smith*, interest on funds used to refinance that investment will be deductible. *Roberts and Smith* is concerned with refinancing of investments, and when it applies, the deductibility status of the initial investment is

[7] See note 2.

taken on by the replacing funds. It is not necessary to understand the reasons for the deductibility or otherwise of the initial investment to understand the *Roberts and Smith* principle. Because the deductibility of interest incurred in relation to qualifying companies, controlled foreign companies and foreign investment funds is not relevant to an understanding of how the *Roberts and Smith* case applies, the issue is not dealt with further in this commentary or in the Rulings.

PUBLIC RULING BR PUB 10/20: DEDUCTIBILITY OF BREAK FEE PAID BY A LANDLORD TO EXIT EARLY FROM A FIXED INTEREST RATE LOAN ON SALE OF RENTAL PROPERTY

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

Taxation Laws

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

This ruling applies in respect of sections DA 1, DB 6, DB 7, and EW 31 and the definition of "interest" in section YA 1.

The Arrangement to which this Ruling applies

The Arrangement is where a person has entered into a fixed interest rate loan and the money has been used to acquire a property from which rental income is derived. The person subsequently pays a break fee to the lender to repay in full and terminate that loan earlier than its agreed repayment date in order to sell the rental property. Therefore, the person ceases to derive rental income from the property.

This Ruling will not apply when the loan is not used solely for the deriving of rental income or where the loan is part of or connected with one or more other financial arrangements between the lender and the borrower.

This Ruling will also not apply if the taxpayer has adopted the IFRS financial reporting method in section EW 15D.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the arrangement as follows:

- A base price adjustment is required in the income year the loan is repaid.
- The amount of any break fee is included in the "consideration" element of the base price adjustment formula and will increase the overall negative figure that the base price adjustment provides.
- The negative amount under the base price adjustment is expenditure incurred under the financial arrangements rules and constitutes interest.
- An automatic deduction is available for companies (other than qualifying companies) for the negative base price adjustment amount as interest under section DB 7.
- A deduction is available for other taxpayers under section DB 6 and the general permission in section DA 1.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2008–09 income year to the last day of the 2011–12 income year.

This ruling is signed by me on the 28th day of October 2010.

Martin Smith
Chief Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 10/20

This commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 10/20 ("the Ruling"). The commentary is not a legally binding statement.

All legislative references are to the Income Tax Act 2007 unless otherwise stated. The relevant legislative provisions are reproduced in the Appendix to this commentary.

Background

This Ruling deals with the deductibility of a fee charged by banks to permit landlords to repay a fixed interest rate loan early in order to sell a rental property. These fees are variously referred to by terms such as "early repayment fees", "early repayment adjustment charge", "early exit fees" and "mortgage break fees". In this Ruling, the term "break fee" is used to refer to all such charges.

The amount of the break fee and the circumstances that trigger the charging of the fee vary from lender to lender. The fee is generally seen as compensation for the loss the lender may have suffered if their current interest rate for a similar loan for a fixed interest rate period closest to the borrower's unexpired fixed interest period is lower than the fixed interest rate applying to the borrower's loan.

Public rulings BR Pub 09/09 "Deductibility of break fee paid by a landlord to exit early from a fixed interest rate loan" and BR Pub 09/10 "Deductibility of break fee paid by landlord to vary the interest rate of an existing fixed interest rate loan" deal with the deductibility of the break fee in two scenarios. These are when:

- the loan is repaid early (whether replaced by further borrowing from the same or another financial institution or not);

- the interest rate of the loan is simply renegotiated during the term of the loan and the existing loan continues.

This Ruling considers the additional scenario where the break fee is paid in order to sell the rental property, so the landlord ceases to derive assessable income from the property.

Application of the legislation

Financial arrangements rules and base price adjustment

A fixed interest rate loan is a financial arrangement under section EW 3. The financial arrangements rules (FA rules) will therefore apply. When a loan is repaid in full, a base price adjustment (BPA) is required under section EW 29.

Although many landlords are likely to be cash basis persons under the FA rules and not required to use a spreading method, they are still subject to the FA rules and will be required to do a BPA when the loan is repaid in full.

The formula for calculating a BPA is in section EW 31(5):

consideration – income + expenditure + amount remitted

A break fee charged by a bank in respect of the early repayment of the loan will fall within the definition of "consideration" in section EW 31(7) as "consideration that has been paid … by the person for or under the financial arrangement". "Consideration" is defined to exclude "non-contingent fees" and "non-integral fees". The break fee will not be excluded as a "non-contingent fee" because the fee is not "for services provided for the taxpayer **becoming a party** to the financial arrangement and payable whether or not the financial arrangement proceeds" (emphasis added). The fee is payable to allow the taxpayer to cease being a party to the financial arrangement. The scope of these rulings excludes landlords who have adopted the IFRS financial reporting method under section EW 15D, so it is unnecessary to consider whether the break fee constitutes a non-integral fee.

As part of the consideration paid by the borrower, the amount of the break fee will increase the overall negative figure that the BPA provides in this scenario.

Deductibility of negative base price adjustment amount

A negative BPA is expenditure incurred under the FA rules under section EW 31(4). Taxpayers who have previously returned income under a financial arrangement (such as lenders) are allowed an automatic deduction for the negative BPA expenditure under section DB 11 to the extent of that previously returned income. However, as landlords are generally borrowers who have not derived income from their loans, section DB 11 has no application in those circumstances.

Negative BPA expenditure is "interest" for the purposes of sections DB 6 and DB 7 (see the definition of "interest" in section YA 1). In the case of a company (other than a qualifying company), the amount of the negative BPA will be automatically deductible under section DB 7.

An individual taxpayer or a qualifying company will be able to deduct the amount of the negative BPA as interest under section DB 6, provided the general permission in section DA 1 is satisfied and none of the general limitations (excluding the capital limitation) apply. Section DB 6 specifically provides the capital limitation will not apply, so it is unnecessary to consider whether the amount is of a capital or revenue nature.

The Commissioner's view is that the general permission will be satisfied and the amount of the negative BPA will be deductible under section DB 6. The borrowed money was used to purchase a property from which rental income is derived. The BPA is being carried out at the time the rental property is sold and the deriving of rental income ceases. The negative BPA amount is deductible as interest as it has a sufficient relationship with the derivation of the rental income. Note that if the borrowing was used for a private or domestic purpose, a deduction would be denied under the private limitation in section DA 2(2).

Alternative view – general permission not satisfied

The Commissioner notes that some commentators have suggested that because the break fee is paid to allow the taxpayer to dispose of the property, and therefore to cease deriving assessable rental income, the break fee does not have a sufficient relationship with the derivation of assessable income and the general permission is not satisfied to the extent of the amount of the break fee. The Commissioner's view is that the break fee amount is an indivisible part of the negative BPA amount produced by the application of the BPA formula. The BPA provides a net figure at the end of the financial arrangement. This net figure is treated as interest, and it is the deductibility of that interest net figure that must be considered. The individual amounts that go into the BPA formula are not considered separately to determine assessability or deductibility.

Relevance of post-cessation business cases

It has also been suggested that relevant here is the line of reasoning in the post-cessation of business cases, such as *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 295, *Case U29* (2000) 19 NZTC 9,273 and *Inglis v CIR* (2001) 20 NZTC 17,379.

The post-cessation cases look at the deductibility of expenditure incurred after a business has ceased. These cases are concerned with how long after a business has ceased that expenditure may be claimed. However, under the present arrangement, the BPA is being performed at the same time as the rental property is sold and the deriving of rental income from it ceases. Therefore, the post-cessation cases are not relevant.

Example

At the beginning of year 1, B borrows $200,000 at a flat 10% per year fixed interest rate to purchase a rental property from which rental income is derived. The loan is interest only. At the end of year 2, B breaks the loan in order to sell the property. B repays the loan and pays an additional $10,000 break fee.

B must calculate a BPA in relation to the loan as follows:

consideration – income + expenditure + amount remitted

The consideration received by B is the original loan amount of $200,000. The consideration paid by B is the return of the principal, two instalments of interest at $20,000 each, and the break fee of $10,000:

($200,000 + $20,000 + $20,000 + $10,000) = $250,000

There is no income or amount remitted. The expenditure is the $20,000 interest incurred under the loan in year 1.

Therefore, the BPA is:

($200,000 – $250,000) – $0 + $20,000 + $0

= –$50,000 + $20,000

= –$30,000

The negative BPA amount of $30,000 effectively represents the $20,000 interest expense for year 2 and the amount of the break fee.

The negative BPA amount is expenditure incurred under the FA rules and is deemed to be interest. If B is a company, B will obtain an automatic deduction for the $30,000 in the year in which it is incurred under section DB 7. If B is a non-corporate or a qualifying company, the $30,000 will be deductible under section DB 6 and the general permission. The general permission is satisfied because the borrowed money was used to purchase the rental property from which assessable income was derived.

APPENDIX: LEGISLATION

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

Section DA 1(1) and (2) states:

Nexus with income

(1) 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.

General permission

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

Section DA 2(1) states:

Capital limitation

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

Section DB 6(1) and (4) states:

Deduction

(1) A person is allowed a deduction for interest incurred.

…

Link with subpart DA

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

Section DB 7(1), (2), and (8) states:

Deduction

(1) A company is allowed a deduction for interest incurred.

Exclusion: Qualifying company

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

…

Link with subpart DA

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

Section DB 11 states:

DB 11 Negative base price adjustment

Deduction

(1) A person who has a negative base price adjustment under section EW 31(4) (Base price adjustment formula) is allowed a deduction for the expenditure to the extent to which it arises from assessable income, under section CC 3 (Financial arrangements), derived by the person under the financial arrangement in earlier income years.

Link with subpart DA

(2) This section supplements the general permission and overrides all the general limitations.

Section EW 3(2) and (3) states:

Money received for money provided

(2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—

(a) at a future time; or

(b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

Examples of money received for money provided

(3) Without limiting subsection (2), each of the following is a financial arrangement:

(a) a debt, including a debt that arises by law:

(b) a debt instrument:

(c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:

(d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

Section EW 29(3) states:

Maturity

(3) A party to a financial arrangement must calculate a base price adjustment as at the date on which the arrangement matures.

Section EW 31 states:

EW 31 Base price adjustment formula

Calculation of base price adjustment

(1) A person calculates a base price adjustment using the formula in subsection (5).

When formula applies

(2) The person calculates the base price adjustment for the income year in which section EW 29 applies to them.

Positive base price adjustment

(3) A base price adjustment, if positive, is income, under section CC 3 (Financial arrangements), derived by the person in the income year for which the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred by the person under the financial arrangement in earlier income years and for which a deduction was denied in those income years.

Negative base price adjustment

(4) A base price adjustment, if negative, is expenditure incurred by the person in the income year for which the calculation is made. The person is allowed a deduction for the expenditure under section DB 11 (Negative base price adjustment).

Formula

(5) The formula is—

consideration – income + expenditure + amount remitted

Definition of items in formula

(6) The items in the formula are defined in subsections (7) to (11).

Consideration

(7) **Consideration** is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. For the purposes of this subsection, the following are ignored:

(a) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D:

(b) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D.

Consideration in particular cases

(8) If any of sections EW 32 to EW 48 applies, the consideration referred to in subsection (7) is adjusted under the relevant section.

Income

(9) **Income** is—

(a) income derived by the person under the financial arrangement in earlier income years; and

(b) dividends derived by the person from the release of the obligation to repay the amount lent; and

(c) income derived under section CF 2(2) and (3) (Remission of specified suspensory loans).

Expenditure

(10) **Expenditure** is expenditure incurred by the person under the financial arrangement in earlier income years.

Amount remitted

(11) **Amount remitted** is an amount that is not included in the consideration paid or payable to the person because it has been remitted—

(a) by the person; or

(b) by law.

Section YA 1 states:

> **IFRS** means a **New Zealand** Equivalent to International Financial Reporting Standard, approved by the Accounting Standards Review Board, and as amended from time to time or an equivalent standard issued in its place
>
> **interest**,—
>
> …
>
> (c) in sections DB 6 (Interest: not capital expenditure), DB 7 (Interest: most companies need no nexus with income), and DB 8 (Interest: money borrowed to acquire shares in group companies),—
>
> (i) includes expenditure incurred under the financial arrangements rules or the old financial arrangements rules; …
>
> **maturity**,—
>
> (a) in the financial arrangements rules, means,—
>
> (i) for an agreement for the sale and purchase of property or services or an option, the date on which the agreement or option ends:
>
> (ii) for any other financial arrangement, the date on which the last payment contingent on the financial arrangement is made:
>
> **non-contingent fee** means a fee that—
>
> (a) is for services provided for a person becoming a party to a financial arrangement; and
>
> (b) is payable whether or not the financial arrangement proceeds
>
> **non-integral fee** means a fee or transaction cost that, for the purposes of financial reporting under IFRSs, is not an integral part of the effective interest rate of a financial arrangement

INTERPRETATION STATEMENTS

This section of the *TIB* 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 10/08: RETIREMENT VILLAGES – GST TREATMENT

This Interpretation Statement considers the legislation as it is before any relevant amendments to the Goods and Services Tax Act 1985 in the Taxation (GST and Remedial Matters) Bill 2010 take effect. When the form of any relevant amendments is finalised, a further item will be issued to address the GST position of retirement villages affected by the amendments.

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

Summary

2. This Interpretation Statement addresses the GST treatment of payments received by retirement villages (the owners and operators of retirement villages) and their entitlement to input tax credits in respect of goods or services acquired for the purposes of operating a retirement village.
3. To determine whether GST is chargeable on supplies made by a retirement village and whether retirement villages are entitled to input tax credits on goods and services acquired for the purpose of operating the retirement village, it is necessary to consider whether the supplies made by a retirement village are taxable or exempt supplies. For this purpose, it is necessary to consider the rights and obligations under contracts entered into between retirement villages and their residents.
4. Retirement villages supply accommodation and care services. The main legal structures used for the provision of occupation rights in a retirement village are sales, leases or licences. Where a unit is sold, a retirement village may have an obligation to re-purchase the unit or they may have an option to purchase the unit. The payments made by residents under their contracts include an entry payment (either the purchase price for a unit, a loan or deposit), a payment that is commonly described as the "facilities fee" or "amenities contribution", periodic services fees and termination charges. The nature of the supplies made by a retirement village and the consideration for the supplies are considered at paragraphs 44 to 106.
5. A retirement village may make the following types of exempt supplies:
   - The supply of financial services (the allotment or issue of a debt security): sections 14(1)(a) and 3(1)(c). The meaning of "debt security" is considered at paragraphs 58 to 61.
   - The supply of accommodation in a dwelling by way of hire, service occupancy agreement or licence to occupy: section 14(1)(c). The meaning of "accommodation" is considered at paragraphs 79 to 80 and the meaning of "dwelling" is discussed at paragraphs 116 to 145.
6. The Commissioner considers that a retirement village makes a supply of a financial service (the allotment of a debt security) under any transaction where the retirement village accepts an obligation to re-purchase a unit or to repay a loan or deposit. That service is supplied for no consideration. Section 14(1)(a) is considered at paragraphs 111 to 113.
7. As section 14(1)(c) applies to the supply of accommodation by way of hire, service occupancy agreement or licence to occupy, it is necessary to consider whether section 14(1)(c) applies only where the right to occupy a unit in a retirement village is supplied under a lease or licence. For section 14(1)(c) to apply, accommodation must be supplied in a dwelling. If paragraph (f) of the definition of "commercial dwelling" applies to a unit in a retirement village, the unit is a dwelling rather than part of a commercial dwelling. To determine whether paragraph (f) applies, it is necessary to:
   - identify the consideration that residents are contractually obliged to pay for the right to occupy a dwelling; and
   - determine whether such consideration is for the supply of accommodation.

The Commissioner considers that paragraph (f) does not apply to units whose residents have purchased a package of care services; therefore, such units are part of a commercial dwelling so that the supply of accommodation in the units under a lease or licence is a taxable supply. On the basis of contractual arrangements that are currently entered into between retirement villages and residents, paragraph (f) applies to other units in a retirement village so that the supply of accommodation in such units under a lease or licence is an exempt supply.

The issue of whether section 14(1)(c) applies to the supply of accommodation in a retirement village is considered at paragraphs 114 to 145.

8. A retirement village may also supply a participatory security under which residents have a right to use the common areas and facilities in the village. If the right to use the common areas under a participatory security that is part of a taxable supply of accommodation is an "associated supply", section 14(1)(a) does not exempt the associated supply: section 14(1B). An associated supply is treated as a separate taxable supply: section 5(14B). This issue is considered at paragraphs 146 to 156.

Input tax credits

9. Whether an input tax credit is allowable on the individual goods and services that go into a retirement village development depends on whether the asset produced using those goods and services is acquired for the principal purpose of making taxable supplies.

10. The principal purpose at the time of acquisition must be ascertained. If at the time land is acquired development plans are not finalised, whether the principal purpose test is satisfied in respect of the land depends on whether the intended use of the land is principally for the making of taxable supplies. There must be objective evidence of the intended use of the land (such as planning applications, feasibility studies and preliminary designs).

11. Where a retirement village includes both dwellings and a commercial dwelling, the dwellings and the commercial dwelling are treated as separate supplies in applying the principal purpose test. Whether the principal purpose test is satisfied in respect of the common areas and facilities depends on whether the retirement village principally supplies exempt supplies of accommodation or taxable supplies of accommodation and other services. The principal purpose test is to be applied to a supply as a whole. Areas within a community centre such as the kitchen, dining room and nursing station that are used exclusively for the purpose of making taxable supplies are not a separate supply for the purpose of the principal purpose test.

12. The principal purpose test is considered at paragraphs 157 to 171.

Adjustments

13. If the principal purpose test is not satisfied in respect of goods and services acquired for the development or operation of a retirement village, an input tax adjustment is allowable to the extent that the goods and services are applied for making taxable supplies if:
    - the goods and services were acquired on or after 1 October 1986; and
    - GST was charged on the supply of the goods or services; or
    - the goods are secondhand goods that have always been situated in New Zealand and were acquired by way of sale: section 21E.

14. The extent to which goods or services are applied for the purpose of making taxable supplies may be calculated by reference to the ratio of dwellings to commercial dwellings in a retirement village. However, another method of calculation would be acceptable if the method results in fair and reasonable amounts.

15. Taxpayers have an option of making input tax adjustments on a periodic or annual basis: section 21G(1). However, a one-off input tax adjustment is allowable in respect of goods and services costing more than $18,000 only if the goods and services are wholly applied for the purpose of making taxable supplies and:
    - the Commissioner consents to a one-off input tax adjustment in respect of goods and services; or
    - the goods and services are applied for a different purpose as a consequence of a change in the legislation: sections 21G, 21G(1A) and 21H.

16. An asset is a capital asset if it is acquired for retention and use in carrying on a taxable activity. In some circumstances, it may be necessary to consider whether an item is a separate asset. The Interpretation Statement on *Residential rental properties – depreciation of items of depreciable property* provides guidance as to the matters to be considered in determining whether an item is a separate asset.

17. An output tax adjustment is required in respect of goods and services acquired for the principal purpose of making taxable supplies to the extent the goods and services are applied for another purpose: section 21(1).

An output tax adjustment would be required at one of the following times:

- In the first taxable period in which goods and services are applied for a purpose other than that of making taxable supplies;
- In each taxable period in which goods and services are applied for a purpose other than that of making taxable supplies;
- In each year in which goods and services are applied for a purpose other than that of making taxable supplies: section 21C.

18. Land acquired for the principal purpose of making taxable supplies would be applied for a purpose other than of making taxable supplies when it is determined that a particular part of the land is to be allocated for the construction of dwellings where exempt supplies of accommodation are to be made. This may occur before the land is actually used for the purpose of making taxable supplies.

19. Input tax and output tax adjustments are considered at paragraphs 172 to 192.

Background

20. A retirement village is a complex that is used for the provision of accommodation to retirees: *Norfolk Apartments Ltd v CIR* (1995) 17 NZTC 12,003 (HC). A central concept of retirement villages is the provision of accommodation: *Norfolk Apartments Ltd v CIR* (1995) 17 NZTC 12,212 (CA). Another feature of retirement villages is the provision of community facilities to residents. Care and other services may also be provided in a retirement village. The services other than accommodation that are provided to residents may vary from village to village. Residents within a retirement village may also receive different levels of care and services.

21. The Commissioner has referred to several sources that contain a broad outline of the legal and financial structure of arrangements between retirement villages and their residents. The Commissioner has also considered a range of contracts used in respect of particular retirement villages. These indicate that the main legal structures used for the provision of occupation rights in retirement villages are sales, leases or licences. The financial structures commonly entered into between retirement villages and their residents may broadly be described as follows:

- Generally, residents are required to pay a lump sum payment on entry to the retirement village, which, in legal terms, is either the purchase price for a unit or an interest-free loan or refundable deposit.
- The entry payment may include a separate component (commonly known as the "facilities fee" or "amenities contribution"), which is treated as payment for either the provision of community facilities or for management services. A retirement village may be entitled to take the facilities fee or amenities contribution or it may accrue to the retirement village over a period of years. If the entry payment does not include a facilities fee or amenities contribution, the facilities fee or amenities contribution is payable when the resident leaves the village and is deducted from the amount that is repayable to the resident.
- Residents are also required to pay periodic fees, which are a proportionate share of village overheads such as rates, insurance, security, management expenses and maintenance.
- An additional payment or a higher service fee is chargeable where residents receive other services such as laundry, cleaning, nursing and meals.
- Residents may also be required to pay refurbishment costs relating to their unit when they leave the village.
- Residents may be required to pay a termination fee or the legal costs incurred by the retirement village in granting the occupation right.
- The amount that is repaid to the resident will often be less than the amount originally paid by the resident. Residents may not be entitled to share in the capital gain on their units and, if they are entitled to do so, a higher entry payment may be required.

22. It is not possible in the context of an Interpretation Statement to address every type of arrangement that may be entered into between retirement villages and their residents. This Interpretation Statement deals with sales, leases and licences (which are the main legal structures used in retirement villages) and the financial structures outlined above. It is hoped that the principles outlined in this Interpretation Statement will be relevant in the majority of cases.

Legislation

Goods and Services Tax Act 1985

23. Under section 3(1)(c) and (d), the following activities are financial services:

> (c) the issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security:
>
> (d) the issue, allotment, or transfer of ownership of an equity security or a participatory security:

24. Section 5(14B) provides:

    If part of a supply of an equity security or participatory security is the supply of a right to receive supplies of goods and services that are not exempt supplies, the supply of the right is treated as being a supply of goods and services made for a consideration.

25. Section 8(1) provides:

    Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 15 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

26. Section 10(2) provides:

    Subject to this section, the value of a supply of goods and services shall be such amount as, with the addition of the tax charged, is equal to the aggregate of,—

    (a) to the extent that the consideration for the supply is consideration in money, the amount of the money:

    (b) to the extent that the consideration for the supply is not consideration in money, the open market value of that consideration.

27. Section 10(6) provides:

    Where and to the extent that any supply of goods and services consists of the supply, to any individual, of domestic goods and services in a commercial dwelling, the value attributable to that part of that supply of domestic goods and services that is for a period in excess of 4 weeks shall be deemed to be reduced to an amount equal to 60 percent of the amount that would, if that part of that supply were chargeable with tax at the rate of 9.0 percent, be the value of that part of that supply of domestic goods and services:

    Provided that to the extent that any supply is a supply of domestic goods and services, and where that commercial dwelling is a residential establishment, and where the supplier and the recipient have agreed that that supply shall be for a period of or in excess of 4 weeks, or for a number of periods which in the aggregate will exceed 4 weeks, the value attributable to that supply of domestic goods and services shall, from the commencement of that supply, be deemed to be reduced to an amount equal to 60 percent of the amount that would, if that supply were chargeable with tax at the rate of 7.5 percent, be the value of that supply of domestic goods and services.

28. Section 10(18) provides:

    Where a taxable supply is not the only matter to which a consideration relates, the supply shall be deemed to be for such part of the consideration as is properly attributable to it.

29. Section 14(1)(a) and (c) provides:

    The following supplies of goods and services shall be exempt from tax:

    (a) the supply of any financial services (together with the supply of any other goods and services, supplied by the supplier of those financial services, which are reasonably incidental and necessary to that supply of financial services), not being a supply referred to in subsection (1B):

    …

    (c) the supply of accommodation in any dwelling by way of—

    (i) hire; or

    (ii) a service occupancy agreement; or

    (iii) a licence to occupy:

30. Section 14(1B) provides:

    The following supplies are excluded from the exemption under subsection (1):

    (a) a supply of financial services that, in the absence of subsection (1)(a), would be charged with tax at the rate of zero per cent under section 11A:

    (b) a supply described in paragraph (b) of the definition of associated supply:

    (c) a supply of goods and services which (although being part of a supply of goods and services which, but for this paragraph, would be an exempt supply under subsection (1)(a)) is not in itself, as between the supplier of that first-mentioned supply and the recipient, a supply of financial services in respect of which subsection (1)(a) applies.

31. Section 20(3) provides:

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

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

    (i) input tax in relation to the supply of goods and services (not being a supply of secondhand goods to which section 3A(1)(c) of the input tax definition applies), made to that registered person during that taxable period:

    (ia) input tax in relation to the supply of secondhand goods to which section 3A(1)(c) of the input tax definition applies, to the extent that a payment in respect of that supply has been made during that taxable period:

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

    (iii) any amount calculated in accordance with any one of sections 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b); and

(b) in the case of a registered person who is required to account for tax payable on a payments basis or a hybrid basis pursuant to section 19 of this Act, the amount of the following:

(i) input tax in relation to the supply of goods and services made to that registered person, being a supply of goods and services which is deemed to take place pursuant to section 9(1) or section 9(3)(a) or section 9(3)(aa) or section 9(6) of this Act, to the extent that a payment in respect of that supply has been made during the taxable period:

(ii) input tax paid pursuant to section 12 of this Act during that taxable period:

(iii) input tax in relation to the supply of goods and services made during that taxable period to that registered person, not being a supply of goods and services to which subparagraph (i) of this paragraph applies:

(iv) any amount calculated in accordance with any one of sections 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b), to the extent that a payment has been made in respect of that amount; and

32. Section 21E provides:

(1) Section 21F applies if—

(a) a person acquires goods and services on or after 1 October 1986 for the principal purpose other than that of making taxable supplies; and

(b) the goods and services are applied in a taxable period for a purpose of making taxable supplies either by the person or, if the person is a member of a partnership, by the partnership; and

(c) either subsection (2) or subsection (3) applies.

(2) This subsection applies if—

(a) tax has been charged under section 8(1) on the supply of the goods and services made to the person; or

(b) tax has been levied under section 12(1) of this Act on the goods that have been entered for home consumption under the Customs and Excise Act 1996 by the person.

(3) This subsection applies if—

(a) the goods are secondhand goods that are supplied to the person by way of sale and the goods—

(i) have always been situated in New Zealand; or

(ii) have had tax levied on them under section 12(1); and

(b) the supply is not a taxable supply; and

(c) the person has not supplied the goods to another registered person who has entered them for home consumption under the Customs and Excise Act 1996.

(4) For the purpose of subsection (1)(a), goods and services are treated as if they were acquired for the principal purpose other than that of making taxable supplies to the extent that—

(a) section 21 or 21I have treated the goods and services as being supplied; or

(b) section 5(3) has deemed the goods and services as being supplied by a person who ceases to be a registered person and the goods or services are subsequently applied by the person, or by a partnership of which the person is a partner, for a purpose of making taxable supplies.

33. Section 21F provides:

(1) For the purpose of this Act, the goods and services referred to in section 21E are treated as being supplied in the taxable period to the person or partnership, and the Commissioner must, to the extent that the goods and services are applied, allow the person or partnership to make a deduction under section 20(3) for the tax fraction of the lesser of—

(a) the cost of the goods and services, including any tax charged or input tax deduction claimed for the goods and services; and

(b) the open market value of the supply of the goods and services.

(2) Subsection (1) does not apply to a supply of services provided by an employee.

34. Section 21G provides:

(1) A person to whom section 21F applies may make the deduction at either of the following times:

(a) in each taxable period in which goods and services are applied for a purpose of making taxable supplies; or

(b) in each year in which goods and services are applied for a purpose of making taxable supplies.

(1A) Despite subsection (1) and subject to subsection (1B), if section 21F(1) applies to goods that are capital assets with a cost of less than $18,000, the person or the partnership referred to in section 21F(1) may make a single deduction in the taxable period during which the goods are applied for a purpose of making taxable supplies.

(1B) Subsection (1A) does not apply to a registered person if the goods referred to in section 21E are applied for a different purpose as a consequence of a change in this Act.

(2) If a person makes a deduction at the time allowed by subsection (1)(b), the person must reduce the amount of the deduction allowed under section 21F by the amount of deductions made in earlier taxable periods in relation to the supply.

(3) A person may change the time at which the person makes a deduction only with the Commissioner's approval.

35. Section 21H provides:

(1) Despite section 21G(1), a person to whom section 21F applies may apply to the Commissioner to make a single deduction in the taxable period in which goods and services are wholly applied for a purpose of making taxable supplies.

(2) Subsection (1) does not apply to goods and services that—

(a) cost less than $18,000:

(b) are applied for a different purpose as a consequence of a change in this Act.

(3) When determining whether to allow a person to make a single deduction, the Commissioner must take the following factors into account:

(a) the nature of the goods or services:

(b) whether it is practical to require a deduction at either of the times specified in section 21G(1):

(c) whether the person has previously made an attribution under section 21C(1)(a):

(d) whether the person has previously made a single adjustment under section 21(1), as it was before the enactment of the Taxation (GST and Miscellaneous Provisions) Act 2000:

(e) whether the person has previously made a single deduction under either—

(i) this section; or

(ii) section 21(5), as it was before the enactment of the Taxation (GST and Miscellaneous Provisions) Act 2000.

(4) If the Commissioner allows the person to make a single deduction and the goods and services are subsequently applied for a purpose other than that of making taxable supplies, the person must apply section 21C(1)(a) in the taxable period in which the change occurs.

36. Section 25(1) provides:

This section shall apply where, in relation to the supply of goods and services by any registered person,—

(a) that supply of goods and services has been cancelled; or

(aa) the nature of that supply of goods and services has been fundamentally varied or altered; or

(b) the previously agreed consideration for that supply of goods and services has been altered, whether due to the offer of a discount or otherwise; or

(c) the goods and services or part of those goods and services supplied have been returned to the supplier,—

and the supplier has—

(d) provided a tax invoice in relation to that supply and as a result of any one or more of the above events, the amount shown thereon as tax charged on that supply is incorrect; or

(e) furnished a return in relation to the taxable period for which output tax on that supply is attributable and, as a result of any one or more of the above events, has accounted for an incorrect amount of output tax on that supply.

37. Section 25(2) provides:

Where a supplier has accounted for an incorrect amount of output tax as specified in subsection (1)(e) of this section, that supplier shall make an adjustment in calculating the tax payable by that supplier in the return for the taxable period during which it has become apparent that the output tax is incorrect, and if—

(a) the output tax properly charged in relation to that supply exceeds the output tax actually accounted for by the supplier, the amount of that excess shall be deemed to be tax charged on a taxable supply made by that supplier and be attributable to the taxable period in which the adjustment is to be made, and not attributable to any prior taxable period:

(b) the output tax actually accounted for exceeds the output tax properly charged in relation to that supply, that supplier shall make a deduction under section 20(3) of this Act of the amount of that excess.

38. The definitions of "associated supply", "commercial dwelling", "domestic goods and services", "dwelling" and "consideration" in section 2 read as follows:

associated supply means—

(a) a supply for which the supplier and recipient are associated persons:

(b) a supply of a right, under an equity security or participatory security, to receive for no consideration, or consideration at other than the open market value, a supply of goods and services that is—

(i) not an exempt supply; and

(ii) not a supply relating to the control of the issuer of the equity security or participatory security

commercial dwelling means—

(a) any hotel, motel, inn, hostel, or boardinghouse; or

(b) any camping ground; or

(c) any convalescent home, nursing home, rest home, or hospice; or

(d) any establishment similar to any of the kinds referred to in paragraphs (a) to (c) of this definition;—

but does not include—

(e) a hospital except to the extent that that hospital is a residential establishment:

(f) a dwelling situated within a retirement village or within a rest home, where the consideration paid or payable for the supply of accommodation in that dwelling is for the right to occupy that dwelling:

domestic goods and services means the right to occupy the whole or part of any commercial dwelling, including, where it is provided as part of the right to so occupy, the supply of—

(a) cleaning and maintenance:

(b) electricity, gas, air-conditioning, or heating:

(c) telephone, television, radio, or any other similar chattel:

dwelling means any building, premises, structure, or other place, or any part thereof, used predominantly as a place of residence or abode of any individual, together with any appurtenances belonging thereto and enjoyed with it; but does not include a commercial dwelling

consideration, in relation to the supply of goods and services to any person, includes any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body

39. "Debt security" and "participatory security" are defined in section 3(2) as follows:

debt security means any interest in or right to be paid money that is, or is to be, owing by any person; but does not include a cheque

participatory security means any interest or right to participate in any capital, assets, earnings, or other property of any person where that interest or right forms part of a contributory scheme (as defined in section 2 of the Securities Act 1978); and includes an interest in a unit trust within the meaning of the Unit Trusts Act 1960; but does not include an equity security, a debt security, money, or a cheque

40. "Input tax" is defined in section 3A(1) and (2) as follows:

(1) **input tax**, in relation to a registered person, means—

(a) tax charged under section 8(1) on the supply of goods and services made to that person, being goods and services acquired for the principal purpose of making taxable supplies:

(b) tax levied under section 12(1) of this Act on goods entered for home consumption under the Customs and Excise Act 1996 by that person, being goods applied or acquired for the principal purpose of making taxable supplies:

(c) an amount determined under subsection (3) after applying subsection (2).

(2) In the case of a supply by way of sale to a registered person of secondhand goods situated in New Zealand, the amount of input tax is determined under subsection (3) if—

(a) the supply is not a taxable supply; and

(b) the goods are not supplied by a supplier who—

(i) is a non-resident; and

(ii) has previously supplied the goods to a registered person who has entered them for home consumption under the Customs and Excise Act 1996; and

(c) the goods are acquired for the principal purpose of making taxable supplies and—

(i) the taxable supplies are not charged with tax at the rate of 0% under section 11A(1)(q) or (r); or

(ii) the taxable supplies are charged with tax at the rate of 0% under section 11A(1)(q) or (r) and the goods have never, before the acquisition, been owned or used by the registered person or by a person associated with the registered person.

Scheme of the legislation

41. GST is chargeable on the supply of goods and services in the course of a taxable activity carried on by a registered person by reference to the value of the supply. Exempt supplies are not subject to GST: section 8(1).

42. The value of a supply is the consideration paid for the supply. Where the consideration relates to both a taxable supply and an exempt supply, it is necessary to identify the portion of the consideration that is attributable to each supply. Only the part of the consideration that is attributable to a taxable supply is subject to GST.

43. In calculating the tax payable in respect of any taxable period, an input tax credit is allowable on goods and services supplied to a registered person in that period, if such goods and services were acquired for the principal purpose of making taxable supplies: section 20(3); definition of "input tax" in section 3A. If the principal purpose test is not satisfied and the goods and services were acquired on or after 1 October 1986, an input tax credit is allowable to the extent that the goods or services are applied for the purpose of making taxable supplies: sections 21E to 21H. An output tax adjustment is required in respect of goods and services acquired for the purpose of making taxable supplies to the extent the goods and services are applied for another purpose: section 21(1).

Nature of the supply

44. The Court of Appeal in *Gulf Harbour Development Ltd v CIR* (2004) 21 NZTC 18,915 and *CIR v Motorcorp Holdings Ltd* (2005) 22 NZTC 19,126 confirmed that the principles in *Marac Life Assurance Ltd v CIR* (1986) 8 NZTC 5,086 are to be applied in determining the nature of a supply. To determine the nature of a supply, it is necessary to consider the legal rights and obligations entered into between the parties in the light of the surrounding circumstances. The relevant principles were stated by Richardson J in Marac as follows:

> The true nature of a transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out: not on an

> assessment of the broad substance of the transaction measured by the results intended and achieved or of the overall economic consequences. The nomenclature used by the parties is not decisive and what is crucial is the ascertainment of the legal rights and duties which are actually created by the transaction into which the parties entered. The surrounding circumstances may be taken into account in characterising the transaction. Not to deny or contradict the written agreement but in order to understand the setting in which it was made and to construe it against that factual background having regard to the genesis and objectively the aim of the transaction. Of course the documentation may be a sham hiding the true agreement or its implementation. Or there may be a statutory provision mandating a broader or different approach. But at common law there is no halfway house between sham and characterisation of the transaction, according to the true nature of the legal arrangements actually entered into and carried out. (p. 5,098)

45. Where a single supplier makes a supply of a package of services or a package of goods and services, the elements in the transaction may be so closely linked that objectively they constitute a single supply.

46. The principles in VAT cases were adopted in *Auckland Institute of Studies Ltd v CIR* (2002) 20 NZTC 17,685. In that case the principles for determining whether there is a single supply were summarised as follows:

> [a] In determining whether a supply may be apportioned for GST purposes, it is necessary to examine the true and substantial nature of the consideration given to determine whether there is a sufficient distinction between the allegedly different parts to make it reasonable to sever them and apportion them accordingly.
>
> [b] The enquiry is to determine whether one element of the transaction (or consideration given) is a necessary or integral part of another or whether it is merely ancillary to or incidental to that other element.
>
> [c] A service will be ancillary to a principal service if it does not constitute for customers an aim in itself, but a means of better enjoying the principal service supplied. [para 36]

47. VAT cases decided after the *Auckland Institute* case clarify that a single supply made up of a number of elements, none of which are the ancillary (in the sense of subservient, subordinate or ministering to) element in the transaction: see *College of Estate Management v C & E Commrs* [2005] 4 All ER 933 *Levob Verzekeringen Bv v Staatssecretaris van Financiën* [2007] BTC 5186. It is necessary to consider the true and substantial nature of the consideration given for the payment. This will identify the core supply (which may consist of a number of supplies that are integral to each other, none of which is the dominant element in the core supply). It would then be necessary to consider whether there are supplies that are ancillary to the core supply: *C & E Commrs v FDR Ltd* [2000] BTC 5277.

48. Viewed in isolation, an ancillary feature of a transaction could be regarded as an independent supply. However, an ancillary feature is not in any real and substantial sense part of the consideration (objectively ascertained) for the payment made. An ancillary feature is a minor, peripheral and non-essential element of the transaction. It is a question of fact and degree whether the relationship between the elements in a transaction is such that the transaction cannot be regarded as a single supply. In *British Airways plc v C & E Commrs* [1990] BTC 5,124 (where the issue was whether in-flight catering was a separate supply from air transport) the court accepted that the supply of food and beverages was not necessary or essential to the supply of air transport but had concluded in-flight catering was merely an optional extra. The cost of the food and beverages was reflected in the price of the ticket but the food and beverages supplied were not in any real and substantial sense part of the consideration (objectively ascertained) for the payment made by passengers. However in *Sea Containers Ltd v C & E Commrs* [2000] BVC 60 the court considered that food and drink provided on day train excursions was a separate supply from the supply of transport. The court considered that the catering was an important part of what the customer was paying for. Its importance was demonstrated by the references in the marketing brochures to "a unique series of lunch and dinner excursions".

49. Cases in the VAT context establish that in order to determine whether a single supply is made and the nature of the supply or supplies:

- It is necessary to identify the essential features of the transaction (the true and substantial nature of the consideration provided for the payment made by the customer). This requires consideration of the contract between the parties. The true and substantial nature of the consideration is to be ascertained objectively.
- All the circumstances in which the transaction takes place must be considered.
- Whether a separate charge is made or whether a separate price can be identified does not determine the legal nature of the transaction and cannot alter the essential features of the transaction.
- Whether the supplies are "physically and economically dissociable" (for example, there is a supply of goods and a supply of services and the price for each supply can be identified) is not determinative.

- The individual elements in a supply including several elements do not necessarily determine the nature of an "over-arching single supply".

See *C & E Commrs v Wellington Private Hospital* [1997] BTC 5140; *Card Protection Plan Ltd v C & E Commrs* [1999] BTC 5121 (ECJ); ([2001] 2 All ER 143 (HL); *C & E Commrs v British Telecommunications plc* [1999] 3 All ER 961; *Dr Beynon v C & E Commrs* [2004] 4 All ER 1091; *College of Estate Management v C & E Commrs* [2005] 4 All ER 933; *Levob Verzekeringen Bv v Staatssecretaris van Financiën* [2007] BTC 5186.

50. The Commissioner considers that the requirement to consider the transaction from the perspective of a typical consumer or average customer means no more than that the focus is on the supply actually made and not on whether a supply of goods or services could be made separately. In the *British Telecom* case whether the car could have been supplied without the delivery service was irrelevant. The supply contracted for was the supply of a delivered car. In the *Auckland Institute* case the supply that students had contracted for was the supply of tuition services. Pre-arrival services (advice on courses to be undertaken, arrangements for accommodation and other matters relating to the welfare of students, immigration formalities and the completion of documentation for enrolment purposes) could have been provided by a third party under a separate contract. However, the court considered that the pre-arrival services (arranging payment of tuition fees, completion of enrolment and application forms) were ancillary to the supply of tuition in that they facilitated the students undertaking a course of study. Therefore, whether a service could be supplied separately is irrelevant in determining whether a single supply is made. The focus is on the supply made under the contract with the customer.

51. A transaction involving the supply of a package of services or a package of goods and services has been treated as a single supply in the following circumstances:

- Where one element in a transaction is the dominant element in the transaction and the other elements are ancillary to the dominant element in the sense that they facilitate, contribute to or enable the supply of the dominant element in the transaction.
- In the *British Telecom* case there was a single supply of a delivered car. The supply contracted for was for a delivered car and the delivery of the car enabled the completion of the transaction. In the *Card Protection* case it was held that there was a single supply of insurance. The essential feature of the transaction was insurance against loss arising from the misuse of credit cards. The other features in the transaction (the maintenance of a register of credit cards, the ordering of replacement cards, a change of address service, lost key location tags and luggage stickers to ensure the quick return of lost keys and luggage) assisted in the administration of the insurance scheme. In the *Auckland Institute* case the pre-arrival services were ancillary to the supply of tuition services to overseas students in that they facilitated that supply.
- No one element in the transaction is the dominant element in the transaction and the elements in the transaction are so closely linked that, considered objectively, they form a single supply.
- Examples of such transactions include: the supply of distance learning courses, an essential component of which was the supply of written materials (*College of Estate Management*); the supply of medical treatment, which required both the exercise of medical skill and the use of drugs (*Beynon*), the supply of repair services, which required the repair of a vehicle by the replacement of defective parts (*CIR v Motorcorp Holdings Ltd* (2005) 22 NZTC 19,126 (CA); (2004) 21 NZTC 18,437 (HC)) and restaurant transactions, which include the provision of food and a cluster of features and acts (*Faaborg-Gelting Linien A/S v Finanzamt Flensburg* [1996] BTC 5391).
- The transaction includes the provision of minor or peripheral benefits that are optional extras and that are not in any real or substantial sense part of the consideration for which a payment is made.
- In the *Card Protection* case the House of Lords considered that to the extent that the services supplied could not be categorised as insurance, they were ancillary or minor features of the insurance scheme that were not sufficiently coherent to be treated as a separate supply. In *Tumble Tots (UK) Ltd v R & C Commrs* [2007] BTC 5210 it was held that there was a single supply of membership of a club that conferred on a child the right to attendance at classes involving structured physical play and that other benefits received on admission to membership (a DVD, CD, gym bag, membership card, T-shirt, personal accident insurance for a child while attending a class and a subscription for a magazine) did not alter the nature of the supply.

52. Section 5(14) is relevant if (applying the principles outlined above) it is determined that only part of a supply is subject to GST at the standard rate: "Interpretation Statement on GST: Role of section 5(14) of the Goods and Services Tax Act 1985" *Tax Information Bulletin* Vol 20, No 5 (June 2008).

Essential features of the transaction

53. To determine whether the supply made by a retirement village is the supply of accommodation, it is necessary to identify the essential features of the transaction. This requires consideration of the contract entered into between retirement villages and their residents.

54. Contracts may vary from village to village and not all residents within a particular village receive the same services under their contracts. However, a broad outline of contracts entered into between retirement villages and their residents is possible.

55. Generally under leases or licences in respect of a unit in a retirement village:

    - Residents have the right to occupy a particular unit and the right in common with other residents and other persons authorised by the operator to use the common areas and facilities of the village.
    - Retirement village operators are obliged to manage the village, to repair and maintain the village and to provide a security system for the village.
    - An emergency alarm system is installed in units and an emergency response service is available to all residents.
    - Residents must pay a loan or deposit which is repayable on termination of occupation.
    - Residents must also pay periodic fees which are calculated by reference to the costs of operating the village. If residents purchase a package of care services, the periodic fee payable is a higher amount.
    - A "facilities fee" or "amenities contribution" is payable either up-front or on termination of a resident's occupation. If the facilities fee or amenities contribution is an up-front payment, the retirement village may be entitled to take the payment immediately or it may accrue to the retirement village over a period. If the facilities fee or amenities contribution is payable on termination, it is set off against the loan or deposit repayable to the resident.
    - Residents may also be required to pay the cost of refurbishing their units on termination of occupation and other termination charges.

56. In some cases, a resident's contract obliges retirement village operators to supply a package of care services in addition to accommodation. The lowest level care package will typically include daily or weekly visits by a nurse, emergency call monitoring, removal of rubbish from the apartment, weekly cleaning of the apartment, provision of communal transport, organised activities and outgoings, weekly change of towels and bed linen, weekly personal laundry, morning and afternoon teas and the main meal each day. The highest level care package will typically equate to full rest home care. Generally a higher periodic fee is required where a care package is provided. If optional care or other services not included in a care package are supplied to residents at the request of residents, an additional charge is payable.

57. Where a unit is sold to a resident, residents have the right to similar services to those outlined above, including the right to use the common areas and facilities of the village. Generally the retirement village has either an obligation to re-purchase the unit or an option to purchase the unit.

Debt security

58. The definition of "financial services" includes the issue, allotment, drawing, acceptance or transfer of ownership of a debt security: section 3(1)(c).

59. In *Case S54* (1996) 17 NZTC 7,354 it was held that a "debt security" for GST purposes meant a loan. Therefore, even if a narrow interpretation of "debt security" is adopted, a loan or refundable deposit is a debt security. Most retirement village contracts involve a loan or deposit.

60. However, the definition of "debt security" is not limited to loans or deposits. The essence of the definition of "debt security" in the Securities Act 1978 is that money is deposited with, lent to a person or otherwise owing by that person so that the investor retains an interest in the money or a right to be repaid: *Francken v Ministry of Economic Development* (High Court, Dunedin; CRI 2008-412-000025; 1 December 2008) para 34. As under the GST Act, for Securities Act 1978 purposes the definition of debt security will be satisfied if under the transaction an investor has an interest in or right to be paid money, regardless of the form of the transaction. In *Culverden Retirement Village Ltd v Registrar of Companies* [1997] 1 NZLR 257, the Privy Council considered that an arrangement under which a unit was sold on the basis that a retirement village would re-purchase the unit at a specified price was a debt security under the Securities Act.

61. As the definition of "debt security" includes an interest in or right to be paid money that is to be owing, a debt security includes a right to be paid money in the future.

62. For the purpose of the Securities Act 1978 an allotment of a security is made by a person who offers securities to the public or who confers a right under

a security (the issuer). Generally an allotment is made when the contract for the issue of the security is formed. This occurs when the issuer accepts a subscriber's offer to purchase the security offered by the issuer. In exceptional cases, an allotment could take the form of dispositions of rights or interests. See *DFC Financial Services Ltd (in statutory management) v Abel* (1991) 2 NZLR 619 and *Re Loan and Finance (Dunedin) Ltd (in rec)* (1990) 5 NZCLC 66,367; *Owers v Braemar Lodge 2004 Ltd (in receivership)* (2010) NZCLC 264,677.

63. The issue of a security generally involves the delivery of a document or some act (such as the entry of the holder's name on the register) that perfects the title of the holder of the security: *Agricultural Mortgage Corporation Ltd v Inland Revenue Commrs* [1978] 1 All ER 248; *Trustees Executors and Agency Company of New Zealand Ltd v Deutsche Hypothekenbank Frankfurt-Hamburg Aktiengesselschaft* (2008) NZCLC 262,208.

64. Before the Retirement Villages Act 2003 was enacted, offers of securities by retirement villages (being offers of securities to the public) were subject to the Securities Act: *Culverden Retirement Village v Registrar of Companies* [1997] 1 NZLR 257; *Fenton v Pakuranga Park Village Trust* Baragwanath J, HC Auckland CP 269/96, (1998) 3 NZConvC 192,681 (CA); *Covenant Trustee Co v Ohope Lodge Ltd* (Penlington J, 28 April 1993, HC Rotorua M70/90). Therefore, the contractual analysis that applies to public offers applies to retirement village schemes. A contract for the issue of a debt security is formed by a retirement village's acceptance of a prospective resident's offer. A debt security is allotted by the retirement village when it accepts the offer.

65. The Commissioner considers that the activities of a retirement village in allotting a debt security to a resident are a service to the resident. "Services" means some action that helps or benefits the recipient: *Case S65* (1996) 17 NZTC 7,408; *F B Duvall Ltd v CIR* (1997) 18 NZTC 13,470. When a retirement village allots a debt security to a resident, the retirement village undertakes a contractual obligation to pay money to the resident on termination of occupation. As a result, the resident receives a service (an action that is for the benefit of the residents), being the acceptance of an obligation to pay money. That service is a financial service (the allotment of a debt security under which the residents have a right to be paid money).

66. The Commissioner considers that a retirement village supplies a financial service (the allotment of a debt security) under any arrangement under which residents of a retirement village are entitled to receive repayment of all or part of the lump sum payment paid on entry to the retirement village. This is so whether or not the arrangement is a loan in form.

67. However, the Commissioner considers that a sale with an option to purchase in favour of the retirement village would not be a debt security as any right to receive money would be conditional on the option being exercised when occupation terminates. The most commonly accepted theory in relation to the nature of an option is that it is an offer to sell coupled with a contract not to revoke the offer: *Alexander v Tse* [1988] 1 NZLR 318. The purchase price becomes payable only if a contract for the sale and purchase of a unit is formed when the option is exercised. The Commissioner accepts that in practice a retirement village that holds an option to purchase a unit will invariably exercise the option. However, where an option is granted in favour of a retirement village, the obligation on the part of the retirement village to pay the purchase price and the right of the resident to payment of the purchase price do not arise unless and until the option is exercised. Under an arrangement where a retirement village has an obligation to re-purchase a unit, residents have an absolute right to be paid the purchase price on termination of occupation.

68. Therefore, the Commissioner considers that a retirement village supplies a financial service (the allotment of a debt security) under any transaction where the retirement village accepts an obligation to re-purchase a unit from a resident or to repay a loan or deposit.

Consideration for debt security

69. The value of a supply is the consideration for the supply: section 10(2). The definition of "consideration" refers to "any payment … in respect of, in response to or for the inducement of a supply". For the payments to be consideration for a supply, there must be a sufficient relationship between payments and a supply: *CIR v NZ Refining Co Ltd* (1997) 18 NZTC 13,187; *Chatham Islands Enterprise Trust v CIR*; *Suzuki NZ Ltd v CIR* (2001) 20 NZTC 17,096; *The Trustee, Executors & Agency Co Ltd v CIR* (1997) 18 NZTC 13,076. The consideration for a supply may comprise a number of payments. In the *Trustees Executors* case a lease of land provided that in addition to rent, the tenant was required to pay the rates in respect of the land. Chisholm J considered that the payment of rates by the tenant was part of the "consideration" for the supply of the land.

70. If a payment is consideration under contract law, the necessary element of reciprocity in the relationship between payer and payee would be present and there would be a sufficient relationship between the payment made by the payer and a supply by the payee. Consideration under contract law has been defined as "the price for which the promise of the other is bought": *Dunlop v Selfridge* [1915] AC 847. Therefore, if a payment is consideration for contract law purposes, the payment is consideration for GST purposes.

71. The *Culverden* case supports the view that under contract law an entry payment is consideration for a debt security (being the price paid for the promise by the retirement village to repay a loan or deposit to residents). In that case, the entry payment was in the form of the purchase price for a unit in the retirement village. In the High Court Morris J considered that the consideration for a debt security (the right to be paid money under the buy-back arrangement) was either the purchaser entering into the restrictive covenant or the original purchase price for the unit, or both. The Court of Appeal considered that the purchase price paid by residents was consideration for the unit and for other rights conferred on residents under their contracts (including the right to be paid money under the buy-back arrangement). That view is consistent with the judgment of the Privy Council which considered that a purchaser acquired two rights for the lump sum payment (the right to occupy a unit and the right, on termination of occupation, to be repaid the purchase price, subject to adjustment).

72. However, the Commissioner accepts that payments received in respect of the supply of financial services do not reflect the true value of the financial services supplied and that for that reason, the principal under a debt security is not to be treated as the consideration for the supply of a debt security.

73. Therefore, the entry payment (the purchase price for a unit, loan or deposit) is not consideration for a debt security.

Whether single supply of debt security

74. The Commissioner accepts that the *Gulf Harbour* case establishes that under the New Zealand legislation the focus is on what in legal terms is supplied and whether the supply satisfies the statutory definition of "financial services". The *Gulf Harbour* case involved a sale of shares, which is a bundle of rights and is a single item of property: *Re Alex Russell* (1968) VR 285. The supply of a share carries with it all the rights that make up the share and results in the shareholder becoming entitled to those rights but the subject of the supply is the share rather than the rights that make up ownership of the share. The rights attached to the share did not determine the nature of the supply made. Therefore, the transfer of a share involved a single supply which was a financial service (being the transfer of an equity security).

75. The amendments made following *Gulf Harbour* override the *Marac* principle so far as transactions involving equity securities and participatory securities are concerned. However, the amendments do not apply to debt securities. Therefore, the analysis in *Gulf Harbour* remains applicable to debt securities.

76. The subject of the supply of a debt security is a debt security. Ownership of a debt security confers only one right on the recipient, the right to be paid money. The right to accommodation and other services are not rights that make up ownership of a debt security. The supply of a debt security does not result in the recipient having the right to accommodation and other services. In *Gulf Harbour* there was only one element in the transaction (the supply of the share, ownership of which conferred the right to membership of the golf club), which fell within the definition of "financial services". Therefore, the *Gulf Harbour* case is distinguishable.

77. In the *Culverden Retirement Village* case the Privy Council held that a debt security was issued where an agreement for the sale and purchase of a unit in a retirement village required the retirement village to repurchase the unit. The Privy Council did not accept that the debt security was ancillary to the sale of the unit and considered that the purchaser acquired two rights: the right to occupy the unit and the right to be repaid the price paid for the unit (adjusted upwards or downwards according to the length of occupation, the condition of the unit and the movement of the market). In the context of considering whether the transaction involved an "investment of money", the Privy Council considered that the return received by purchasers for the original purchase price was in the form of the use of the unit (together with necessary services) and in the form of the repayment of all or most of the initial payment. In other words, the true and substantial nature of the consideration provided for the original purchase price (the essential features of the transaction) was both the right to occupy the unit (and associated services) and the right to payment of the repurchase price (the debt security).

78. Therefore, the Commissioner considers that the supply of a debt security is a separate supply from the supply of accommodation.

Accommodation

79. "Accommodation" is defined in the *Concise Oxford Dictionary* (11th ed) as meaning:

> a room, building or space in which someone may live or stay.

80. "Accommodation" means lodgings; living premises; a place to live; somewhere where someone resides: *Byrne v Glasgow Corporation* (1955) SLT 9; *Butter v Bennett* [1963] Ch 185; *Pulhofer v Hillington* [1986] AC 484; *Owen v Elliott* (1990) STC 469; *Urdd Gobaith Cymru v C & E Commrs* (1997) V & DR 273.

Care services

81. Care services are medical and nursing services and assistance with daily living and include the services provided as part of a care package. These services are described in paragraph 56.

Whether single supply of accommodation

82. The supply of accommodation in the sense of a place to live is central to the concept of retirement villages and is an essential feature of the transaction between retirement villages and their residents.

83. For the reasons outlined in paragraphs 117 to 134, the Commissioner considers that the right to use the common areas and facilities is part of the dwellings in a retirement village (being an appurtenance belonging to and enjoyed with the dwellings).

84. However, if that conclusion is incorrect, the Commissioner considers that the right to use common areas and facilities is part of the supply of accommodation.

85. Without access to the dwellings over the common areas, it would not be possible to exercise the right to occupy the dwellings.

86. The availability of the recreational facilities in a retirement village may make a retirement village more attractive to prospective residents. However, the motives of the recipient and the way in which a retirement village is marketed are not relevant in determining the nature of a supply: see *Gulf Harbour*. It is also irrelevant that a retirement village may supply the right to use a Community Centre to non-residents (that is, separately from the supply of accommodation). In *Gulf Harbour* the Court of Appeal did not accept that the fact that in some cases, membership of a golf club was supplied separately from the supply of shares did not mean that in all cases two separate supplies were made.

87. In *Hidden Valley Golf Resort Association v The Queen* (2000) GTC 4104 (which concerned a lease under which the tenants were granted exclusive right to a lot on which a vacation cottage could be built and the right to use a golf course, club house, artificial lake and tennis court on the lessor's property) it was held that the essence of the transaction was a long-term residential lease and that the taxpayer had not made a separate supply of the right to use the recreational facilities and the right to compel the lessor to provide certain services. An analogy can be drawn with the transaction considered in *British Airways plc v C & E Commrs* [1990] STC 124 where the issue was whether in-flight catering was a separate supply from the supply of air transport. It was held that the supply made by British Airways was the supply of air transport of a particular standard and that the supply of food and beverages was an incidental part of the supply of air transport. The right to use the facilities in a Community Centre is ancillary or incidental to the supply of accommodation in the sense that the right contributes to the supply of accommodation of a particular quality.

88. In *Norfolk Apartments Ltd v CIR* (1995) 17 NZTC 17,212 the Court of Appeal noted that rights and services going with accommodation are part of the supply of accommodation (p. 12,216).

89. The amount of the periodic fees is calculated by reference to the costs incurred in operating a retirement village (including administration cost, rates, insurance, maintenance, depreciation, salaries, statutory costs, the costs of providing security, cleaning, gardening in respect of common areas and facilities). Generally the periodic fees include the cost of providing the emergency call response service. The periodic fees may also include an amount to cover the cost of transport services. Alternatively, a separate charge may be made for transport services on each occasion such services are supplied. However, the way in which a payment is calculated does not determine the nature of the supply made for the payment: *Motorcorp*.

90. The maintenance of the unit and of village facilities is part of the supply of accommodation, being services that make possible the supply of accommodation by keeping the unit and the village facilities in good repair.

91. The Commissioner considers that the supply of care services as part of a care package is not part of the supply of accommodation. Care services do not facilitate, enable or contribute to the supply of accommodation and are not a minor or incidental feature of the transaction.

92. The care services provided under a care package include an emergency response service. An emergency response service is also supplied to residents who

do not purchase a care package. The Commissioner considers that where an emergency response service is the only care service provided, that service is a minor or incidental feature of the transaction and is not in any real or substantial sense part of the consideration supplied for the payments made by residents. Therefore, the Commissioner considers that the emergency response service is part of the supply of accommodation.

93. This view is supported by *Wairakei Court Ltd v CIR* (1999) 19 NZTC 15,202 where it was held that:

- the consideration payable by residents of the serviced apartments whose contracts provided for the supply of either full care or partial care was paid for the supply of both care and accommodation; and
- the supply of the care component to residents of the villas (which could only be the emergency response service) was at best ancillary or incidental to the supply of accommodation.

94. The Commissioner also considers that the provision of transport services as part of a package of services is a minor or peripheral feature of the supply of accommodation and that the supply of transport services does not alter the nature of the supply made.

95. The Commissioner also considers that any additional optional care or other services supplied at the request of the resident for an additional charge are separate supplies made under separate transactions.

96. Therefore, the Commissioner considers that:

- The supply of accommodation is an essential feature of a retirement village contract.
- The supply of maintenance services are part of the supply of accommodation, being services that contribute to the supply of accommodation by keeping the unit and the village facilities in good repair.
- The right to use the common areas and facilities is also part of the supply of accommodation. It would not be possible to use the units without access through the common areas. The right to use the facilities in a Community Centre are ancillary or incidental to the supply of accommodation in the sense that the right contributes to the supply of accommodation of a particular quality.
- Care services supplied as part of a care package are not part of the supply of accommodation. Care services do not facilitate, enable or contribute to the supply of accommodation and are not a minor or incidental feature of the transaction. Where an emergency call response service is the only care service supplied, that service is a minor or peripheral benefit that does not alter the character of the supply.
- Transport services supplied as part of a package of services is also incidental to the supply of accommodation. Transport services are peripheral or minor benefits that do not constitute a supply separate from the supply of accommodation.
- Any additional optional care or other services supplied at the request of residents for an additional payment are separate supplies made under separate transactions.

Consideration for the supply of accommodation

97. The Commissioner considers that the consideration for the supply of accommodation includes:

- the "facilities fee" or "amenities contribution";
- the periodic fees; and
- the refurbishment charge and other termination charges.

98. There is a clear relationship between the "facilities fee" or "amenities contribution", the periodic charges and the refurbishment and termination charges and the supply of accommodation. These charges are "in respect of, in response to or for the inducement of" the supply of accommodation.

"Facilities fee" or "amenities contribution"

99. The facilities fee is either:

- An upfront payment that the retirement village is entitled to take immediately or that accrues to the retirement village over a specified period; or
- A payment that becomes due on termination and that is deducted from the loan or deposit refundable to the resident. A payment may be made by way of set off: *Re Harmony & Montague Tin & Copper Mining Co Ltd (Spargo's Case)* [1873] 8 Ch App 407. The principle in *Spargo's* case applies where there are mutual liabilities and an agreement that these liabilities would be set off: *FCT v Steeves Agnew & Co (Victoria) Pty Ltd* 9 ATD 259; *Lend Lease Corporation Ltd v FCT* 90 ATC 4401. The Commissioner considers that the obligation of a resident to pay the facilities fee is a separate obligation from the obligation of the retirement village to make payment under a debt security; therefore, there are mutual debts between a retirement village and the resident. It is also agreed that the facilities fee is to be deducted from the amount repayable to the resident. Therefore, the Commissioner considers that the "facilities fee" or "amenities contribution" payable on termination is paid when the obligation of residents to pay the "facilities fee" or "amenities contribution" is set off against the obligation of the retirement village to repay the loan or deposit.

100. Under section 9(3)(a), if goods are supplied under an agreement for hire or services are supplied under any agreement that provides for periodic payments, the time of supply in respect of the goods or services is the earlier of the time when a payment becomes due or is received, whichever is the earlier. Leases or licences of units provide for periodic payments (periodic fees). The "facilities fee" or "amenities contribution" is not consideration for a separate supply.

101. The Commissioner considers that in terms of section 9(3)(a):

- Where an agreement requires the payment of an up-front facilities fee, a supply is made when the facilities fee becomes payable (generally at the same time as the loan or deposit). If the incorrect amount of output tax on the facilities fee has been paid as a result of early termination, section 25 would apply. Section 25 applies if the previously agreed consideration for a supply has been altered: section 25(1)(b). Section 25(2) would allow the retirement village to make an adjustment in the period during which it has become apparent that the output tax is incorrect.
- Where the facilities fee is payable on termination, a supply is made when the facilities fee is set off against the loan or deposit repaid to the resident. On that date (the repayment date), the facilities fee becomes due for payment and payment is received by the retirement village by way of set off.

Periodic fees

102. Generally residents who have purchased a package of care services are required to pay a higher amount as periodic fees. In such circumstances the periodic fees are attributable to both the supply of accommodation and to the supply of care services.

103. Under section 10(6) a reduced rate of GST applies to the supply of "domestic goods and services" (being the supply of accommodation including, where they are supplied as part of the supply of accommodation, the services described in paragraphs (a) to (c) of the definition of "domestic goods and services") in a commercial dwelling. Therefore, where the periodic fees are paid both for the supply of accommodation and for the supply of care services, it would be necessary to determine what proportion of the periodic fees is consideration for "domestic goods and services" for the purpose of section 10(6).

Refurbishment costs and other termination charges

104. The Commissioner accepts that if residents have an obligation to refurbish their units on termination of occupation and that obligation is carried out by the retirement village, the refurbishment costs would be consideration for the carrying out of refurbishment work. In *Suzuki NZ Ltd v CIR* (2001) 20 NZTC 17,096 and in *Motorcorp* (where an overseas manufacturer had an obligation under the warranty given to the New Zealand importer to repair defective vehicles and the repairs were carried out by the New Zealand importer or its agents at the cost of the overseas manufacturer) the Court of Appeal considered that the reimbursement payment was consideration for the supply of repair services by the New Zealand importer. However, the Commissioner understands that generally residents have an obligation to pay for the costs incurred by the retirement village in refurbishing their units rather than an obligation to carry out the refurbishment of their units.

105. Residents are not a party to any contract for the sale, lease or licence of their units to a new resident. In marketing a unit and obtaining a replacement resident, retirement villages are acting for their own benefit.

106. Whether a lessee has an obligation to pay the lessor's legal costs in connection with the preparation of a lease depends on the agreement between them. A lessor cannot recover such costs unless the lessor is liable for them: *Metcalfe v Venables* [1921] NZLR 576. Therefore, legal costs in relation to the preparation of a lease or licence (or the termination of a lease or licence) are costs for which the retirement village is primarily liable. A payment to a third party could be consideration. The crucial factor in determining whether a payment is consideration is whether there is a sufficient connection between the payment and the supply: *Trustees Executors* case.

Use of the refundable payment

107. The provision of a loan or deposit interest-free or low interest results in an economic benefit to the retirement village in the form of use of money. However, the definition of "consideration" refers to a payment, act or forbearance. The use of money is not a payment, act or forbearance. *Exeter Golf and Country Club Ltd v C & E Commissioners* [1981] STC 211 supports the view that a loan made at no interest or low interest could give rise to consideration (being consideration otherwise than in money) for the supply of accommodation. The Commissioner accepts that *Exeter* is not authority in New Zealand. The *Exeter* case was decided under legislation that did not define financial services and that did not contain a statutory definition of "consideration". In *Gulf Harbour* it was considered that as financial services are not defined

INTERPRETATION STATEMENTS

in the value added tax (VAT) legislation, the approach in *Exeter* and other United Kingdom cases relating to financial services is not applicable.

108. There are practical difficulties in applying the legislation to value the use of a loan and the time of supply rules in respect of consideration in the form of the use of a loan. Such difficulties may also lead a court to conclude that for GST purposes the use of a loan is not intended to be treated as consideration for a supply.

109. Financial services were exempted because of the difficulty of determining the consideration for financial services. A loan was considered to be an exchange of an asset (the principal) and income from the use of the asset (interest), that is, payments under a loan were considered to be a supply of money (not a supply of goods or services): Advisory Panel on Goods and Services Tax, *Proposed Application of Goods and Services Tax to Financial Services* (The Treasury, 1985); Carl Bakker and Phil Chronican, *Financial Services and the GST: A discussion paper* (Victoria University Press, 1985); Alan A Tait, *Value Added Tax: International practice and problems* (International Monetary Fund, 1988); *Discussion Document on GST & Financial Services* (2002).

110. Whether the facilities fee, the periodic fees and the refurbishment and other termination charges are subject to GST depends on whether they relate to the supply of accommodation in a dwelling or commercial dwelling. If the charges are paid for the supply of accommodation in a commercial dwelling (a taxable supply), they are subject to GST. This issue is considered in paragraphs 114 to 145.

Section 14(1)(a) – issue or allotment of a debt security

111. The supply of financial services is an exempt supply under section 14(1)(a). The definition of "financial services" includes the issue or allotment of a debt security: section 3(1)(c). If one of the activities in section 3(1)(c) is carried out by a taxpayer, a service (being a financial service) would be supplied by the taxpayer. This is supported by *Case T27* (1997) 18 NZTC 8,188 and *Gulf Harbour Development Ltd v CIR* (2003) 21 NZTC 18,192 (HC); (2004) 22 NZTC 18,915 (CA). In those cases the court held that the transfer of a security was a financial service. For the reasons outlined in paragraphs 58 to 78, the Commissioner considers that a retirement village makes an allotment of a debt security under any transaction where a retirement village accepts an obligation to re-purchase a unit or to repay a loan or deposit.

112. Section 14(1)(a) also applies to services that are reasonably incidental or necessary to the supply of financial services. The Commissioner does not accept that the supply of accommodation or other services is reasonably incidental or necessary to the supply of financial services. The reasons are as follows:

- "Incidental" means something that is incidental to or is usually associated with another activity or that occurs or is liable to occur in fortuitous or subordinate conjunction with another activity: *Canadian National Railway v Harris* [1946] 2 DLR 545; *C & E Commrs v C H Beazer (Holdings) plc* (1989) 4 BVC 121. The core activities of a retirement village are the supply of accommodation and care services. Debt securities are supplied to provide funding for the development of a retirement village where accommodation and other services are supplied. Accommodation and care are not generally supplied by financial institutions who supply debt securities. The supply of accommodation and care is not usually associated with, does not arise out of the supply of a debt security and is not liable to occur in conjunction with the supply of a debt security.
- "Necessary" means indispensable, expedient or really needed: *Shorter Oxford Dictionary*; *Re an Inquiry under the Company Securities (Insider Dealing) Act 1985* [1988] 1 All ER 203. The supply of accommodation and care services is not indispensable, useful, expedient or really needed for the supply of a debt security, which are frequently supplied without such services.

113. Therefore, the Commissioner considers that a retirement village under any transaction where the retirement village allots a debt security by accepting an obligation to pay the purchase price on the re-purchase of a unit or to repay a loan or deposit. Such a supply is an exempt supply under section 14(1)(a), being the allotment of a debt security. Section 14(1)(a) does not apply to the supply of accommodation and other services. Such services are not reasonably incidental or necessary to the supply of a debt security.

Section 14(1)(c) – supply of accommodation in a dwelling

114. The sale of a unit in a retirement village is a taxable supply. As section 14(1)(c) applies to the supply of accommodation by way of hire, service occupancy agreement or licence to occupy, section 14(1)(c) cannot apply where a unit in a retirement village is sold to a resident.

115. Potentially, section 14(1)(c) applies to the lease or licence of a unit in a retirement village as a lease or licence is a supply by way of hire or licence to occupy. However, for section 14(1)(c) to apply, the supply must be the supply of accommodation in a dwelling.

Meaning of dwelling

116. The definition of "dwelling" refers to "any building, premises, structure, or other place, or any part thereof". Therefore, part of a building may be a dwelling. To be a dwelling, a place must be used predominantly as a place of residence or abode of any individual.

Appuртenances

117. A dwelling includes "appurtenances belonging to [the dwelling] and enjoyed with it".

118. The *Shorter Oxford Dictionary* (6th ed) defines "appurtenance" as follows:

> **1** A minor property, right, or privilege, subsidiary or incidental to a more important one; an appendage.
>
> **2** A contributory adjunct, an accessory.
>
> **3** The fact or state of appertaining.

The *Shorter Oxford Dictionary* definition indicates that an appurtenance is a "minor property, right, or privilege" that is subsidiary or incidental to a more important one.

119. Historically, it was considered that only rights in respect of land (incorporeal hereditaments) could be appurtenances and that land could not be appurtenant to other land: *Lister v Pickford* (1865) 34 Beav 576. An incorporeal hereditament is a right over land that does not entitle the owner to possession of the land: *Halsbury's Laws of England* "Real Property" Vol 39(2) para 74.

120. An easement is an incorporeal hereditament and may be an appurtenance. An easement is an interest in land and not merely a personal right: *Auckland City Council v Man O'War Station Ltd* [1996] 3 NZLR 460; *Kawau Copper and Sulphur Developments Ltd v District Land Registrar* [1980] 2 NZLR 529.

121. Later case law established that land can be an "appurtenance": *Trim v Sturminster Urban District Council* [1938] 2 All ER 168; *Methuen-Campbell v Walters* [1979] 1 All ER 606. In *Trim v Sturminster* Slesser LJ considered that the word "appurtenance" included nothing that would not pass under a transfer of a house without being specifically mentioned and that this limited "appurtenances" to land within the curtilage and incorporeal hereditaments (p. 516). In *Case M64* (1990) 12 NZTC 2,363 Judge Bathgate considered that "appurtenance" will pass with the house, the rights, privileges and accessories to the house.

122. Whether the above interpretation of "appurtenance" is applied depends on the context in which the word is used. If a word or phrase has received a judicial interpretation, that interpretation will be applied to the word or phrase in the same context in subsequent legislation. In the context of legislation that applied to flats that may not have their own curtilage, to be an appurtenance, land need not pass with the transfer or assignment of the flat without being specifically mentioned. It was sufficient if the land is within the building of which the flat forms part or within the curtilage of the building: see *Cadogan v McGirk* [1996] 4 All ER 643.

123. The meaning of "appurtenances" in the context of retirement villages was considered in *Norfolk and Wairakei.*

124. *Norfolk* concerned a retirement village consisting of a four-storey building containing 22 apartments with garages underneath. The building took up one-third of the land area and was surrounded by gardens and landscaped grounds, paths and driveways. Access to the apartments was through common areas (corridors, stairwells, driveways, parking areas and the like). Other common areas included community and reception lounges, a library, an activities room, a consulting room, visitors' car parking spaces, and the gardens and the grounds. Residents were granted occupation licences of the apartments and garages for terms of 99 years. The rights granted under the licence included a right to the use and enjoyment of common areas.

125. The Court of Appeal in *Norfolk* distinguished *Trim v Sturminster* and *Methuen-Campbell v Walter* on the basis that all of the land was within the curtilage of the building in which the apartments were situated. The court also considered that shared rights could be appurtenances and that given that the definition of dwelling refers to appurtenances "belonging thereto and enjoyed with" the building or premises, Parliament must have intended appurtenances to include a non-exclusive right to use areas and facilities situated outside four walls of the apartment and garage in respect of which residents had exclusive use. The Court of Appeal said (at page 12,215):

> In our view the common areas and the facilities upon them, the use and enjoyment of which is promised to the residents of the dwellings in the occupation licences, are appurtenances to the dwellings.
>
> On the subject of "appurtenances" Mr Martin referred us to *Trim v Sturminster Urban District Council* [1938] 2 All ER 168 in which it was held that the word "appurtenances" in the definition of "house" in a statute had to be given its natural meaning and could

not be extended to cover land outside the curtilage of the house. In that case the land consisted of a house with 10 acres of grassland and cow-stalls capable of accommodating 10 or 12 cows. It is unsurprising that the part of the land which was being farmed was not regarded as an appurtenance. But significantly the Court observed that in the early case of *Bryan v Wetherhead* (1625) Cro Car 17 "appurtenances" of a house had been held to include its orchard, yard, curtilage and gardens. In another authority referred to by Mr Martin, *Methuen-Campbell v Walters* [1979] 1 All ER 606, it was held that whether land fell within the curtilage of other land was a question of fact and that a paddock physically separated from a house was not within the curtilage of the house and was therefore not an appurtenance for the purposes of the Leasehold Reform Act 1967. That case is also clearly distinguishable. In the present case the **whole of the land in question is laid out in driveway, paths, gardens and landscaped grounds for the use and enjoyment of occupants of residences in the building and all of it is accordingly integral to and within the curtilage of the building.**

Mr Martin also argued that the rights of the residents relating to the common areas were not "accommodation in any dwelling by way of … a licence to occupy" because those rights were not in themselves accommodation and because a "licence to occupy" means a "right to exclusive personal occupancy" and therefore cannot extend to shared areas and facilities. However, **we think that rights and services going with accommodation are properly to be regarded as part of the accommodation provided to residents and that the element of exclusivity and occupation need not extend to those rights and services. Rights appurtenant to a title to land are very often shared with others**. When it included within the term "dwelling" the appurtenances "belonging thereto and enjoyed with" the building or premises we do not think that the Legislature would have had in mind only those amenities which were exclusively contained within the walls of a dwelling or garage.

[Emphasis added]

126. *Norfolk* is consistent with *Cadogan v McGirk* [1996] 4 All ER 643, which confirms that appurtenances may include land within the building in which the apartments are situated or within the curtilage of the building in which the apartments are situated. However, *Wairakei*, which concerned detached buildings that had their own curtilage, cannot be explained on that basis. *Wairakei* concerned a retirement village that consisted of a rest home complex with 37 beds, six villas (stand-alone units) and 17 studio units that were contained in one building. Occupants of the villas were entitled to use community facilities. Chisholm J considered that (on the basis of the authority of *Norfolk*) the common areas and facilities were appurtenances to the villas. Chisholm J did not consider whether the common areas and facilities were within the curtilage of the villas.

127. Both *Wairakei* and *Norfolk* concerned non-exclusive rights to use land. The Commissioner considers that the basis for the decisions in *Norfolk* and *Wairakei* is that the right to use the common areas and facilities was an appurtenance, rather than the land or building comprising the common areas and facilities being an appurtenance. Areas within a Community Centre to which residents do not have access are not within the meaning of "common areas and facilities".

128. The Commissioner considers that the right to use the common areas and facilities is an easement and is an appurtenance of dwellings in a retirement village, including dwellings occupied by residents under an arrangement described as a licence. The reasons are as follows:

- In *Norfolk* and *Wairakei* the court considered that a right to use common areas and facilities was appurtenant to dwellings occupied by residents under an arrangement that was described as a licence.
- As the definition of "dwelling" is relevant to the interpretation of section 14(1)(c) and section 14(1)(c) does not apply to the sale of a dwelling, the legislation contemplates that for land or a right to use land to be an appurtenance, the recipient of the supply of accommodation need not be the legal owner of a dwelling to which the appurtenance belongs.
- For the right to use the common areas and facilities to be an easement and, therefore, an appurtenance of dwellings in a retirement village, residents need not hold legal title to their units. A lessee may acquire an easement: *Halsburys Laws of England* "Easements and Profits à prendre" para 17. In *Trim v Sturminster*, *Methuen-Campbell v Walters* and *William Hill v (Southern) Ltd v Cabras Ltd* (1987) 54 P & CR 42 the meaning of "appurtenance" was considered in relation to property that was subject to a lease. The test of whether an arrangement is a lease or a licence is whether the right of exclusive possession is conferred: *Fatac Ltd (in liq) v CIR* (2002) 20 NZTC 17,903. As residents in a retirement village invariably have the right to exclusive possession of their dwellings, they are lessees even if the transaction is described as a licence. In *Cashmere Capital Ltd v Crossdale Properties Ltd* (2008) NZCPR 766 (HC); 2010] 1 NZLR 577 the court held that as residents in a retirement village had the right to exclusive possession of their units, an occupation loan agreement relating to the units was a lease.

- The right to use the common areas and facilities has the other essential characteristics of an easement. It would not be possible to use and enjoy the dwellings in a retirement village without means of access to the dwellings over the common areas. A right to use the gardens and the recreation facilities in a Community Centre may be the subject of an easement, being a right that is reasonably necessary for and that is sufficiently connected to the normal enjoyment of the dwellings as a place to live. *Re Ellenborough Park* [1955] 3 All ER 667; *Ryan v Penttila* VR 547. For a right to be the subject of an easement, the right conferred must be sufficiently defined and must not amount to joint occupation: *Re Ellenborough Park*. A right to use a garden, park or recreation facilities satisfies that requirement.
- The land subject to the easement and the land having the benefit of the easement need not be contiguous but they must be sufficiently close that the easement benefits the land having the benefit of the easement: *Todrick v Western National Omnibus Co Ltd* [1934] Ch 564. The Commissioner considers that a Community Centre in a retirement village that is on the same site and that is part of the same complex is sufficiently close to benefit the dwellings.
- The right of residents to use a Community Centre may be limited to certain times or to certain areas but this does not mean that the right to use a Community Centre cannot be a right affecting land. A right granted under an easement may be for limited purposes or limited as to the time when the right may be exercised: *Hart v Timmins* (High Court, Palmerston North; CIV-2006-454-353; 4 October 2006); *Leon Asper Amusements Ltd v Northmain Carwash Enterprises Ltd* (1966) 56 DLR (2d) 173; *Coleman v Shand* (2004) 5 NZ ConvC 194,019. The fact that a retirement village has the right to vary the hours of access to a Community Centre does not mean that the right to use a Community Centre is a licence rather than an easement. The owner of the land subject to the easement may reserve the right under the easement to vary the terms of the easement: *Greenwich Healthcare National Health Service Trust v London and Quadrant Housing Trust* [1998] 3 All ER 437.
- An equitable easement will be recognised and enforced if the right has the essential characteristics of an easement, consideration is provided and there is sufficient memorandum in writing or part performance: *Read v Read* (1999) 4 NZ ConvC 139,077. Residents provide consideration for the right to use the common areas and facilities. In all cases, there would be sufficient memorandum in writing of the grant of the right to use the common areas and facilities as there is normally a written agreement between a retirement village and its residents.

129. In *Re Ellenborough Park* the court considered that a mere right of recreation "possessing no quality of utility or benefit" would not be an easement; therefore, a right granted to residents to use the zoo or the right to attend Lords cricket ground without charge could not be an easement because these rights were wholly extraneous to and independent of the use of the house as a place to live. Therefore, the right to receive services such as nursing, meals and transport cannot be an appurtenance. The right to use facilities outside the boundary of a retirement village (such as a right to membership of a golf club) is not an appurtenance.

130. In some contexts, the phrase "belonging to" indicates ownership: *Myerson v Collard v the Commonwealth* (1918) 25 CLR 154. However, the words "belonging to" in the context of the definition of "dwelling" relate to a "building, premises, structure or other place", which cannot own or possess something. The Commissioner considers that:

    - Whether a building belongs to a principal building depends on whether the use of the building is associated with and is part of the use of the principal building; and
    - A degree of physical separation between two buildings does not mean that one does not belong to the other. An ancillary building belongs to the principal building if the two buildings are on the same site, are adjacent to (next or adjoining: Concise Oxford Dictionary) each other or sufficiently close to each other so that the use or occupation of the ancillary building is for all practical purposes part of the use or occupation of the principal building. To belong to the principal building, the ancillary building need not be contiguous with (neighbouring or connected with) the principal building.

    See *English Clays Lovering Pochin & Co Ltd v Plymouth Corporation* [1974] 2 All ER 239; *Re Red Lion Inn Ltd* [1979] 2 NZLR 668 and *Re Angus Hotels Ltd* (1986) 6 NZAR 148.

131. "Enjoyed" means "having had the amenity or advantage of using" and is nearly equivalent to "having had the use of": *Cooper v Straker* (1888) 40 Ch D 21.

132. An appurtenance belongs to and is enjoyed with a dwelling if the use of an appurtenance is part of the use and occupation of a dwelling and the resident of the dwelling has the right to use the appurtenance together with the dwelling. The Commissioner accepts that there must a reasonable degree of proximity between the dwellings in a retirement village and a Community Centre before the right to use the Community Centre could be said to be associated with and part of the use of the dwellings. However, it is unlikely that a Community Centre would be so geographically distant from the dwellings that the use of the Community Centre could not, in practical terms, be associated with and used with the dwellings. The Commissioner considers that the right to use the common areas and facilities in a retirement village is an appurtenance that belongs to the dwellings in a retirement village, being a right that is connected with and that is part of the use of the dwellings in the retirement village as a place to live.

133. Residential rentals were exempted because of the practical difficulty of collecting GST on residential rentals and to place owner–occupiers and tenants on the same footing: *White Paper on Goods and Services Tax: Proposals for the administration of the goods and services tax* (New Zealand Government, 1985). The extension of the definition of "dwelling" to include appurtenances belonging to or enjoyed with a dwelling means that the entire amount of the consideration paid for the supply of accommodation in a dwelling, including rights going with the supply of accommodation, is exempt.

134. Therefore, the Commissioner considers that the right to use the common areas and facilities for access or for recreation purposes is an appurtenance of dwellings in a retirement village, including dwellings occupied under an arrangement described as a licence.

Commercial dwelling or dwelling?

135. A commercial dwelling is not a dwelling. The definition of "commercial dwelling" includes convalescent homes, nursing homes, rest homes and hospices, and establishments that are similar to convalescent homes, nursing homes, rest homes and hospices: paragraphs (c) and (d) of the definition of "commercial dwelling" in section 2. However, a dwelling situated within a retirement village is not a commercial dwelling, if the consideration paid or payable for the supply of accommodation in that dwelling is for the right to occupy the dwelling: paragraph (f) of the definition of "commercial dwelling" in section 2.

136. A rest home is a residential institution where old or frail people are cared for: *Concise Oxford Dictionary* (11th ed). In *Wairakei Court Ltd v CIR* (1999) 19 NZTC 15,202, it was considered that the studio units situated in a retirement village fell within paragraph (c) of the definition of "commercial dwelling". The court considered that in substance the studio units were no different from the rest home in the retirement village as both accommodation and care were provided there.

137. To be similar to a convalescent home, nursing home, rest home or hospice, an establishment need not be exactly the same as a convalescent home, nursing home, rest home or hospice. "Similar" does not mean identical or exactly the same: *Mays v Roberts* [1928] SASR 217; *NZ Central Region etc Local Government Officers' Union v Lower Hutt City Council* (1992) 1 ERNZ 558; *Adelaide Caravan Park Pty Ltd v Department of Industry, Technology and Commerce* (1985) ALD 75. In *Case L75* (1989) 11 NZTC 1,435, 1, 440, Judge Keane considered that the premises in question, although not exactly the same as a hotel, a motel, an inn, a hostel or a boarding house, shared some significant defining features of such establishments, so were a commercial dwelling. The Commissioner considers that the significant defining features of convalescent homes, nursing homes, rest homes and hospices are the provision of accommodation and care and that to be similar to a convalescent home, nursing home, rest home or hospice, an establishment must have those features.

138. The units in a retirement village will generally be predominantly used as a place of residence or abode of the residents and may, therefore, be dwellings. In a Canadian GST case it was held that the rooms in a "nursing home and senior care centre" were occupied by the patients as their "place of residence", *North Shore Health Region v R* (2006) GSTC 134.

139. Therefore, potentially units in a retirement village could be regarded either as a collection of dwellings (each of the units being a place that is used predominantly as a place of residence or abode of a resident) or as a commercial dwelling (being a rest home or an establishment that is similar to a rest home). However, if paragraph (f) of the definition of "commercial dwelling" applies to a unit situated in a retirement village, the unit is a dwelling (rather than part of a commercial dwelling) for the purpose of section 14(1)(c). In *Wairakei* Chisholm J made the following comments on paragraph (f) (at pages 15,209–15,210):

> In 1990 the definition of "commercial dwelling" was amended (by inserting para (f)) to ensure that dwellings situated within a retirement village or a rest home complex would be governed by the same rules as other dwellings ie the supply of accommodation would be exempt. **Notwithstanding the close links between such a dwelling and the remainder of the retirement village or rest home complex Parliament had seen fit to notionally sever the dwelling from the remainder of the complex so that the dwelling would qualify as an exempt supply.**
>
> [Emphasis added]

The effect of paragraph (f) is that if a retirement village contains dwellings (being units to which paragraph (f) applies), the retirement village as a whole will not be a commercial dwelling, although parts of the retirement village may be a commercial dwelling.

Paragraph (f) of the definition of "commercial dwelling"

140. Paragraph (f) of the definition of "commercial dwelling" applies to a dwelling within a retirement village or rest home, if the consideration paid or payable for the supply of accommodation in the dwelling is for the right to occupy the dwelling. The distinction between rest homes and retirement villages may be blurred, both being places where care and accommodation are provided for senior citizens. The inclusion of "rest home" in paragraph (f) means that it is unnecessary to decide where the boundary between rest homes and retirement villages should be drawn.

141. In *Wairakei* it was considered that paragraph (f) applied to some units situated in a retirement village (the villas) but that paragraph (f) did not apply to other units (the studio units). Residents of the studio units were required under their licence to pay a weekly rest home fee for full or partial care, in addition to the licence fee and occupation loan. Chisholm J noted that if a resident breached his or her obligations under the licence, the licence could be terminated on one month's notice. The court did not distinguish between the two levels of care provided to residents of the serviced apartments. The essential difference between the serviced apartments and the villas was that in order to be entitled to occupy the studio units, residents were required to also pay for (and were entitled to receive) care services. Residents of the villas were not required to receive and pay for care services in order to be entitled to the supply of accommodation. The consideration that villa residents were required to pay in order to be entitled to the supply of accommodation related solely to the supply of accommodation.

142. The Commissioner considers that to decide whether paragraph (f) applies it is necessary to:
    - identify the consideration that residents are contractually obliged to pay in order to be entitled to the supply of accommodation. The consideration that residents are contractually obliged to pay in order to be entitled to the supply of accommodation will normally include the entry payment, the "facilities fee" or "amenities contribution", the periodic charges, and exit payments. Optional payments that residents make if they require additional services are not part of the consideration that residents are contractually required to pay in order to be entitled to the supply of accommodation.

    This does not mean that the total amount of the consideration that would be payable by residents over the period of their occupation must be determined. It requires consideration of the terms of the agreement under which residents obtain a right to occupy a unit in a retirement village (generally a lease or the licence).
    - determine whether such consideration is for the supply of accommodation is for the right to occupy the dwelling (that is, for the supply of accommodation). Where residents have a right to occupy a dwelling in a retirement village, there is a corresponding obligation on the part of the retirement village to supply accommodation.

143. Paragraph (f) applies to a unit in a retirement village, if the consideration that residents are contractually obliged to pay to be entitled to the supply of accommodation is for the supply of accommodation (including appurtenances to a dwelling and including goods or services that are ancillary or incidental to the supply of accommodation). Paragraph (f) does not apply where the consideration that residents are contractually obliged to pay to be entitled to accommodation relates to the supply of services other than accommodation. Where residents have purchased a care package, the consideration that they are contractually obliged to pay to be entitled to accommodation is for the supply of accommodation and care services. The fact that a contractual obligation to pay for care services is suspended during any period of temporary absence when care services are not provided does not mean that the consideration that residents are obliged to pay to be entitled to occupy a unit does not include consideration for care services.

144. This view is consistent with the scheme and purpose of the legislation. The purpose of paragraph (f) is to determine whether a unit in a retirement village is to be classified as a dwelling for the purpose of section 14(1)(c), which applies only to the supply of accommodation. The legislation contemplates that both taxable and exempt supplies of accommodation (including the right to use the common areas and facilities) will be made in a retirement village. The policy underlying paragraph (f) is that the supply of accommodation in a retirement village is intended to be exempt from GST where the contract under which accommodation is provided is for the supply of no more than accommodation.

145. Therefore, the Commissioner considers that:

- Paragraph (f) would not apply to units whose residents have purchased care packages. Therefore, such units are part of a commercial dwelling so that the supply of accommodation in such units is a taxable supply.
- On the basis of contractual arrangements that are currently entered into between retirement villages and their residents, paragraph (f) would apply to other units. Therefore, such units are dwellings. The supply of accommodation in such units is an exempt supply.

Participatory security

146. A right under a participatory security to receive a taxable supply for no consideration (other than the consideration for the participatory security) or a below-market consideration is an associated supply: see definition of "associated supply". If an associated supply is supplied under a participatory security, the exemption for financial services does not apply to the associated supply: section 14(1B). An associated supply is treated as a separate taxable supply: section 5(14B).

147. A "participatory security" for GST purposes:

- is an interest in or right to participate in any capital, assets, earnings, royalties or other property;
- is an interest or right that forms part of a contributory scheme (as defined in the Securities Act 1978);
- includes an interest in a unit trust; and
- does not include an equity security, a debt security, money or a cheque.

148. In *R v Smith* [1991] 3 NZLR 740, 748, Wylie J accepted that the concept of participation involves some form of sharing with others even if only with the promoter of the scheme.

149. A "contributory scheme" is defined in the Securities Act as meaning:

> any scheme or arrangement that, in substance and irrespective of the form thereof, involves the investment of money in such circumstances that—
>
> (a) the investor acquires or may acquire an interest in or right in respect of property; and
>
> (b) pursuant to the terms of investment that interest or right will or may be used or exercised in conjunction with any other interest in or right in respect of property acquired in like circumstances, whether at the same time or not;—
>
> but does not include such a scheme or arrangement if the number of investors therein does not exceed 5, and neither a manager of the scheme nor any associated person is a manager of any other such scheme or arrangement:

150. In *Culverden* the Privy Council considered (obiter) that the expression "investment of money" includes schemes under which the return is received in the form of capital (the initial investment) or in the form of income in cash or in kind (or both). A similar view was expressed in *Munna Beach Apartments Pty Ltd v Kennedy* (1983) Qd R 151, 155–156, which concerned a similar concept in the Australian companies legislation ("investment contract"), where the court considered that an investment implied the payment of money in the expectation of some form of return, whether in the form of money or otherwise.

151. Case law on the interpretation of "investment contract" under the Australian companies legislation indicates the following:

- For an interest or right in respect of property to be used or employed in common with the interest or right of other investors, there must be a sharing in the return from the investment. The main factor that must be considered is whether the purchaser is able to exercise individual control over the property.
- Where the right obtained is the ownership of a specific apartment together with a share of the common area, each owner will merely be exercising their individual rights as co-owner of land to use the common area.

See *Munna Beach; Brisbane Unit Development Corp Pty Ltd v Deming No 456 Pty Ltd (No 2)* (1983) 2 Qd R 92; *Jones v Acfold Investments Ltd* FCR 512, *Amadio Pty Ltd v Henderson* 81 FCR 149; *Butterworth v Lezem Pty Ltd* (1983) 1 ACLC 821.

152. A scheme with five or fewer investors is not a contributory scheme. This exception would apply in respect of a retirement village scheme if the scheme involved five or fewer residents.

153. A contract may include separate and quite different securities: Culverden. In the High Court in *Fenton v Pakuranga Park Village Trust* (HC Auckland CP 269/96) Baragwanath J considered that a retirement village scheme involved both a debt security and a participatory security conferring on residents a right to occupy a unit in the village and to receive repayment of a deposit on termination of occupation. In the High Court in *Norfolk*, Robertson J considered that a licence in respect of an apartment in a retirement village was a participatory security. In *Covenant Trustee Co v Ohope Lodge Ltd* Penlington J, 28 April 1993, HC Rotorua M70/90, a retirement village scheme was referred to as a participatory security for Securities Act 1978 purposes. Therefore, the Commissioner considers that although a debt security cannot be a participatory security (being excluded from the definition of "participatory security") a retirement village scheme could include more than one security and could include both a participatory security and a debt security.

154. The issue in *Fenton* was whether a proposal to sell land occupied by a bowling green and to re-site the bowling green would constitute a breach of the retirement village's obligation under the licence not to alter the basic scope and nature of the facilities provided as part of the village. The Court of Appeal in *Fenton* [(1998) 3 NZConvC 192,681] did not consider whether the scheme involved a "participatory security". However, the Court of Appeal considered that the obligation under the licence not to alter the basic scope and nature of the facilities was indivisible (that is, a right owed to residents as a group). The Court of Appeal also considered that NZ Guardian Trust (which was both the trustee for the residents in respect of the deposits and the statutory supervisor under the deed of participation) had separate obligations in respect of the debt security and the participatory security. The obligations under the participatory security related to the protection of the residents under their licences, including the right to preservation of the basic nature and scope of the facilities provided as part of the village for the use of residents. This suggests that the rights of residents in respect of the common areas and facilities were not individual rights but rights enjoyed in common with other residents.

155. Residents have separate rights under a debt security and a participatory security that form part of a retirement village scheme. Under the debt security residents have a right to be paid money (the repurchase price, loan or deposit). Under the participatory security residents have a right to the use and enjoyment of the village facilities.

156. Therefore, if a retirement village scheme includes a participatory security under which an associated supply is made (the right to receive the supply of accommodation in a commercial dwelling for no consideration or for a consideration that is below the open market value), the consideration attributable to the supply of accommodation would be subject to GST. That being the case, if accommodation is supplied in a commercial dwelling, the supply of accommodation would be a taxable supply, whether or not a participatory security is also supplied. If an associated supply is supplied under a participatory security, the right is treated as a taxable supply for all purposes, including when applying the principal purpose test.

Input tax

157. An input tax credit is allowable on goods and services acquired for the principal purpose of making taxable supplies.

Principal purpose test

158. In *Wairakei*, Chisholm J summarised the principles relating to the application of the principal purpose test as follows (at page 15,206):

> The key issue is whether the goods and services for which input credits are claimed were acquired for the principal purpose of making taxable supplies or of making exempt supplies. Thus the test known as the "principal purpose" test is of considerable importance.
>
> Within a GST context the following features of the principal purpose test seem to be relatively well settled:
>
> (1) Purpose is a reference to the object that the taxpayer had in mind or in view. This is not synonymous with intention or motive. Moreover, care must be taken to avoid confusing the means by which the taxpayer achieves its purpose with the purpose itself: *C of IR v BNZ Investment Advisory Services Limited* (1994) 16 NZTC 11,111; *Norfolk Apartments Limited v C of IR* (1995) 17 NZTC 12,003 (HC) and (1995) 17 NZTC 12,212 (CA).
>
> (2) The principal purpose is the main, primary or fundamental purpose. This does not equate with a more than 50% test: *BNZ Investment Advisory Services Limited; Norfolk Apartments*.
>
> (3) Where the taxpayer is a company its purpose is to be determined by examining the collective purpose of those in control: *C of IR v National Distributors Limited* (1989) 11 NZTC 6,346.
>
> (4) The principal purpose is to be ascertained as at the time the goods and services were acquired: *National Distributors Limited* and *Case M53* (1990) 12 NZTC 2,312.
>
> (5) The focus should be on individual supplies: *Norfolk* at p 12,006.

INTERPRETATION STATEMENTS

159. Therefore, the application of the principal purpose test requires the relevant supply to be identified and the principal purpose for which the supply was acquired to be determined.

Identifying the supply

160. In *Wairakei*, Chisholm J applied the principal purpose test separately in respect of the studio units, which were part of a single building, and detached villas (including the land on which these buildings stood). The supply of the villas (which were separate capital assets from the building containing the studio units) was a separate supply from the studio units.

161. In *Norfolk*, the court did not accept that the principal purpose test should be applied separately to the common areas and facilities in the village. The retirement village in *Norfolk* included an apartment building surrounded by landscaped grounds. The common areas and facilities were leased to a related company, which supplied the right to use and enjoy the common areas to residents. Rental was paid to *Norfolk* by the related company for the common areas and facilities. It was accepted that the apartments in the village were dwellings. *Norfolk* argued that two-thirds of the land (the common areas and facilities) was not used for the construction of the apartment building and that the supply of the common areas and facilities was a taxable supply; therefore, on an area basis the principal purpose was for making taxable supplies. The court rejected this argument.

162. In the High Court in *Norfolk*, Robertson J considered that as the ratios of density and development were dictated by resource management requirements, the percentages of actual use did not provide helpful evidence as to the principal purpose for acquisition of the land and construction of the development. The principal purpose of the development was the accommodation (an exempt supply). The use of the common areas was essential to the enjoyment of the apartments. Access to the apartments could be obtained only through part of the common areas. The right to use the common areas and facilities was an appurtenance of the apartments (and, therefore, part of the dwellings in the village). Therefore, the common areas and facilities were acquired for the principal purpose of making exempt supplies.

163. The Court of Appeal in *Norfolk* noted that the supply of accommodation was central to the concept of a retirement village and, as the common areas and facilities were ancillary to the apartment building, the only conclusion that could be reached was that Norfolk's principal purpose in acquiring the land and entering into the construction contract was to provide accommodation in dwellings. The court considered that even if the taxpayer had made two supplies (the supply of the dwellings and the supply of the common areas and facilities under the lease to the related company), as the rights of residents relating to the common areas were appurtenances to the dwellings, the right to use the common areas and facilities was part of the supply of accommodation. The Court of Appeal said (at page 12,215):

> It is unconvincing for Norfolk to assert that its principal purpose can be seen from the fact that about two-thirds of the land was not required to be utilised for the erection of the apartment building itself. (It points out also that some of the space within the building is common area.) A glance at the site plan showing the substantial apartment building centrally positioned on the land and the balance of the property depicted as developed for gardens, driveway, paths and other facilities which are obviously ancillary to the building is sufficient to dispose of the argument. Norfolk may now wish to say that its principal purpose was to provide a package for the residents of the retirement village but common sense suggests that what must have been uppermost in the minds of the Tuke family was the supply of the apartments (the dwellings), for without them the project would simply not exist. They are obviously central to the concept of a retirement village. The only conclusion which can sensibly be reached is that Norfolk's principal purpose in acquiring the land and entering into the construction contract was to be able to provide accommodation in dwellings situated within a retirement village by way of licences to occupy. That is an exempt supply. It follows that the goods and services acquired by Norfolk were not acquired for the principal purpose of making taxable supplies and that no input tax deduction is available.
>
> Even if the conclusion had been that there were two proposed supplies, one of the dwellings and the other, under the lease, of the common areas and the facilities upon them, *Norfolk* still faced another insuperable difficulty in its argument that the purpose relating to the common areas was the principal purpose. That is because the definition of "dwelling" means not only the building or premises but also "any appurtenances belonging thereto and enjoyed with it". In our view the common areas and the facilities upon them, the use and enjoyment of which is promised to the residents of the dwellings in the occupation licences, are appurtenances to the dwellings.

164. If the principal purpose test is satisfied in respect of a supply of goods and services, a full input tax credit is allowed: *CIR v Coveney* (1994) 16 NZTC 11,329 (HC); (1995) 17 NZTC 12,193 (CA). In *Coveney* the court rejected the Commissioner's argument that the legislation contemplates apportionment of the input

tax credit on a supply of goods and services. In *Case S56* (1996) 17 NZTC 7,361 Judge Barber commented that *Coveney* made it clear that if the principal purpose test is satisfied, a full input tax credit is allowed on goods and services. *Case Z12* (2009) 24 NZTC 14,142 confirms that under the principal purpose test an input tax credit is allowed on an all or nothing basis.

165. Generally the development of a retirement village involves the purchase of bare land and the construction of a retirement village complex on the land. Land acquired for the purpose of a retirement village development under a single transaction is a single supply of a single property. The individual goods and services that go into the construction and development of a retirement village acquired under separate transactions are separate supplies. However, if the principal purpose test is satisfied in respect of the asset or assets produced using these individual supplies, the principal purpose test would be satisfied in respect of the individual supplies that go into a retirement village development. Areas of a Community Centre such as a kitchen or dining room that are used exclusively for the purpose of making taxable supplies are not a supply that is separate from the supply of the Community Centre as a whole. The principal purpose test is to be applied to the Community Centre as a whole.

166. The Commissioner considers that:

- Where a retirement village includes both dwellings and a commercial dwelling, the dwellings and the commercial dwelling are treated as separate supplies. The villas and the studio apartments are treated as separate supplies because the effect of paragraph (f) is that dwellings within a retirement village are notionally severed from the remainder of a retirement village complex: *Wairakei*.
- The principal purpose test is not applied separately in respect of the common areas and facilities, roading, landscaping, lighting and other similar infrastructure costs or separately to areas within a community centre. As the supply of the right to use the common areas and facilities is part of the supply of units in a retirement village, whether the principal purpose test is satisfied in respect of the common areas and facilities depends on whether the retirement village principally supplies exempt supplies of accommodation or taxable supplies of accommodation and other services. The right to use the common areas and facilities is granted to residents of both dwellings and a commercial dwelling within a retirement village complex.

  Therefore, it is not possible to argue that the parts of the common areas and facilities that are immediately adjacent to the commercial dwelling part of a retirement village were acquired for the principal purpose of making taxable supplies in a commercial dwelling in the village. Areas within a community centre such as the kitchen, dining room and nursing station that are used exclusively for the purpose of making taxable supplies are not a separate supply. The principal purpose test is to be applied to a supply as a whole.

Determining the principal purpose

167. The principal purpose is to be determined at the time of acquisition. In determining the principal purpose all relevant circumstances (including objective and subjective matters) are to be considered. Both immediate and long-term or ultimate purposes that would be fulfilled in the future may be relevant in determining the principal purpose. In *Wairakei*, Chisholm J did not accept that a long-term or ultimate objective or purpose was necessarily irrelevant and that only the immediate object or purpose should be taken into account in determining the principal purpose. The court considered that although the principal purpose for which goods or services were acquired is to be ascertained at the time of acquisition, purposes that would be fulfilled in the future may, in some cases, be relevant in determining the principal purpose.

168. The principal purpose could be satisfied although no taxable supplies have been made in the period in which goods or services were acquired. However, there must be objective factors to support the taxpayer's stated intention. In the retirement village context it would be necessary to have regard to matters such as the nature of the development permitted by the resource consent, the disclosure statement required to be provided to prospective residents under the Retirement Villages Act 2003 and the form of the occupation right agreement intended to be entered into with residents.

169. *Norfolk* and *Wairakei* suggest that as the central purpose of a retirement village is the supply of accommodation, the nature of the supply of accommodation supplied will normally determine whether land acquired and construction contracts entered into for the development of a retirement village were for the principal purpose of making taxable supplies. The supply of the common areas and facilities is ancillary to the supply of accommodation, which is the fundamental purpose of a retirement

village. Therefore, whether the supply of the right to use the common areas and facilities is a taxable supply depends on the nature of the supply of accommodation.

170. At the time that land is acquired, development plans may not be finalised. However, the principal purpose at the time of acquisition is to be ascertained. Whether the principal purpose test is satisfied in respect of land acquired for the purpose of a retirement village development depends on whether the intended use of the land is principally for the purpose of making taxable supplies (the supply of accommodation in a commercial dwelling, the supply of care or other personal services). Both subjective and objective factors are relevant in determining the principal purpose: *Wairakei*. Therefore, there must be objective evidence of the intended use of the land (such as planning applications, feasibility studies and preliminary designs).

171. A building could include both dwellings and commercial dwellings. In applying the principal purpose test to such a building, it is necessary to consider whether on an area basis the building is used principally for the purpose of making taxable supplies. The use or intended use to which a building is put is relevant evidence of the principal purpose in acquiring the building and may be determinative of the principal purpose: *Case S16* (1995) 17 NZTC 7,123. Overhead costs relate to goods and services that may not be directly used in making particular supplies. It is appropriate to assess the principal purpose for which overhead costs are incurred on the basis of the ratio of taxable supplies to exempt supplies (the turnover method). However, it is not necessary to use the turnover method to determine the principal purpose for acquiring a building as it is possible to identify the use or uses to which the building is put. Determining the principal purpose on the basis of the ratio of residents in the dwelling and commercial dwelling areas of a building may not give a true picture of the principal purpose for which a building was acquired. There may be more residents in the commercial dwelling part of a building but the dwellings could occupy more of the building on an area basis. It may be necessary to ascertain the principal purpose before a building is occupied. Therefore, the Commissioner considers that the principal purpose in acquiring a building is to be determined on the basis of the use or intended use of the building.

Input tax adjustments

172. If the principal purpose test is not satisfied in respect of a supply of goods or services, an input tax adjustment may be allowable to the extent that the goods or services are applied for the purpose of making taxable supplies if:

- the goods or services were acquired on or after 1 October 1986; and
- GST was charged on the supply of the goods or services; or
- the goods are secondhand goods that have always been situated in New Zealand and were acquired by way of sale: section 21E.

The input tax adjustment is based on the lesser of the cost of the goods and services or the open market value of the goods and services: section 21F.

173. If the principal purpose is not satisfied in respect of goods and services, an input tax adjustment must be allowed to the extent that such goods and services are applied in any taxable period for a purpose of making taxable supplies, based on the lesser of the:

- cost of the goods and services; or
- open market value of the goods and services.

174. The term “applied” has a wider meaning than “used”. In *Case N13* (1991) 13 NZTC 3,105, 3,113 Judge Bathgate considered that “applied” meant “put to the use of” and that goods and services may be applied in an active or passive manner pending their supply. In *Case N22* (1991) 13 NZTC 3,187, 3,193-3,194 Judge Bathgate said that “use” meant “direct, physical involvement or use” while “apply” meant “put to practical use”. In *Case N31* (1991) 13 NZTC 2,377, 3,279 Judge Bathgate considered that “used” may have a physical connotation while the application of property may be a more passive concept. In practice, it may be difficult to distinguish between the use and application of a property. A property could be used in a passive way (including when an owner obtains some advantage from the property without doing anything to it): *Sloss v Sloss* (1989) 5 FRNZ 148. In *CIR v Lundy Family Trust* (2006) 22 NZTC 19,738 the Court of Appeal considered that properties acquired for the purpose of sale and rented for residential purposes pending their sale were used and applied for both taxable purposes and exempt purposes. The properties continued to be part of the taxpayer’s trading stock and remained on the market. At the same time the properties were dedicated to use (applied) for both residential rental purposes and taxable purposes: see para 41 and 43. Some act by the

taxpayer would be necessary to establish that goods and services had been applied for a particular purpose.

175. The extent to which goods and services are applied for the purpose of exempt supplies is to be determined either according to the actual use of goods and services or by using the formula in section 21A(2), which determines the proportion of the turnover attributable to taxable supplies. Any method that is used must ensure that the allocated amounts are fair and reasonable: section 21A(1)(b) and (3). An input tax adjustment is intended to reflect the extent of the taxable use of a good or service acquired and the adoption of some measure that is a fair and reasonable approximation of the actual use is required. Measures based on distance travelled, time spent, the numbers of transactions of particular types, area used for different activities and the actual use of goods or services usually give an accurate estimate of how a good is intended to be used or is used. Indirect estimation methods may be appropriate where there are overhead expenses that are not directly referable to particular supplies. Indirect methods that may be used are based on turnover or profit.

176. Taxpayers have an option of making input tax adjustments on a periodic or an annual basis. Section 21G(1) says that the input tax adjustment is to be allowed in either of the following:
    - In each taxable period in which the goods and services are applied for the purpose of making taxable supplies.
    - In each year in which the goods and services are applied for a purpose of making taxable supplies. (However, if an annual deduction is made, the amount of the deduction made in any subsequent period must be reduced by the amount of the deductions made in any earlier period).

177. A one-off adjustment is allowable in the following circumstances:
    - If the goods are capital assets with a cost of less than $18,000, a one-off deduction may be made in the taxable period during which the goods are applied for a purpose of making taxable supplies: section 21G(1A).
    - If goods and services costing more than $18,000 are wholly applied for the purpose of making taxable supplies and the Commissioner allows a single deduction to be made, a one off deduction may be made in the taxable period in which such goods and services are wholly applied for the purpose of making taxable supplies: section 21H(1).

178. "Capital asset" is not defined in the legislation. The GST Act does not distinguish between capital and revenue. "Capital asset" is an income tax concept. For income tax purposes capital assets are acquired for retention and use in carrying on a business while revenue assets are assets that are acquired for sale: *Sun Newspaper Ltd and Associated Newspapers Ltd v Federal Commissioner of Taxation* (1939) 61 CLR 337; *Duff v CIR* (1982) 5 NZTC 61,131; *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233. In the GST context in *Case K55* (1988) 10 NZTC 453 Judge Bathgate accepted that a car that was used in carrying on the taxpayer's sheepfarming activity was a capital asset. The Commissioner considers that for GST purposes, a capital asset is an asset that is acquired for retention and use in carrying on a taxable activity whereas revenue assets are acquired for sale.

179. In some circumstances, it may be necessary to consider whether an item is a separate asset. The Interpretation Statement on *Residential Rental Properties – depreciation of items of depreciable property* provides some guidance as to the matters to be considered in determining whether an item is a separate asset, although the Interpretation Statement considers this issue only in relation to residential rental properties.

Common areas and facilities

180. A retirement village may include a commercial dwelling or dwellings. Residents of both dwellings and commercial dwellings in the village have the right to use the common areas and facilities. A community centre may also include areas such as kitchens, restaurants and nurses' workstations that are used solely for the provision of taxable services.

181. The Commissioner considers that to the extent that part of a community centre (such as kitchens, restaurants and nursing stations) is used for the preparation and provision of meals and the provision of nursing care, such an area would be used and applied solely for the making of taxable supplies. Therefore, an input tax adjustment would be allowable under section 21F based on the lesser of the cost or market value attributable to that part of the community centre that is exclusively used for the making of taxable supplies (the supply of meals and nursing services).

182. The Commissioner also considers that, to the extent that the right to use the common areas and community facilities is made available for the use of residents of a commercial dwelling in a retirement village, the common areas and community facilities would be applied for the purpose of

making taxable supplies. Such common areas and community facilities will also be applied for the purpose of making exempt supplies if residents of dwellings in the retirement village (parts of the village to which paragraph (f) of the definition of "commercial dwelling" applies) also have the right to use these areas. The Commissioner considers that an apportionment based on the proportion of commercial dwellings to dwellings (that is, the number of units that are commercial dwellings relative to the number of units that are dwellings) in the retirement village would be fair and reasonable and would reflect the use of the common areas and facilities for both taxable and exempt supplies to all residents.

183. If the cost of the capital assets that make up the common areas and facilities (including land, buildings, roading, landscaping and lighting) exceeds $18,000 (as is likely), a one-off input tax adjustment would not be permitted. A building that is a separate physical structure constitutes a capital asset separate from the other assets that make up a retirement village complex. The Commissioner considers that it is unlikely that separate paths and roads within a retirement village complex constitute separate capital assets for the purpose of section 21G(1A). The fact that paths and roads may have been constructed at different times is not determinative. The roads and paths in a retirement village form a network for vehicle and pedestrian travel within a retirement village and in and out of the complex and function together as part of that network.

184. Therefore, the Commissioner considers that a one-off input tax adjustment would generally not be allowable in respect of a community centre (or other building) or in respect of parts of the common areas such as paths, roads and infrastructure costs that are applied for both taxable and exempt supplies.

185. The input tax adjustment is based on the lesser of the cost and the market value of the common areas and facilities. The cost of the goods and services means their acquisition cost: *Lundy*. In *Lundy*, the court accepted that the cost of land and buildings (which were used for both taxable and exempt supplies over more than one taxable period) in each taxable period was to be determined on the basis of the depreciation rate. The cost of the common areas and the community centre includes the cost of the land within the common areas and the land on which a community centre is constructed, the cost of constructing the community centre, roads and footpaths and landscaping. Therefore, the cost of the common areas and community centres in each taxable period would be depreciation on the land and buildings comprised in the common areas and community centre.

Dwellings

186. The Commissioner does not consider that dwellings in a retirement village (being parts of the village to which paragraph (f) of the definition of "commercial dwelling" applies) would be applied for the purpose of making taxable supplies merely because taxable supplies such as nursing, meals and cleaning services are provided there. Dwellings would not be applied for the purpose of making taxable supplies merely because taxable supplies that have no relationship with the dwellings are provided to residents in the dwellings. Dwellings are not applied (used) for the provision of a cleaning service; the cleaning service is something that is done to the dwelling.

187. The Commissioner also does not accept that the dwellings in a retirement village are applied for the purpose of making taxable supplies where the dwellings provide a catchment for the remainder of the village. Although it is likely that residents in a retirement village will require more care as they age and a retirement village may anticipate that residents would transfer from dwellings to a serviced apartment or rest home in the same village, there is no obligation on residents to do so. While dwellings are occupied as dwellings, they are applied solely for the purpose of making exempt supplies.

Output tax adjustments

188. An output tax adjustment would be required in respect of goods and services acquired for the principal purpose of making taxable supplies and that are applied for another purpose. Section 21C requires output tax adjustments to be made at one of the following times:

- In the first taxable period in which goods and services are applied for a purpose other than that of making taxable supplies. If a taxpayer makes an output tax adjustment in that period, the taxpayer is required to make further output tax adjustments to reflect further changes of use of 20 percent or more.
- In each taxable period in which goods and services are applied for a purpose other than that of making taxable supplies.
- In each year in which goods and services are applied for a purpose other than that of making taxable supplies.

189. Goods and services would be "applied" for a particular purpose if they are allocated for a particular purpose. Therefore, land or other goods or services acquired for the principal purpose of making taxable supplies could be "applied" for a non-taxable purpose before it is actually used for a non-taxable purpose. The Commissioner considers that land acquired for the purpose of making taxable supplies would be applied (dedicated to use) for the purpose of making exempt supplies if the land has been surveyed and an identifiable area of land has been allocated for the construction of dwellings where exempt supplies of accommodation will be made. The area is also used for the purpose of making exempt supplies in the sense that an advantage is obtained from holding the land for use in making exempt supplies.

190. The Commissioner considers that land, buildings and other assets in a retirement village are not used or applied for the purpose of supplying debt securities. Debt securities are issued to finance the development of retirement villages. Hence, the objective of supplying debt securities is the acquisition of buildings where exempt or taxable supplies of accommodation and other services will be made.

191. Taxpayers have an option of making an output tax adjustment in the first taxable period, in each taxable period or in each year in which goods and services are applied for the purpose of making taxable supplies: section 21C. The Commissioner considers that land or a building would be applied for the purpose of making exempt supplies of accommodation when a particular area of the land or a building is allocated for that purpose and the land or a building would continue to be applied for the purpose of making exempt supplies while they continue to be used for that purpose.

192. Section 21A specifies the methods for calculating the extent of the application for a non-taxable purpose. The output tax adjustment is based on the lesser of the cost of the goods and services or the open market value of the supply: section 10(8). "Cost" means the acquisition cost: *Lundy*.

Examples

193. It is not possible to provide examples relating to every factual situation that may arise in respect of supplies made or received by retirement villages. The following examples are intended to provide guidance on common situations.

Example 1

194. RV Ltd is building a retirement village. The village will include a block of 50 apartments and 200 stand-alone villas, roads, landscaped gardens and a community centre, including a lounge, kitchen, dining room, nursing station, library, theatre and bowling green. The cost of the common areas and facilities amounted to $2 million.

195. A licence in respect of an apartment or villa is granted to residents. Under the licence, residents have a right to use the common areas and facilities. Residents are required to pay an up-front facilities fee of $50,000 and are required to make an interest-free loan of $250,000. The facilities fee accrues to RV Ltd at the rate of $10,000 per year over five years. The loan is repaid when residents leave the village. Residents of apartments are required to pay a weekly fee for accommodation and care services (including the provision of meals and linen, the cleaning of their room or apartment, and the provision of activities and outings and nursing services). Residents of the villas are required to pay a lower weekly fee for the right to use the common areas and facilities but are not required to pay for and receive care services. If residents of the villas require any additional services such as meals or nursing services, an additional charge is payable.

196. As the consideration that residents of the apartments are required to pay in order to be entitled to the supply of accommodation is for both accommodation and other services, the apartments are a commercial dwelling. The supply of accommodation and care services in the apartments is a taxable supply for which the consideration is the facilities fee and the weekly fees. GST is chargeable on the facilities fee and the weekly fees paid by residents of the apartment.

197. The villas are dwellings as the consideration that residents must pay in order to be entitled to the supply of accommodation relates solely to the supply of accommodation including the right to use the common areas and facilities, which is an appurtenance of the dwellings and is, therefore, part of the dwellings. The supply of accommodation in the villas under the licence is an exempt supply. GST is not chargeable on the payments made by residents of the villas, except additional payments for the supply of meals or care services made at the request of residents.

198. RV Ltd is entitled to an input tax credit for goods and services acquired for the purpose of constructing the apartments (including the land on which they stand). An input tax credit is not allowable in respect of goods and services acquired for the purpose of constructing the villas as they are acquired for the principal purpose of making exempt supplies of accommodation.

199. The principal purpose test is not satisfied in respect of the common areas and facilities as the village largely consists of dwellings (the villas). A one-off adjustment is not allowable as the common areas and facilities are a capital asset that cost more than $18,000. As the cost of the common areas and facilities is less than their market value, periodic input tax adjustments would be calculated on the basis of the depreciation rate relating to the land and building comprised in the common areas and facilities in the following manner:

- As the kitchen, dining room and nursing station will be exclusively applied to the making of taxable supplies (the supply of meals and nursing services), an input tax adjustment would be allowable on the basis of the depreciation rate relating to the land and building comprised in these areas. The retirement village has an option of making an input tax adjustment in the first taxable period, in each taxable period or in each year in which the kitchen, dining room and nursing station are applied for making taxable supplies. The first taxable period in which the kitchen, dining room and nursing station are applied for the purpose of making taxable supplies is the period in which it is determined that specific areas of the building will be allocated for the purpose of the kitchen, dining room and nursing station and the kitchen, dining room and nursing station will continue to be applied for the purpose of making taxable supplies while they continue to be used for that purpose.
- As the remainder of the common areas and facilities will be available for the use of residents of both the commercial dwelling part of the village and residents of dwellings in the village, they are applied both for taxable supplies and exempt supplies. The commercial dwelling part of the village represents 20 percent of the village. An input tax adjustment based on 20 percent of the depreciation rate attributable to the remainder of the common areas and facilities would be allowable in each taxable period.

(In this example, the amount of the input tax adjustments has been calculated on the basis of the ratio of dwellings to commercial dwellings in the retirement village. However, another method of calculating an input tax adjustment would be acceptable provided it results in fair and reasonable amounts.)

Example 2

200. ABC Ltd owns and operates a retirement village that comprises an apartment building that includes garages, a library, theatre, kitchen, dining room and nursing station and is surrounded by gardens, paths and driveways.

201. A lease for life in respect of a resident's apartment and a garage in the basement of the building, together with a right to use the common areas and facilities of the village, is granted to residents. Residents are required to pay an entry payment of $300,000. On the termination of the lease, the entry payment less the following charges is repaid to residents:

- a facilities fee of $50,000;
- a refurbishment charge, the amount of which depends on the period of occupation.

Residents are also required to pay a weekly fee for the management of the village. Residents have an option of receiving meals or care services on payment of an additional charge.

202. The apartments are dwellings as the consideration payable in order to be entitled to occupy an apartment in the village (the facilities fee, the periodic charges and the refurbishment charge) relates solely to the supply of accommodation (including the right to use the common areas and facilities, which is an appurtenance of the apartments, and including management services, which are incidental or ancillary to the supply of accommodation). GST is not chargeable on the facilities fee, the periodic charges, the refurbishment charge or the entry payment as these payments are consideration for exempt supplies (the supply of accommodation in a dwelling by way of hire and the supply of a financial service). Any additional payments for the optional supply of care and other services relate to a taxable supply and are subject to GST.

203. An input tax credit is not allowable in respect of land and construction costs relating to the apartment and the common areas and facilities. However, input tax adjustments would be allowable in respect of the kitchen, dining room and nursing station. The basis for calculating and the timing of such input tax adjustments is as outlined above.

Example 3

204. XYZ Co Ltd acquires land for the development of a rest home complex. The rest home beds are intended for residents who require a high level of care. The rest home is a commercial dwelling (para (c) of the definition of "commercial dwelling"). The supply of accommodation and care in the rest home is a taxable supply. An input tax credit is allowable on land and construction costs incurred in developing the rest home complex.

205. A decision is later made to expand the retirement village by the construction of 200 villas and a community centre that includes recreational facilities available to residents of the villas, a kitchen, dining room and administration areas. A licence to occupy is granted in respect of villas and serviced apartments. Residents of the villas must pay a refundable deposit of $300,000. The deposit is refundable on termination of occupation. Residents must also pay a facilities fee of $50,000 on termination of occupation and periodic fees. As the consideration payable by residents for the supply of accommodation relate solely to the right to occupy a villa, the villas are dwellings and the supply of accommodation in the villas is an exempt supply.

206. An output tax adjustment must be made as the land will be applied in part for the making of exempt supplies. As the cost of the land allocated for the purpose of the villas, the recreation facilities and other common areas to which residents have access is less than its open market value, the output tax adjustment is based on the cost of the land. The extent to which the land is applied for the purpose of making exempt supplies may be calculated on an area basis. However, the output tax adjustment may be calculated on the basis of the proportion of the turnover from the making of taxable and exempt supplies (or another method of calculation) if the method results in a fair and reasonable output tax adjustment.

207. The retirement village elects to make the output tax adjustment in each year in which the land is applied for the making of taxable supplies. However, the retirement village would also have been permitted to make the output tax adjustment at either of the following times:

- in the first taxable period in which the land and common areas and facilities are applied for the making taxable supplies. The land would be applied for the purpose of making exempt supplies when it is determined that a particular area of the land would be allocated for the construction of the villas and community centre and the common areas serving the villas; or
- in each taxable period in which the land is applied for the making of exempt supplies.

STANDARD PRACTICE STATEMENTS

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 10/04: DISPUTES RESOLUTION PROCESS COMMENCED BY THE COMMISSIONER OF INLAND REVENUE

Introduction

1. This Standard Practice Statement ("SPS") sets out the Commissioner's rights and responsibilities with a taxpayer in respect of an adjustment to an assessment when the Commissioner commences the disputes resolution process.
2. Unless specified otherwise, all legislative references in this SPS refer to the Tax Administration Act 1994 ("TAA").
3. Where a taxpayer commences the disputes resolution process, the Commissioner's practice is set out in SPS 10/05: *Disputes resolution process commenced by a taxpayer*.
4. The Commissioner regards this SPS as a reference guide for taxpayers and Inland Revenue officers. Where possible, Inland Revenue officers must follow the practices outlined in this SPS.
5. The disputes resolution process is designed to ensure that there is a full and frank communication between the parties in a structured way within strict time limits for the legislated phases of the process.
6. The disputes resolution process is designed to encourage an "all cards on the table" approach and the resolution of issues without the need for litigation. It aims to ensure that all the relevant evidence, facts and legal arguments are canvassed before a case proceeds to a court.
7. In accordance with the objectives of the disputes resolution process, the Commissioner (unless a statutory exception applies under section 89C or 89N(1)(c)) must go through the disputes resolution process before the Commissioner can issue an assessment.

Application

8. This SPS applies from 8 November 2010 and incorporates changes made to the Commissioner's administrative practice in relation to the disputes process which were implemented by Inland Revenue on 1 April 2010.
9. It replaces SPS 08/01: *Disputes resolution process commenced by the Commissioner of Inland Revenue*.
10. We acknowledge that Inland Revenue issued an officials' issues paper entitled "Disputes: a review" in July 2010. However, the outcome of that review has yet to be finally determined. This SPS represents the law and the Commissioner's administrative practice as it currently stands. If changes to the law and/or the Commissioner's administrative practice arise out of "Disputes: a review" this SPS will be reviewed and amended to reflect those changes.

Background

11. The tax disputes resolution procedures were introduced in accordance with the recommendations of the Richardson Committee in the *Report of the Organisational Review of the Inland Revenue Department* (April 1994) and were designed to reduce the number of disputes by:
    (a) promoting full disclosure, and
    (b) encouraging the prompt and efficient resolution of tax disputes, and
    (c) promoting the early identification of issues, and
    (d) improving the accuracy of decisions.
12. The disputes resolution process ensures that there is a full and frank communication between the parties in a structured way within strict time limits for the legislated phases of the process.

13. The disputes resolution process is designed to encourage an "all cards on the table" approach and the resolution of issues without the need for litigation. It aims to ensure that all the relevant evidence, facts and legal arguments are canvassed before a case goes to a court or hearing authority.

14. In accordance with the objectives of the disputes resolution process, the Commissioner (unless a statutory exception applies under section 89C or 89N(1)(c)) must go through the disputes resolution process before the Commissioner can issue an assessment.

15. The early resolution of a dispute is intended to be achieved through a series of steps specified in the TAA. The main elements of those steps are the issue of:

    (a) A notice of proposed adjustment ("NOPA"): this is a notice that either the Commissioner or taxpayer issues to the other advising that an adjustment is sought in relation to the taxpayer's assessment, the Commissioner's assessment or other disputable decision (the prescribed form is the *IR 770 Notice of proposed adjustment*). A NOPA is the formal document which begins the disputes process.

    (b) A notice of response ("NOR"): this must be issued by the recipient of a NOPA if they disagree with it (the preferred form is the *IR 771 Notice of response*).

    (c) A disclosure notice and statement of position ("SOP"): the issue of a disclosure notice and SOP by the Commissioner triggers the requirement for the taxpayer to provide a SOP to continue the dispute. Each SOP must provide an outline of the facts, evidence, issues and propositions of law with sufficient details to support the positions taken. Each party must issue a SOP (the preferred form is the *IR 773 Statement of position*). The SOPs are important documents because they limit the facts, evidence, issues and propositions of law that either party can rely on if the case proceeds to court to what is included in the SOP (unless a hearing authority makes an order that allows a party to raise new facts or evidence under section 138G(2)).

16. There are also two administrative phases in the disputes process—the conference and adjudication phases. If the dispute has not been already resolved after the NOR phase, the Commissioner's practice will be to hold a conference. A conference can be a formal or informal discussion between the parties to clarify and, if possible, resolve the issues.

17. If the dispute remains unresolved after the conference phase, the Commissioner will prepare a SOP and refer the dispute to adjudication, except in certain circumstances. One of the circumstances where the Commissioner will not refer a dispute to adjudication is where the Commissioner and the taxpayer have agreed in writing not to complete the disputes process (referred to as "opt out" (see paragraphs 261 to 285).

18. Adjudication involves an independent review of the dispute by Inland Revenue's Adjudication Unit, which was formed to provide an internal but impartial review of unresolved disputes. Adjudication is the final phase in the disputes process before the taxpayer's assessment is amended (if it is to be amended) following the exchange of the SOPs.

19. Timely progression of disputes through the disputes process may require the use of the Commissioner's information gathering powers (particularly section 17) before and/or during the disputes process.

20. Inland Revenue has a quality assurance review process known as Core Task Assurance ("CTA") which is designed to ensure that key pieces of work (including NOPAs and SOPs) are subject to an independent review by Legal & Technical Services ("LTS") before being issued. Given the importance of the disputes process to the Commissioner and to taxpayers, Inland Revenue officers are required to get CTA approval of disputes documents prior to issue.

Glossary

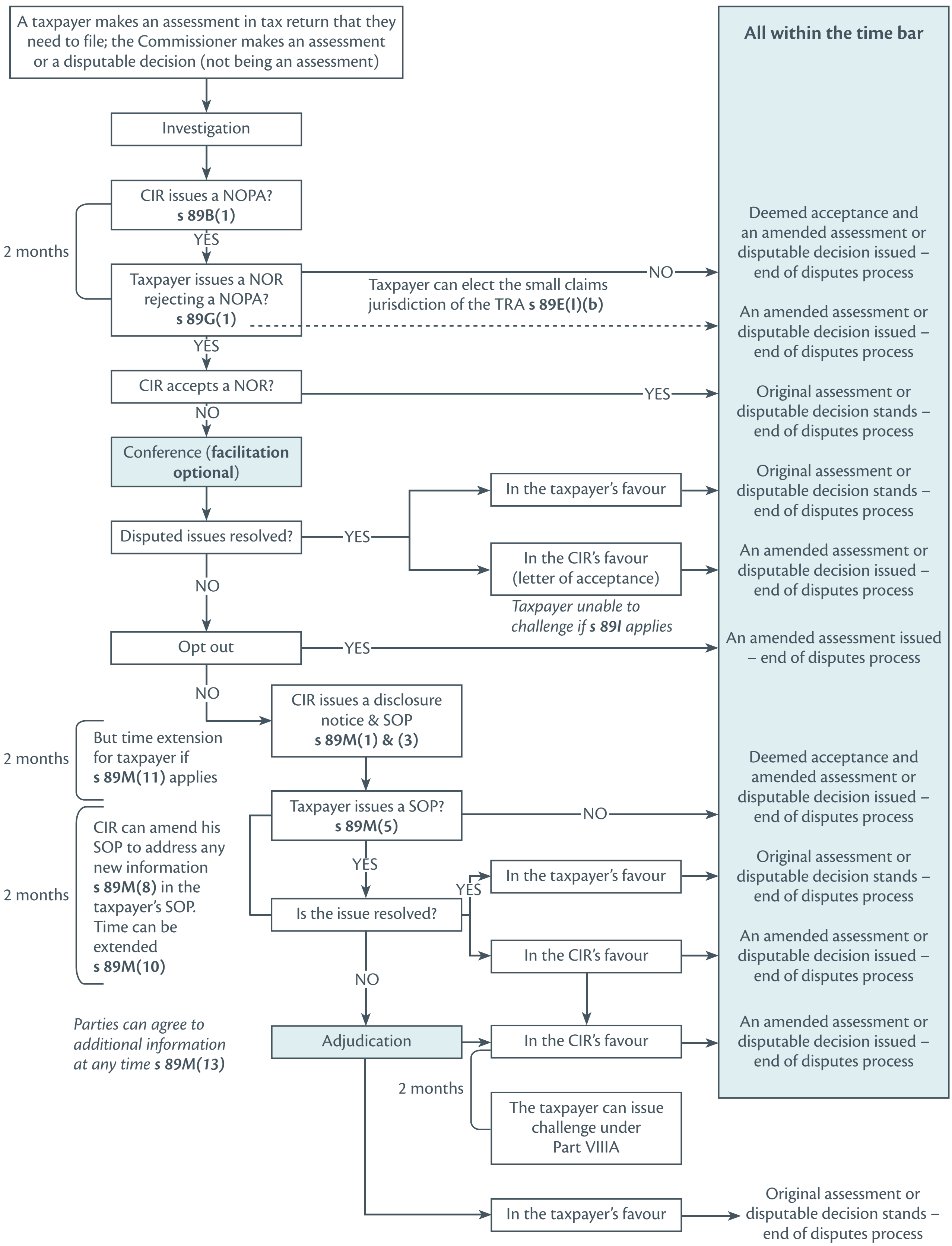
21. The following abbreviations are used throughout this SPS:

    - NOPA – Notice of Proposed Adjustment
    - NOR – Notice of Response
    - SOP – Statement of Position
    - Disputes Process – Disputes Resolution Process
    - TRA – Taxation Review Authority.

Diagram of disputes process

The disputes process is set out in the following diagram.

Disputes resolution process commenced by the Commissioner of Inland Revenue



Summary of key actions and indicative administrative timeframes

22. Set out below is a summary of the key actions and administrative timeframes where the disputes process is commenced by the Commissioner of Inland Revenue.

23. These key actions and timeframes are intended to be administrative guide lines for Inland Revenue officers. Any failure to meet these administrative timeframes will not invalidate subsequent actions of the Commissioner or prevent the case from going through the disputes process.

Paragraph in the SPS	Key actions	Indicative timeframes
	The Commissioner's NOPA	
94	The Commissioner will advise the taxpayer that a NOPA will be issued.	Usually within five working days before the date that the Commissioner issues a NOPA, but this may happen earlier.
99	The Commissioner will confirm whether the taxpayer has received the Commissioner's NOPA (either by telephone or in writing).	Within 10 working days from the date that the Commissioner's NOPA is issued, where practicable.
	Taxpayer's NOR	
196	The taxpayer issues a NOR in response to the Commissioner's NOPA within the applicable response period.	Within two months from the date that the Commissioner's NOPA is issued, unless any of the "exceptional circumstances" under section 89K applies.
198	The Commissioner will confirm whether the taxpayer will issue a NOR.	Usually two weeks before the response period for the Commissioner's NOPA expires.
216	The Commissioner will forward the taxpayer's NOR to the responsible officer.	Usually within five working days after the taxpayer's NOR is received.
217	The Commissioner will acknowledge the receipt of the taxpayer's NOR.	Usually within 10 working days after the taxpayer's NOR is received.
222	The Commissioner will advise that the taxpayer's NOR is deficient, but the two-month response period has not expired.	Inland Revenue officers will advise the taxpayer or their agent immediately after they become aware of the deficiency.
213	The Commissioner will consider the application of "exceptional circumstances" under section 89K, where a taxpayer's NOR has been issued outside the applicable response period.	Usually within 15 working days after the taxpayer's application is received.
202	The taxpayer is deemed to accept the Commissioner's NOPA, because they failed to issue a NOR within the applicable response period and none of the "exceptional circumstances" apply in the case of a late NOR.	At the end of the two month period starting on the date of issue of the Commissioner's NOPA.
202	The Commissioner will advise the taxpayer in writing that they are deemed to accept the Commissioner's NOPA.	Usually two weeks after the response period to the Commissioner's NOPA has expired.
218	The Commissioner will advise the taxpayer whether their NOR is being considered, has been accepted, or rejected in full or part.	Usually within one month after the taxpayer's NOR is received.
219	If the taxpayer's NOR has been accepted in full, the dispute finishes and Inland Revenue will take appropriate actions (for example, issue an amended assessment).	Usually within one month after the advice of acceptance of the NOR is issued.
	Conference phase	
236	The Commissioner will write to the taxpayer to initiate the conference phase and to offer a facilitated conference.	The Commissioner's offer of a facilitated conference will be made in writing within one month from the date of issue of the taxpayer's NOR. The conference letter marks the start of the conference phase.
238	The taxpayer will advise Inland Revenue whether they will attend the conference meeting, and whether they will accept the conference facilitation offer.	Usually within two weeks of receipt of the conference facilitation letter. If the taxpayer does not respond within this timeframe, the Inland Revenue officers involved in the dispute will contact the taxpayer about the letter.
239	When a taxpayer agrees to attend a conference meeting, Inland Revenue will contact the taxpayer to establish a timeframe, and agree on how the meeting will be conducted.	Usually within two weeks following the taxpayer's agreement to a conference.
243	Conference meeting(s) and further information exchange between Inland Revenue and the taxpayer.	The suggested average timeframe of the conference phase is three months, subject to the facts and complexity of the dispute.

Paragraph in the SPS	Key actions	Indicative timeframes
	Opt out	
268	The taxpayer may request to opt out of the disputes resolution process	Within two weeks from the end of the conference phase.
268	Inland Revenue officer will advise the taxpayer whether the request to opt out has been agreed to.	Usually within two weeks from the date of the taxpayer's request to opt out.
	Disclosure notice and the Commissioner's SOP	
301	The Commissioner will advise the taxpayer that a disclosure notice and the Commissioner's SOP will be issued.	Usually within two weeks before the date that the Commissioner's disclosure notice and SOP are issued.
310	The Commissioner will issue a disclosure notice and the Commissioner's SOP.	Usually within **three months** from the end of the conference phase or within **three months** from the date when the Commissioner advises that the taxpayer's opt out request has been declined.
	Taxpayer's SOP	
332	The taxpayer must issue a SOP within the response period for the disclosure notice.	Within two months after the date that the disclosure notice is issued, unless any of the "exceptional circumstances" under section 89K apply.
335	The Commissioner will confirm whether the taxpayer will issue a SOP.	Usually two weeks before the response period for the Commissioner's disclosure notice expires.
336	The taxpayer's SOP is forwarded to the responsible officer.	Usually within five working days after the taxpayer's SOP is received.
337	The Commissioner will acknowledge the receipt of the taxpayer's SOP.	Usually within 10 working days after the taxpayer's SOP is received.
337	The Commissioner will advise that the taxpayer's SOP is deficient, but the two-month response period has not expired.	Inland Revenue officers will advise the taxpayer or their agent as soon as they become aware of the deficiency.
338	The Commissioner will consider the application of "exceptional circumstances" under section 89K, where the taxpayer's SOP has been issued outside the applicable response period.	Usually within 15 working days after the taxpayer's application is received.
339	The Commissioner will advise that taxpayer is deemed to accept the Commissioner's SOP, because they failed to issue a SOP within the applicable response period and none of the "exceptional circumstances" apply.	Usually two weeks after the response period for the disclosure notice expires.
	Addendum to the Commissioner's SOP	
340	The Commissioner can provide additional information via an addendum to the Commissioner's SOP under section 89M(8) within the response period for the taxpayer's SOP.	Within two months after the taxpayer's SOP is issued.
343	The Commissioner will advise the taxpayer whether additional information to the Commissioner's SOP will be provided via an addendum under section 89M(8).	Usually within two weeks after the taxpayer's SOP is received, subject to the facts and complexity of the dispute and the available response period.
345	The Commissioner will consider the taxpayer's request to include additional information in their SOP under section 89M(13).	Usually within one month after the date that the Commissioner's addendum is issued.
	Adjudication	
358	The Commissioner will prepare a cover sheet and issue a letter (including a copy of the cover sheet) to the taxpayer to seek their concurrence of the materials to be sent to the adjudicator.	Usually within one month after the date that the Commissioner's addendum (if any) is issued or within one month from the date that the response period for the taxpayer's SOP to expire.
359	The taxpayer must respond to the Commissioner's letter.	Within 10 working days after the date that the Commissioner's letter is issued.
360	The Commissioner will forward materials relevant to the dispute to the Adjudication Unit.	Usually after the taxpayer has concurred on the materials to be sent to the Adjudication Unit or after the 10 working days allowed for the taxpayer's response have elapsed if no response is received.

Paragraph in the SPS	Key actions	Indicative timeframes
352	Adjudication of the disputes case	Usually within 3 months after the date that the Adjudication Unit receives the dispute files depending on the number of disputes that are before the Adjudication Unit, any allocation delays and the technical, legal and factual complexity of those disputes.

STANDARD PRACTICE AND ANALYSIS

Notice of proposed adjustment (NOPA)

The Commissioner must issue a NOPA before making an assessment

24. The Commissioner must issue a NOPA before making an assessment (including an assessment of shortfall penalties but excluding other civil penalties and interest), unless an exception to the requirement that a NOPA be issued applies under section 89C.

25. Nevertheless, even if the Commissioner, in a very unlikely event, made an assessment in breach of section 89C, the assessment would be regarded as being valid under section 114(a).

26. Each exception under section 89C can apply independently or together depending on the circumstances. However, the Commissioner can also choose to issue a NOPA before making an assessment notwithstanding that an exception under section 89C applies.

A disputable decision

27. Pursuant to the definition in section 3(1), a disputable decision is:
    (a) an assessment, or
    (b) a decision that the Commissioner makes under a tax law, except for a decision:
        (i) to decline to issue a binding ruling, or
        (ii) that cannot be the subject of an objection or challenge, or
        (iii) that is left to the Commissioner's discretion under sections 89K, 89L, 89M(8), (10) and 89N(3).

28. The Commissioner will generally issue a NOPA before issuing an assessment that takes into account a disputable decision.

29. For example, the Commissioner issues a notice of disputable decision to a taxpayer who is a director and shareholder of a company advising that the company's loss attributing qualifying company election for the 2007 tax year is invalid because it is received late. However, the company's loss calculation and assessment for the 2007 tax year are not affected. The Commissioner intends to issue an assessment to the taxpayer that takes into account the notice of disputable decision by disallowing the company's losses that the taxpayer has claimed. The Commissioner will issue a NOPA to the taxpayer before making the assessment.

Exceptions

Exception 1: The assessment corresponds with a tax return

30. Section 89C(a) reads:

> The assessment corresponds with a tax return that has been provided by the taxpayer.

31. The application of section 89C(a) is limited under the self-assessment rules. Generally, a taxpayer makes an assessment and files a tax return that includes that assessment. If the taxpayer's assessment is supported by the information in the tax return and any underlying source documents that the taxpayer has provided and the Commissioner agrees with the taxpayer's return and assessment there is no need for the Commissioner to invoke the disputes process.

32. In these circumstances, instead of issuing a notice of assessment the Commissioner will issue a statement of account that confirms the taxpayer's assessment. The statutory response period for the purposes of the disputes process will commence from the date that Inland Revenue receives the taxpayer's assessment.

33. Sometimes, if there is a deficiency in the taxpayer's tax return, the Commissioner will issue an assessment without first issuing a NOPA to the taxpayer because section 89C(a) applies. For example, the Commissioner can issue an assessment, where the taxpayer has provided all their income details but omitted to calculate their income tax liability in the tax return.

Exception 2: Simple or obvious mistake or oversight

34. Section 89C(b) reads:

> The taxpayer has provided a tax return which, in the Commissioner's opinion, appears to contain a simple or obvious mistake or oversight, and the assessment merely corrects the mistake or oversight.

35. This exception is intended to apply to a simple calculation error or oversight that Inland Revenue's Processing Centres generally discover with computer edits and simple return checks. This maintains the

status quo for the many assessments arising in this situation.

36. The Commissioner will generally treat the following as a simple mistake or oversight:

(a) an arithmetical error;

(b) an error in transposing numbers from one box to another in a tax return;

(c) double counting, such as inadvertently including in the taxpayer's income the same item twice;

(d) not claiming a rebate to which the taxpayer is entitled or that was incorrectly calculated, for example, the low income rebate for a taxpayer.

37. A "simple or obvious mistake or oversight" can be determined on a case-by-case basis with no dollar limit. The Commissioner may consider whether this exception applies irrespective of whether the taxpayer has requested that the Commissioner makes an amendment under section 113 or applies the exception under section 89C(b).

38. Where the Commissioner issues an assessment to correct a taxpayer's simple or obvious mistake or oversight, the Commissioner may consider imposing shortfall penalties on the taxpayer, if there is a tax shortfall and the taxpayer has committed one of the culpable acts, for example, lack of reasonable care and not relied on the action or advice of their tax advisor for the purposes of section 141A(2B).

Exception 3: Agreement to amend previous tax position

39. Section 89C(c) reads:

> The assessment corrects a tax position previously taken by the taxpayer in a way or manner agreed by the Commissioner and the taxpayer.

40. This situation can occur if the issue is raised by either the Commissioner or the taxpayer. There is no need to issue a NOPA because no dispute arises.

41. If the Commissioner proposes the adjustment, this exception cannot apply unless the taxpayer accepts the adjustment. For the purpose of section 89C(c), the agreement between the parties can be oral, but the Commissioner's practice will be to seek written agreement. Section 89C(c) applies if Inland Revenue officers can demonstrate that the Commissioner and taxpayer have agreed on the proposed adjustment.

42. However, if the parties agree on only one adjustment and dispute others in respect of the same assessment, the Commissioner cannot issue an assessment on the basis of the agreed adjustment because the tax position is not necessarily correct.

43. Where a taxpayer proposes an adjustment outside the disputes process and the Commissioner agrees, for example a taxpayer makes a request to amend an assessment, the particulars must be recorded in writing and state that the assessment is made in accordance with the Commissioner's practice on exercising the discretion under section 113. (See *SPS 07/03: Requests to amend assessments*.) The Commissioner must also consider if shortfall penalties are applicable.

Exception 4: The assessment otherwise reflects an agreement

44. Section 89C(d) reads:

> The assessment reflects an agreement reached between the Commissioner and the taxpayer.

45. The same procedures apply for section 89C(c) and (d). However, the agreement that the parties reach does not have to relate to a tax position that the taxpayer has previously taken.

46. For example, if the taxpayer has disputed, but now agrees, that they are a "taxpayer" for the purpose of the definition in section YA 1 of the Income Tax Act 2007 ("ITA 2007") and has not provided a tax return. The Commissioner may issue an assessment to the taxpayer under section 89C(d) to reflect this agreement. The Commissioner must also consider whether shortfall penalties are applicable.

47. Another example is where, pursuant to section 6A, the Commissioner settles a tax case and disputes process. In such cases, the Commissioner will usually enter into an individual settlement deed and agreed adjustment in writing with the taxpayer to confirm the settlement.

48. The Commissioner will then give effect to that settlement deed and agreed adjustment by issuing an assessment to the taxpayer under section 89C(d) without first issuing a NOPA.

Exception 5: Material facts and law identical to court proceeding

49. Section 89C(db) reads:

> The assessment is made in relation to a matter for which the material facts and relevant law are identical to those for an assessment of the taxpayer for another period that is at the time the subject of court proceedings.

50. Pursuant to section 89C(db), the Commissioner can issue an assessment to the taxpayer in relation to the other period that is the subject of court proceedings, without first issuing a NOPA. The Commissioner does not have to follow the disputes process for the same issue in the other period because the matter is before the court to resolve. A dual process towards

resolution does not need to be adopted. The Commissioner will also consider whether shortfall penalties are applicable.

51. However, a taxpayer who has been issued with an assessment in relation to another period under section 89C(db), can dispute that assessment by issuing a NOPA to the Commissioner under section 89D within the applicable response period.

52. Section 89C(db) is intended to reduce compliance costs. Notwithstanding this provision, the Commissioner can elect to issue a NOPA in respect of the other period in order to resolve the dispute through the disputes process.

Exception 6: Revenue protection

53. Section 89C(e) reads:

> The Commissioner has reasonable grounds to believe a notice may cause the taxpayer or an associated person—
>
> (i) to leave New Zealand; or
>
> (ii) to take steps, in relation to the existence or location of the taxpayer's assets, making it harder for the Commissioner to collect the tax from the taxpayer.

54. This exception is intended to ensure that the revenue is protected in the relevant circumstances. Section 89C(e) does not require that the taxpayer has physical possession of their assets.

55. If Inland Revenue officers apply the exception under section 89C(e), this should be supported by evidence of the "reasonable grounds" relied on (for example, the taxpayer's correspondence with third parties, application to emigrate overseas and any transcripts of interviews with the taxpayer, etc.)

Exception 7: Fraudulent activity

56. Section 89C(eb) reads:

> The Commissioner has reasonable grounds to believe that the taxpayer has been involved in fraudulent activity.

57. Pursuant to section 89C(eb), a taxpayer has been involved in a fraudulent activity if they have:

(a) engaged or participated in, or been connected with, any fraudulent activity that would have tax consequences for them, and

(b) acted deliberately with the knowledge that they were acting in breach of their legal obligations and did so without an honest belief that they were so entitled to act.

58. If the taxpayer has not been convicted of an offence relating to a fraudulent activity section 89C(eb) can still apply provided that the Commissioner believes on reasonable grounds that the taxpayer has been involved in a fraudulent activity.

59. If Inland Revenue officers apply the exception under section 89C(eb), this should be supported by sufficient evidence of the "reasonable grounds" relied on. The evidence does not have to be absolute proof but, merely sufficient to verify the "reasonable grounds".

Exception 8: Vexatious or frivolous

60. Section 89C(f) reads:

> The assessment corrects a tax position previously taken by a taxpayer that, in the opinion of the Commissioner is, or is the result of, a vexatious or frivolous act of, or vexatious or frivolous failure to act by, the taxpayer.

61. If Inland Revenue officers apply this exception, this should be supported by documentation that evidences:

(a) the action or inaction giving rise to the tax positions previously taken, and

(b) why that action is considered to be vexatious or frivolous and any shortfall penalties/prosecution consideration. Examples of a tax position taken as result of a vexatious or frivolous act are a tax position that is:

  (i) clearly lacking in substance, for example, where the taxpayer continues to take the same position that has previously been finalised, or

  (ii) motivated by the sole purpose of delay.

62. Where this exception applies, the Commissioner must also consider the imposition of shortfall penalties in respect of the taxpayer's tax position resulting from a vexatious or frivolous act.

Exception 9: Taxation Review Authority or court determination

63. Section 89C(g) reads:

> The assessment is made as a result of a direction or determination of a court or the Taxation Review Authority.

64. For the purpose of section 89C(g), a direction or determination includes any court or TRA decision that affects the particular taxpayer in relation to a specific tax period and a court decision on a "test case" that applies to the taxpayer irrespective of whether they were a party to the test case.

65. The Commissioner must retain a copy of the direction or determination to support the application of this exception. In these circumstances, the Commissioner will endeavour to make an assessment including imposing shortfall penalties, within two weeks after receiving the written direction or determination. However, if the direction or determination relates to a test case the Commissioner can issue an assessment within the period specified under section 89O(5).

Exception 10: "Default assessment"

66. Section 89C(h) reads:

> The taxpayer has not provided a tax return when and as required by a tax law.

67. If section 89C(h) applies because the taxpayer has failed to provide a tax return the Commissioner can make an assessment or amended assessment pursuant to section 106(1) (commonly known as a "default assessment").

68. Where a taxpayer seeks to dispute a default assessment through the disputes process, the taxpayer must, within the applicable response period (that is, four months from the date that the default assessment is issued):

    (a) provide a tax return in the prescribed form for the period to which the default assessment relates (pursuant to section 89D(2C) for GST and section 89D(2) for all other tax types) notwithstanding that the tax return will not include the taxpayer's assessment, and

    (b) issue a NOPA to the Commissioner in respect of the default assessment.

69. The requirement to provide a tax return in respect of a default assessment made under section 106(1) before issuing a NOPA is an additional requirement of the disputes process. This ensures that the taxpayer has provided the information that is required by the tax law before they are entitled to dispute the assessment.

70. If the Commissioner agrees with the taxpayer's NOPA and tax return, the Commissioner will generally amend the default assessment by exercising the discretion under section 113, subject to the statutory time bar in section 108 and any other relevant limitations. However, if the Commissioner does not agree with the taxpayer's tax return and NOPA the Commissioner can decide to not amend the default assessment and issue a NOR instead.

71. If a taxpayer cannot provide a NOPA because they are outside the applicable response period to dispute a default assessment or do not want to enter into the disputes process, they must still provide a tax return.

72. Although the Commissioner does not have to amend the initial assessment on receipt of the tax return from a defaulting taxpayer, the Commissioner can exercise the discretion to amend under section 113 subject to the time bar in section 108 or 108A and any other relevant limitations on the exercise of that discretion.

73. If the Commissioner decides not to exercise the discretion under section 113 the Commissioner can issue a NOPA in respect of the default assessment under section 89B(1) where, for example, new information received from the taxpayer suggests that the default assessment is incorrect.

74. The Commissioner is not precluded from further investigating an amended assessment issued on the basis of the taxpayer's tax return and, if necessary, issuing a NOPA to the taxpayer.

Exception 11: Failure to make or account for tax deductions

75. Section 89C(i) reads:

> The assessment is made following the failure by a taxpayer to withhold or deduct an amount required to be withheld or deducted by a tax law or to account for an amount withheld or deducted in the manner required by a tax law.

76. This exception is intended to address a taxpayer's failure to withhold, deduct or account to the Commissioner for an amount of tax including PAYE, schedular payments to non-resident contractors and resident withholding tax ("RWT"). The Commissioner must also consider whether shortfall penalties are applicable.

77. The Commissioner may not apply this exception if there is a dispute that involves statutory interpretation (for example, whether a particular item attracts liability for RWT meaning that the taxpayer was required to withhold or deduct RWT) and/or shortfall penalties.

Exception 12: Non-assessed tax return

78. Section 89C(j) reads:

> The taxpayer is entitled to issue a notice of proposed adjustment in respect of a tax return provided by the taxpayer, and has done so.

79. If a taxpayer proposes an adjustment in a NOPA with which the Commissioner agrees, an assessment can be issued without first issuing a NOPA. This exception only applies to an adjustment that the taxpayer has proposed in their NOPA under section 89DA(1) within the applicable response period.

Exception 13: Consequential adjustment

80. Section 89C(k) reads:

> The assessment corrects a tax position taken by the taxpayer or an associated person as a consequence or result of an incorrect tax position taken by another taxpayer, and, at the time the Commissioner makes the assessment, the Commissioner has made, or is able to make, an assessment for that other taxpayer for the correct amount of tax payable by that other taxpayer …

81. If transactions affect multiple taxpayers, whether in the same way or in related but opposite ways,

the Commissioner can reassess any consequentially affected taxpayers under section 89C(k). This is notwithstanding that the consequentially affected taxpayers have not agreed to the amended assessments.

82. However, those taxpayers subject to the amended assessments may still issue a NOPA to dispute the consequential adjustment within the applicable response period. The Commissioner must also consider whether shortfall penalties are applicable.

83. Section 109(b) deems any assessment that the Commissioner makes to be correct. Therefore, the Commissioner can make any consequential amendment under section 89C(k). However, the Commissioner must be satisfied that there is a direct consequential link between the taxpayers before making any adjustment. For example:

(a) Group loss offsets: if a loss company has claimed losses to which it is not entitled and the Commissioner has amended the loss company's loss assessment to disallow those losses, pursuant to section 89C(k), the Commissioner can also make a separate assessment for the profit company that had offset the loss company's losses against its profits.

(b) GST: the supplier and recipient of a supply have incorrectly assumed that a transaction was GST-exempt. The Commissioner later agrees that the recipient was entitled to a GST input tax credit and issues an assessment to them allowing the credit. The Commissioner can also issue an assessment to the supplier under section 89C(k) in respect of the output tax on the value of the supply.

A taxpayer can dispute an assessment that is issued without a NOPA

84. The Commissioner can issue an assessment without first issuing a NOPA under section 89C in the circumstances outlined above. Although the Commissioner must always endeavour to apply the exceptions under section 89C correctly, any assessment made in breach of section 89C will still be treated as valid under section 114(a).

85. Where the Commissioner issues an assessment without first issuing a NOPA, the taxpayer can dispute the assessment through the disputes process under section 89D(1). (See SPS 10/05: *Disputes resolution process commenced by a taxpayer or any replacement SPS.*)

86. However, where the Commissioner issues a NOPA to a taxpayer and they accept the proposed adjustment by written agreement or are deemed to have accepted the proposed adjustment, then section 89I(1) precludes the taxpayer from challenging the assessment.

87. However, section 89I cannot apply if the Commissioner and taxpayer have agreed on an adjustment before entering into the disputes process. The parties can dispute the amended assessment, notwithstanding the previous agreement.

When the Commissioner can issue a NOPA

88. Section 89B specifies when the Commissioner can issue a NOPA.

89. Under section 89B(1) the Commissioner can issue one NOPA for multiple issues, tax types and periods. Alternatively, the Commissioner can issue multiple NOPAs for the same issue and period, consistent with the obligation to correctly make an assessment within the four-year statutory time period.

90. An investigation will have been substantially completed, the facts ascertained, and the proposed adjustment identified and discussed with the taxpayer before a formal NOPA is issued. The Commissioner may actively use his powers to require production of documents in order to ensure that a sustainable position can be taken in the NOPA. The NOPA will also have been quality checked by the Legal and Technical Services.

91. A NOPA is not an assessment. It is an initiating action that allows open and full communication between the parties. If possible, the taxpayer will be given the opportunity to settle a dispute by entering into an agreed adjustment with Inland Revenue before the Commissioner issues a NOPA.

92. However, the Commissioner or taxpayer is not precluded from issuing a NOPA in respect of any amended assessment that the Commissioner has previously issued to reflect the agreed adjustment.

93. A NOPA forms a basis for ensuring that the Commissioner does not issue an assessment without some formal and structured dialogue with the taxpayer in respect of the grounds upon which the Commissioner will issue any assessment or amended assessment (*McIlraith v CIR* (2007) 23 NZTC 21,456).

94. Once an investigation has commenced, the intended approach must be discussed with the taxpayer. If the Commissioner decides to issue a NOPA, the responsible officer will endeavour to advise the taxpayer at least five working days before the date that the NOPA is issued. This is to allow the taxpayer time to consider their position and/or seek advice. However, the taxpayer can also be advised earlier.

95. The Commissioner will endeavour to ensure that any issues relating to the same period and tax type are kept together in the dispute.

96. The Commissioner can also exercise certain statutory powers (for example, issuing a section 17 notice) after a dispute has commenced and will continue to investigate the facts that relate to the dispute.

97. If the parties agree upon some and dispute other proposed adjustments for the same tax period and type, the Commissioner cannot issue an assessment that reflects any agreed adjustment already accepted under section 89J(1) until all the remaining disputed issues are resolved (even if the Commissioner does not pursue the disputed issue further) or determined by the Adjudication Unit. That is, the Commissioner will not issue a "partial" or "interim" assessment under section 89J(1) if the Commissioner is not satisfied that the assessment is correct.

98. However, where the statutory time bar is about to fall due, the Commissioner can issue an assessment to reflect both the agreed and disputed adjustment, provided that the requirements of section 89N are met. (See paragraphs 152 to 195 for further discussion.)

99. Where it is practicable, Inland Revenue officers will contact the taxpayer or their tax agent within 10 working days after the NOPA is issued to ensure that it has been received. Inland Revenue officers making written contact should comply with section 14.

Exceptions to the statutory time bar

Time bar waivers

100. If it is contemplated that the disputes process cannot be completed before the statutory time bar period for amending an assessment commences, the parties can agree in writing pursuant to section 108B(1)(a) to waive the time bar by up to 12 months to enable the full disputes process to be applied.

101. The taxpayer can also give written notice to the Commissioner and waive the time bar for a further six months after the end of the 12-month period under section 108B(1)(b) to allow sufficient time for the dispute to progress through the adjudication process. This notice must be given to the Commissioner within the initial 12-month period.

102. If the time bar is waived, the taxpayer must be advised in writing that:

(a) a NOPA will be issued, and

(b) the disputes process will be followed.

103. To be effective, a statutory time bar waiver must be agreed in writing on the prescribed form (*IR 775 Notice of waiver of time bar*) and delivered to the Commissioner before the relevant four-year period expires.

104. The statutory time bar waiver only applies to those issues that the parties have identified and understood before the initial statutory time bar. Other issues not so identified will still be subject to the original statutory time bar, unless section 108(2) or 108A(3) applies. (See paragraph 110 in this SPS.)

The Commissioner's application to the High Court under section 89N(3)

105. If a NOPA has been issued and the disputes process cannot be completed before the statutory time bar period expires, the Commissioner can apply to the High Court for more time to complete the process. (See the discussion regarding section 89N(3) in paragraphs 182 to 193).

106. However, where the Adjudication Unit has insufficient time (that is, before the statutory time bar arises or further time allowed under section 108B(1) to fully consider a matter submitted to it expires) the matter will be returned to the responsible officer to decide whether to issue an assessment or amended assessment or to accept the taxpayer's position. Section 89N(2)(b) allows the Commissioner to amend an assessment at any time after the Commissioner has considered the taxpayer's SOP in relation to the particular period. (See paragraphs 318 to 320 for further discussion.)

Exceptions under section 89N(1)

107. When a NOPA has been issued, the Commissioner will follow the disputes process unless an exception under section 89N applies. (The application of section 89N is discussed in detail later in paragraphs 151 to 192). The Commissioner must obtain and document administrative approval for any departure from the full disputes process.

Limitations on the Commissioner issuing a NOPA

108. Under section 89B(4), the Commissioner cannot issue a NOPA:

(a) if the proposed adjustment is the subject of challenge proceedings, or

(b) after the statutory time bar has expired.

109. The time bar that arises under sections 108 and 108A prevents the Commissioner from issuing an assessment that increases the amount assessed. The Commissioner can still issue an assessment that

decreases the amount of the initial assessment subject to the limitation on refunding overpaid tax under sections RM 2(1) of the ITA 2007 and 45(1) of the Goods and Services Tax Act 1985.

110. However, the Commissioner is not subject to the statutory time bar that arises under sections 108 and 108A, if the Commissioner considers that the taxpayer has:

(a) provided a fraudulent or willfully misleading tax return (section 108(2)(a)), or

(b) omitted income for which a tax return must be provided that is of a particular nature or source (section 108(2)(b)), or

(c) knowingly or fraudulently failed to make a full and true disclosure of the material facts necessary to determine their GST payable (section 108A(3)).

111. Furthermore, the Commissioner is not subject to the statutory time bar that arises under section 108 if a taxpayer has a remaining tax credit to which section LA 6(1) of the ITA 2007 applies and the Commissioner seeks to amend an assessment or determination to give effect to section LA 6(3) of the ITA 2007 (section 108(3B)).

112. When considering whether the exception under section 108(2)(b) applies, the Commissioner will disregard omissions of relatively small amounts of income by applying the principle of *de minimis non curat lex* (*Babington v C of IR* [1957] NZLR 861).

113. The Commissioner accepts that the time bar ensures finality in relation to assessments, is a key protection for most taxpayers and the exclusions from its protection must be only invoked where there is an adequate basis in fact and law to support their operation. Section 89B(4)(b) requires that the Commissioner initially decides whether an exception to the time bar applies, for example, whether a tax return is fraudulent or willfully misleading, before determining whether a NOPA can be issued under section 89B(1).

114. Any opinion that the Commissioner forms regarding the application of the exceptions to the time bar must be honestly held and reasonably justifiable on the basis of the evidence available and the relevant law. The decision must be clearly documented and include reference to the grounds and reasoning on which it is based.

115. Any decision to examine a particular period (which would otherwise be time barred) on the basis that section 108(2)(a), 108(2)(b) or section 108A(3) may apply, is not, in itself, a disputable decision. Nor is any decision that is made under section 108A, in itself, a disputable decision.

116. Any NOPA where the CIR is proposing an adjustment on the basis that the exception to the time bar in either 108(2)(a), 108(2)(b) or section 108A(3) applies will set out the reasons why the CIR does not consider that the time bar applies.

117. The Commissioner is generally limited to a four-year period within which a taxpayer's assessment can be increased following an investigation or in certain other circumstances. In respect of a dispute, the assessment is amended (if necessary) after the disputes process is completed. The Commissioner will endeavour to undertake the various steps involved in the process within the four-year period.

118. Section 89B(4)(a) applies to individual proposed adjustments. Where the proposed adjustment is the subject of court proceedings, the Commissioner cannot issue a NOPA in respect of those proposed adjustments. However, the Commissioner can issue a separate NOPA to the taxpayer in relation to the same tax period provided it relates to a different adjustment.

119. For example, a taxpayer challenges the deductibility of feasibility expenditure in the 2009 tax year pursuant to section 138B. The Commissioner can also issue a NOPA to the same taxpayer in relation to the tax treatment of a bad debt in the same tax year.

Contents of the Commissioner's NOPA

120. A NOPA is the document that commences the disputes process. It is intended to identify the points of contention and explain the legal or technical aspects of the issuer's position in relation to the proposed adjustment in a formal and understandable manner. This will ensure that information relevant to the dispute is quickly made available to the parties. Section 89F(1) and (2) specifies the content requirements for any NOPA that the Commissioner may issue.

121. Under section 89F(1)(b), the NOPA must be in the prescribed form (*IR 770 Notice of proposed adjustment*). Any NOPA that the Commissioner issues must identify in sufficient detail the adjustment proposed and explain concisely the facts and law that relate to the adjustment and how the law applies to the facts. When preparing a NOPA the Commissioner will endeavour to avoid repeating facts, arguments or using unnecessary detail.

122. Section 89F(2)(b) requires that the NOPA states the key facts and law concisely and in sufficient detail. The Commissioner must ensure that the document is relatively brief and simple to enable the parties to quickly progress the dispute without incurring substantial expenses or excessive preparation time but also detailed enough to explain all the issues relevant to the dispute. The Commissioner's NOPAs should be concise, accurate, coherent and logically presented. In preparing a NOPA Inland Revenue officers should avoid unnecessarily using legalistic language.

123. The Commissioner should identify (but not reproduce in full) the relevant legislation and legal principles derived from leading cases. These references should be in sufficient detail to clarify the grounds for the proposed adjustment. However, lengthy quotations from cases should be avoided.

124. The Commissioner has a statutory obligation to inform a taxpayer adequately, but it is recognised that the matters relevant to the dispute will be set out in greater detail at the SOP phase if the dispute is not resolved.

125. Therefore, what is included in a NOPA or NOR is not conclusive as between the parties because they can introduce further grounds or information or adjust the quantum of the proposed adjustments later in the disputes process (*CIR v Zentrum Holdings Limited* (2006) 22 NZTC 19,912). However, the parties cannot propose another adjustment involving new grounds and a fresh liability at the SOP phase.

126. The Commissioner must always endeavour to issue a NOPA that has sufficient details, is of a high standard and has been considered by Legal and Technical Services. The Commissioner must endeavour to advise the taxpayer during the conference phase of any new grounds, information or reduction in quantum that will be introduced in the SOP.

127. If the Commissioner decides to increase the quantum of any proposed adjustment after the NOPA is issued the Commissioner must issue a new NOPA to the taxpayer.

128. Although candid and complete exchanges of information are implicit in the spirit and intent of the disputes process, the Commissioner's practice will be to ensure that the NOPA is, within those limits, as brief as practicable.

129. The content of any NOPA that the Commissioner issues must satisfy all the requirements specified in section 89F(2)(a) to (c).

Identify adjustments or proposed adjustments – section 89F(2)(a)

130. The Commissioner must consider in respect of each proposed adjustment:

(a) the income amount or impact of the adjustment, and

(b) the tax year or period to which the proposed adjustment relates, and

(c) whether use of money interest will apply.

131. The Commissioner will also consider whether shortfall penalties and/or other appropriate penalties of lesser percentages apply. That is, where sufficient evidence is held to support the imposition of the penalties and this can be justified (by reference to any relevant guidelines).

Shortfall penalties

132. Shortfall penalties are separate items of adjustment that must be explained and supported in the same manner as the underlying tax shortfall. Section 94A(2) also requires that shortfall penalties must be assessed the same way as the underlying tax. Even though assessments of shortfall penalties relate to the underlying tax they are not subject to the time bars that arise under section 108 or 108A.

133. Where there is sufficient evidence to suggest that shortfall penalties should be imposed, the relevant Inland Revenue officer must ensure that the shortfall penalties are proposed in the same NOPA as the substantive issues. However, the officer can dispense with this practice if any of the following exceptions apply:

(a) The evidence supporting the imposition of shortfall penalties does not become available until after the Commissioner has issued the NOPA on the substantive issues. In such circumstances, a separate NOPA may be issued in respect of the shortfall penalties at a later stage.

(b) Before entering into the disputes process, a taxpayer has accepted the proposed adjustment in relation to the substantive issues, but not accepted the imposition of the shortfall penalties. In this circumstance, the Commissioner may still issue a NOPA to the taxpayer for the proposed penalties.

(c) The taxpayer makes a voluntary disclosure of the substantive issues to the Commissioner and the only disputed issue relates to the imposition of the shortfall penalties.

(d) Prosecution action is being considered and shortfall penalties also apply because the taxpayer has committed one of the culpable acts (for example, evasion), in most instances the Commissioner must first complete any prosecution action against the taxpayer before the shortfall penalties can be imposed.

134. Pursuant to section 149(5), if shortfall penalties have been imposed the Commissioner cannot subsequently prosecute the taxpayer for taking the incorrect tax position unless the shortfall penalties are imposed under section 141ED. Therefore, the Commissioner may omit proposing shortfall penalties in a NOPA if prosecution is being considered as an option. The Commissioner must issue a new NOPA in respect of any shortfall penalties that are to be imposed after the prosecution.

135. Furthermore, the Commissioner cannot propose shortfall penalties at the SOP phase if they were not previously proposed in a Commissioner's NOPA.

State the facts and law – section 89F(2)(b)

Facts

136. To provide a concise statement of facts, the Commissioner must focus on the material factual matters relevant to the legal issues. This includes, for each proposed adjustment, the facts relevant to proving all arguments made in support of the adjustment including any facts that are inconsistent with any arguments that the taxpayer has previously raised.

137. The Commissioner should endeavour to state all the material facts in brief, so as to avoid irrelevant detail or repetition. For example, where the parties both know the background to the disputed issues, a summary of the facts in the NOPA will suffice. Where possible, the Commissioner will refer to and/or append any documents that have previously set out the facts on which the Commissioner relies.

138. Although the Commissioner will make every attempt to be concise in the NOPA, the Commissioner considers that the explanation of the material facts should be relative to the complexity of the issues.

Law

139. Under section 89F(2)(b) the Commissioner must state the law concisely by including an outline of the relevant legislative provisions and principles derived from leading cases that affect the proposed adjustment.

140. It is sufficient that the Commissioner explains the nature of the legal arguments without providing lengthy quotations from the relevant case law.

How the law applies to the facts – section 89F(2)(c)

141. The Commissioner must apply the legal arguments to the facts to ensure that the proposed adjustment is not a statement that appears out of context. The application of the law to the facts must be stated concisely and logically support the proposed adjustment.

142. The Commissioner must outline all relevant materials and arguments (including alternative arguments) on which the Commissioner intends to rely. If more than one argument supports the same or a similar outcome, the NOPA must include all the arguments.

143. The evidence exclusion rule under section 138G(1) does not apply to the issues, facts, evidence and propositions of law that are raised in the Commissioner's NOPA. That is, the Commissioner is not restricted to raising the same issues, facts, evidence and propositions of law that are specified in the NOPA at the SOP phase or in challenge proceedings that the taxpayer has commenced where a disclosure notice has not been issued.

Size and length of Commissioner's NOPAs

General guidelines

144. The length of a Commissioner's NOPA will necessarily vary from case to case. The **maximum length** of a Commissioner's NOPA is administratively capped at 30 pages. The 30-page limit excludes any discussion on shortfall penalties (if included in the same Commissioner's NOPA as the substantive issues), the last page of instructions on "What to do next", and schedules that show complicated calculations and diagrams. The application of the 30-page limit is subject to the following further restrictions:

(a) For disputes involving less than $5,000 of tax (excluding evasion and tax avoidance issues), the Commissioner's NOPA should not exceed five pages.

(b) Where the dispute concerns one issue only (for example, the imposition of shortfall penalties), the Commissioner's NOPA should not exceed ten pages.

145. A longer Commissioner's NOPA may be appropriate, where the dispute concerns multiple issues or the issue is very complex and involves a substantial amount of tax.

146. The Commissioner will strive to keep NOPAs as short as possible, but this will be balanced with the need to achieve the objective of issuing the NOPA, (ie sufficiently communicating to the recipient the proposed adjustments and the reasons for them). Inland Revenue officers are required to get approval

before a Commissioner's NOPA can exceed the 30-page limit.

147. Wherever practicable, all adjustments proposed for a particular taxpayer should be included in one NOPA. However, where new issues arise during the disputes process, the Commissioner is not precluded from commencing separate disputes for these new issues. If the parties are still in dispute after the conference phase, the proposed adjustments in multiple NOPAs may, subject to the taxpayer's agreement, be combined into one SOP. Combining multiple issues into one dispute has the benefit of reducing compliance costs and should reduce the time taken in the disputes process.

Timeframes to complete the disputes process

148. If the Commissioner has commenced the disputes process by issuing a NOPA and the dispute remains unresolved, where practicable, the responsible officer must negotiate a timeframe with the taxpayer to ensure that the dispute is progressed in a timely and efficient way.

149. Although not statutorily required, agreeing to a timeframe is a critical administrative requirement that requires both parties to be ready to progress the dispute in a timely manner. The parties should endeavour to meet the agreed timeframe. Where there are delays in the progress of the dispute the responsible officer will manage the delay including any relationship with internal advisers and liaise with the taxpayer.

150. If the negotiated timeframe cannot be achieved, the responsible officer will enter into a continuing discussion with the taxpayer to either arrange a new timeframe or otherwise keep them advised of when the disclosure notice and SOP will be issued. This is consistent with the purpose of the disputes process which is to promote the prompt and efficient resolution of disputes. Therefore, the failure to negotiate or adhere to an agreed timeframe will not prevent a case from progressing through the disputes process in a timely manner.

151. In addition to the above administrative practice, the Commissioner is bound by section 89N(2). Under that provision, if a NOPA has been issued and the parties cannot agree on the proposed adjustment, the Commissioner cannot amend an assessment without completing the disputes process unless any of the exceptions in section 89N(1)(c) apply. These exceptions are explained in paragraphs 152 to 193. If any of these exceptions apply the disputes process will end and the dispute will not go through the adjudication phase.

Exceptions – when an assessment can be issued without completing the disputes process – section 89N

152. If a NOPA has been issued and the dispute is unresolved, the Commissioner can issue an assessment without completing the disputes process under the following circumstances:

Exception 1: In the course of the dispute, the Commissioner considers that the taxpayer has committed an offence under an Inland Revenue Act that has had the effect of delaying the completion of the disputes process (section 89N(1)(c)(i))

153. Section 89N(1)(c)(i) reads:

> (i) the Commissioner notifies the disputant that, in the Commissioner's opinion, the disputant in the course of the dispute has committed an offence under an Inland Revenue Act that has had an effect of delaying the completion of the disputes process:

154. This exception applies where the Commissioner may need to act quickly to issue an assessment because it is considered that the taxpayer has committed an offence under an Inland Revenue Act that has caused undue delay to the progress of the dispute.

155. For example, in the course of a dispute a taxpayer obstructed Inland Revenue officers in obtaining information from the taxpayer's business premise under section 16. The Commissioner will advise the taxpayer in writing that it is considered that an offence has been committed under section 143H. The offence has the effect of delaying the completion of the disputes process meaning that the Commissioner does not have to complete that process and can amend the taxpayer's assessment under section 113.

156. Another example of when the exception may apply is where, in the course of a dispute, a taxpayer willfully refuses to attend an enquiry made under section 19 on the date specified in the Commissioner's notice. In these circumstances, the Commissioner will advise the taxpayer in writing that that it is considered that an offence has been committed under section 143F that has had the effect of delaying the completion of the disputes process. The Commissioner can then exercise the discretion to amend the taxpayer's assessment under section 113 without completing the disputes process.

157. In order to apply this exception, Inland Revenue officers must form an opinion that is honestly and reasonably justifiable on the basis of the evidence available. The Inland Revenue officer's decision must be clearly documented and stipulate the grounds and reasoning on which it is based.

Exception 2: A taxpayer involved in a dispute, or person associated to them, may take steps to shift, relocate or dispose of the taxpayer's assets to avoid or delay the collection of tax, making the issue of an assessment urgent (section 89N(1)(c)(ii) and (iii))

158. If the Commissioner has reasonable grounds to believe that the taxpayer or a person associated with them ("associated person") intends to dispose of assets in order to avoid or defer the payment of an outstanding or pending tax liability, the Commissioner can urgently issue an assessment to the taxpayer. Section 89N(1)(c)(ii) & (iii) reads:

> (ii) the Commissioner has reasonable grounds to believe that the disputant may take steps in relation to the existence or location of the disputant's assets to avoid or delay the collection of tax from the disputant:
>
> (iii) the Commissioner has reasonable grounds to believe that a person who is an associated person of the disputant may take steps in relation to the existence or location of the disputant's assets to avoid or delay the collection of tax from the disputant:

159. In order to issue an assessment on the basis of either of the above exceptions, Inland Revenue officers must record any relevant correspondence and evidence (for example, the directors' written instructions to shift the company's assets overseas, evidence of electronic wiring of funds to overseas countries, transcripts of interviews with the taxpayer, etc) or other grounds for the reasonable belief.

Exception 3: The taxpayer involved in a dispute or a person associated with them involved in another dispute involving similar issues has begun judicial review proceedings in relation to the dispute (section 89N(1)(c)(iv) and (v))

160. Section 89N(1)(c)(iv) and (v) reads:

> (iv) the disputant has begun judicial review proceedings in relation to the dispute:
>
> (v) a person who is an associated person of the disputant and is involved in another dispute with the Commissioner involving similar issues has begun judicial review proceedings in relation to the other dispute:

161. These exceptions apply to any judicial review proceedings that are brought against the Commissioner. In judicial review proceedings, the parties' resources are likely to be directed away from advancing the dispute through the disputes process.

162. For the purpose of section 89N(1)(c)(v), an associated person of a taxpayer may be involved in a similar issue to the taxpayer even if the issue relates to a different revenue type. For example, if the dispute between the Commissioner and taxpayer relates to PAYE issues, but the dispute between the Commissioner and person associated with the taxpayer relates to income tax the taxpayer may still be involved in similar issues to the person associated with them.

163. Even if the two disputes relate to the same revenue type, section 89N(1)(c)(v) will not apply in some circumstances. For example, the dispute with the taxpayer relates to the tax treatment of entertainment expenditure, whereas the dispute with the person associated with the taxpayer relates to the capital and revenue distinction of merger expenditure. The Commissioner would not regard these two disputes as involving similar issues.

Exception 4: The taxpayer fails to comply with a statutory requirement for information relating to the dispute (section 89N(1)(c)(vi))

164. Section 89N(1)(c)(vi) reads:

> (vi) during the disputes process, the disputant receives from the Commissioner a requirement under a statute for information relating to the dispute and fails to comply with the requirement within a period that is specified in the requirement:

165. Generally, a taxpayer provides information to Inland Revenue voluntarily. However, when this does not occur the Commissioner can seek information from the taxpayer under a statutory provision, for example sections 17 or 19. (The Commissioner's practice regarding section 17 is currently set out in SPS 05/08: *Section 17 Notices.*) The requirement for statutory information will specify the period within which the information must be provided. This period will allow the taxpayer reasonable and sufficient time to comply.

166. Where the taxpayer does not comply with a formal requirement for information that relates to a dispute (for example, as a tactic to delay the progress of the disputes process), the Commissioner can issue an assessment to the taxpayer without first completing the disputes process.

Exception 5: The taxpayer elects to have the dispute heard by the TRA acting in its small claims jurisdiction (section 89N(1)(c)(vii))

167. Section 89N(1)(c)(vii) reads:

> (vii) the disputant elects under section 89E to have the dispute heard by a TRA acting in its small claims jurisdiction:

168. A taxpayer can issue a NOPA to the Commissioner under section 89D or 89DA or a NOR rejecting a NOPA issued by the Commissioner under section 89B. (See SPS 10/05: *Disputes resolution process commenced by a taxpayer and any replacement SPS.*)

169. At the same time, under section 89E(1)(a) the taxpayer can elect in their NOPA or NOR that the TRA acting in its small claims jurisdiction should hear any unresolved dispute arising from the NOPA (whether issued by the Commissioner or taxpayer), if the amount in dispute is $30,000 or less. Any such election is irrevocable, final and binding on the taxpayer. In this case, the full disputes process does not have to be followed.

Exception 6: The parties agree in writing that the dispute should be resolved by the court or TRA without completing the disputes process (section 89N(1)(c)(viii))

170. Section 89N(1)(c)(viii) reads:

> (viii)the disputant and the Commissioner agree in writing that they have reached a position in which the dispute would be resolved more efficiently by being submitted to the court or TRA without completion of the disputes process:

171. Under this exception, where the Commissioner or taxpayer commences the disputes process, the parties can make such an agreement in writing before either party issues their SOP. This would occur, for example, if the parties could incur excessive compliance and administrative costs in completing the full disputes process relative to the amount in dispute.

172. This exception allows the taxpayer to bring challenge proceedings against the Commissioner. The parties must have exchanged a NOPA and NOR before the taxpayer can bring challenge proceedings under section 138B(1).

173. The circumstances under which the Commissioner will enter into such an agreement are discussed in detail from paragraph 261 to 285. This SPS refers to this exception as opting out of the disputes process or "opt out".

Exception 7: The parties agree in writing to suspend the disputes process pending the outcome of a test case (section 89N(1)(c)(ix))

174. Section 89N(1)(c)(ix) reads:

> (ix) the disputant and the Commissioner agree in writing to suspend proceedings in the dispute pending a decision in a test case referred to in section 89O.

175. Section 89O(2) allows a dispute to be suspended pending the result of a test case. Pursuant to section 89O(3), the parties can agree in writing to suspend the dispute from the date of the agreement until the earliest date that:

(a) the court's decision is made, or

(b) the test case is otherwise resolved, or

(c) the dispute is otherwise resolved.

176. If the parties agree to suspend the disputes process, any statutory time bar affecting the dispute is stayed. The Commissioner can then make an assessment that is consistent with the test case decision. (However, the taxpayer is not precluded from challenging the Commissioner's assessment under section 89D(1), even if it is consistent with the test case decision.)

177. The Commissioner must issue an amended assessment or perform an action within the time limit specified in section 89O(5).

178. Section 89O(5) reads:

> The Commissioner must make an amended assessment, or perform an action, that is the subject of a suspended dispute by the later of the following:
>
> (a) the day that is 60 days after the last day of the suspension:
>
> (b) the last day of the period that—
>
> (i) begins on the day following the day by which the Commissioner, in the absence of the suspension, would be required under the Inland Revenue Acts to make the amended assessment, or perform the action; and
>
> (ii) contains the same number of days as does the period of the suspension.

179. If the statutory time bar arising under section 108 or 108A is imminent, section 89O(5) allows the Commissioner more time to complete the disputes process.

180. For example, the Commissioner commences a dispute and on 1 March 2010 agrees with the taxpayer in writing to suspend the disputes proceedings pending the decision in a designated test case. The disputed issue is subject to a statutory time bar that commences after 31 March 2010 and the taxpayer does not agree to delay its application under section 108B(1)(a). A decision is reached in the test case on 31 July 2010.

181. The Commissioner must make an amended assessment or perform an action that is the subject of the suspended dispute by 29 September 2010. This date is calculated as follows:

(a) The suspension period commences on the date of the agreement (1 March 2010) and ends on the date of the court's decision in the test case (31 July 2010). This is a period of 153 days.

(b) The last date that the Commissioner can make an amended assessment falls on the later of the following two dates:

(i) 29 September 2010, that is 60 days after the date that the suspension period ends on 31 July 2010 pursuant to section 89O(5)(a), and

(ii) 31 August 2010, that is 153 days after the period commences on 1 April 2010 pursuant to section 89O(5)(b).

Exception 8: The Commissioner applies to the High Court for an order to allow more time to complete or dispense with the disputes process

182. Section 89N(3) reads:

> … [T]he Commissioner may apply to the High Court for an order that allows more time for the completion of the disputes process, or for an order that completion of the disputes process is not required.

183. The Commissioner envisages that this exception will be used if section 89N(1)(c) does not apply and there are exceptional circumstances.

184. Any application made by the Commissioner under section 89N(3) must be based on reasonable grounds. Whether there are reasonable grounds will depend on considerations such as the complexity of the issues in the dispute, whether the taxpayer has caused delays; whether the dispute involves large amounts of revenue or whether there were significant matters in the dispute that were unforeseen by either party and provided a justification for the delay.

185. For example, due to unusual circumstances the Commissioner does not learn about a proposed adjustment until late. Further delays by the taxpayer and the need for the Commissioner to obtain significant legal advice means that the Adjudication Unit cannot consider the dispute before the time bar applies. In these circumstances, the Commissioner may apply to the High Court for an order that allows more time for the disputes process to be completed under section 89N(3). (Note: This is only an example of a possible unforeseen situation and it is anticipated that there will be a wide variety of circumstances under which an application under section 89N(3) will be appropriate.)

186. The Commissioner's application to the High Court under section 89N(3) be made before the four-year statutory time bar falls due.

187. The Commissioner must also issue an amended assessment within the time limit specified in section 89N(5). Section 89N(5) reads:

> If the Commissioner makes an application under subsection (3), the Commissioner must make an amended assessment by the last day of the period that—
>
> (a) begins on the day following the day by which the Commissioner, in the absence of the suspension, would be required under the Inland Revenue Acts to make the amended assessment; and
>
> (b) contains the total of—
>
> (i) the number of days between the date on which the Commissioner files the application in the High Court and the earliest date on which the application is decided by the High Court or the application or dispute is resolved:
>
> (ii) the number of days allowed by an order of a court as a result of the application.

188. Section 89N(5) allows the Commissioner more time to complete the disputes process where the statutory time bar under section 108 or 108A is imminent.

189. For example, the Commissioner commences the disputes process. On 1 March 2010 the Commissioner applies to the High Court under section 89N(3) for an order allowing more time to complete the process. The disputed issue is subject to a statutory time bar that commences after 31 March 2010 and the taxpayer does not agree to delay its application under section 108B(1)(a). On 30 June 2010, the High Court makes an order that allows the Commissioner's application and gives the Commissioner 30 further days to complete the disputes process.

190. Pursuant to section 89N(5), the Commissioner must make an amended assessment by 30 August 2010. This date is calculated as follows:

(a) The Commissioner would have one month to make the amended assessment before the statutory time bar commences. That is, 1 March 2010 to 31 March 2010. The period during which an amended assessment must be made under section 89N(5)(a) commences on 1 April 2010.

(b) The period during which the assessment must be made includes 122 days, that is the period between 1 March 2010 and 30 June 2010 (the date of the decision) under section 89N(5)(b)(i) and the 30-day period allowed by the High Court order under section 89N(5)(b)(ii). This is a total of 152 days.

(c) The Commissioner must issue an amended assessment to the taxpayer on the date that is 152 days from 1 April 2010. That is, by 30 August 2010.

191. During the period from 1 March to 30 August 2010, the parties may continue to attempt to resolve the dispute. This may include exchanging SOPs and going through the adjudication process.

192. The above example indicates that the Commissioner has more time to complete the disputes process. The time bar will not commence until 30 August 2010.

193. Where the Commissioner applies to the High Court under section 89N(3) for an order to truncate the disputes process, an assessment must be issued within the period as calculated under section 89N(5).

Applying the same facts as in the above example, the Commissioner must issue an assessment to the taxpayer by 30 August 2010.

Application of the exceptions in section 89N(1)(c)

194. The Commissioner's practice is that the parties should endeavour to resolve the dispute before or via the adjudication process. If this is not possible and any of the exceptions in section 89N(1)(c) apply the Commissioner can amend an assessment without completing the whole disputes process, that is, before the parties accept a NOPA, NOR or SOP that the other has issued, or the Commissioner has considered the taxpayer's SOP. This will conclude the disputes process and the dispute will not go through the Adjudication phase.

195. In this circumstance, the taxpayer can challenge the Commissioner's assessment by filing proceedings in the TRA (either acting in its general or small claims jurisdiction) or the High Court within the applicable response period, that is, within two months starting on the date that the notice of assessment is issued.

Notice of response (NOR)

Taxpayer's response to the Commissioner's NOPA: NOR

196. If a taxpayer disagrees with the Commissioner's proposed adjustment, then, under section 89G(1), they must advise the Commissioner that any or all of the proposed adjustments are rejected by issuing a NOR within the two-month response period. That is, within two months starting on the date that the Commissioner's NOPA is issued. The Commissioner interprets this as requiring Inland Revenue's receipt of the NOR within the response period.

197. For example, if a NOPA is issued on 9 April 2010, the taxpayer must advise the Commissioner that it is rejected by issuing a NOR to the Commissioner for receipt on or before 8 June 2010. However, taxpayers are encouraged to issue their NOR to the Commissioner once they have completed it.

198. If a taxpayer has not responded to a NOPA issued by the Commissioner reasonable efforts will be made to contact the taxpayer or their tax agent two weeks before the response period expires to ascertain whether the taxpayer will issue a NOR. Such contact may be made by telephone or letter.

199. Section 89G(2) specifies the content requirements of a NOR. The taxpayer must state concisely in the NOR:

(a) the facts or legal arguments in the Commissioner's NOPA that they consider are wrong, and

(b) why they consider that those facts and arguments are wrong, and

(c) any facts and legal arguments that they rely upon, and

(d) how the legal arguments apply to the facts, and

(e) the quantitative adjustments to any figure proposed in the Commissioner's NOPA that results from the facts and legal arguments that the taxpayer relies upon.

200. In respect of the requirement under section 89G(2)(c) that the taxpayer specifies the facts and legal arguments upon which they are relying, the taxpayer can also refer to legislative provisions, case law and any legal arguments that are raised in the Commissioner's NOPA. The taxpayer does not have to refer to different legislative provisions, case law and legal arguments.

201. Pursuant to section 89G(2)(e), the requirement for a quantitative adjustment establishes to what extent the taxpayer considers that the Commissioner's adjustment in the NOPA is incorrect. This amount need not be exact, however, every attempt should be made to ensure that it is as accurate as possible. The amount in dispute can be altered, as the dispute progresses irrespective of whether the parties have agreed on the new figure.

Deemed acceptance

202. Under section 89H(1), if the taxpayer:

(a) has not issued a NOR within the two-month response period, and

(b) there are no exceptional circumstances as defined in section 89K(3),

the taxpayer is deemed to have accepted the adjustment that is proposed in the Commissioner's NOPA and section 89I applies. The Commissioner will usually advise the taxpayer that the deemed acceptance has occurred within two weeks after the two-month response period expires.

203. Pursuant to section 89I(2), the Commissioner must include or take into account each proposed adjustment that the taxpayer accepts or is deemed to accept in a notice of assessment issued to the taxpayer.

Exceptional circumstances under section 89K

204. Section 89K(3) reads:

> (a) an exceptional circumstance arises if—
>
> (i) an event or circumstance beyond the control of a disputant provides the disputant with a reasonable justification for not rejecting a proposed adjustment, or for not issuing a notice

of proposed adjustment or statement of position, within the response period for the notice:

(ii) a disputant is late in issuing a notice of proposed adjustment, notice of response or statement of position but the Commissioner considers that the lateness is minimal, or results from 1 or more statutory holidays falling in the response period:

(b) an act or omission of an agent of a disputant is not an exceptional circumstance unless—

(i) it was caused by an event or circumstance beyond the control of the agent that could not have been anticipated, and its effect could not have been avoided by compliance with accepted standards of business organisation and professional conduct; or

(ii) the agent is late in issuing a notice of proposed adjustment, notice of response or statement of position but the Commissioner considers that the lateness is minimal, or results from 1 or more statutory holidays falling in the response period.

205. The legislation defines exceptional circumstances very narrowly. The cases regarding "exceptional circumstances," such as *Treasury Technology Holdings Ltd v CIR* (1998) 18 NZTC 13,752, *Milburn NZ Ltd v CIR* (1998) 18 NZTC 14,005, *Fuji Xerox NZ Ltd v CIR* (2001) 17,470 (CA), *Hollis v CIR* (2005) 22 NZTC 19,570 and *Balich v CIR* (2007) 23 NZTC 21,230 are also relevant.

206. The case law confirms that the definition of "exceptional circumstances" in sections 89K(3) and 138D should be applied consistently. The following guidelines have emerged from the case law:

(a) a taxpayer's misunderstanding or erroneous calculation of the applicable response period will usually not be regarded as an event or circumstance beyond the taxpayer's control under section 89K(3)(a),

(b) an agent's failure to advise their client that they have received a notice of assessment or other relevant document that causes the taxpayer to respond outside the applicable response period will not generally be considered to be an exceptional circumstance under section 89K(3)(b) (*Hollis v CIR*), and

(c) an exceptional circumstance can arise if the taxpayer has relied on misleading information regarding the applicable response period given to them by the Commissioner that has caused them to respond outside that response period (*Hollis v CIR*).

207. The Commissioner will only accept a late NOR on rare occasions. See *Tax Information Bulletin* Vol 8, No 3 (August 1996) for some examples of situations that can be an "exceptional circumstance" beyond a taxpayer's control.

208. The exception for lateness as a result of statutory holidays is self explanatory. The Commissioner can also accept a late NOR where the lateness is minimal, that is, the document was only one to two days late and the other factors relevant to the exercise of the discretion under section 89K(1) are satisfied. (See discussion in paragraph 210.)

209. For example, the response period ends on Saturday and the taxpayer provides a NOR on the following Tuesday. The Commissioner treats the response period as ending on Monday on the basis of section 35(6) of the Interpretation Act 1999 and accepts that the lateness of the NOR was minimal. That is, the Commissioner has received the NOR within one to two days of Monday, the last day of the response period. If the response period ended on Friday and the taxpayer provided the NOR on the following Monday, the Commissioner would also accept that the lateness is minimal.

210. Besides the degree of lateness, the Commissioner considers that the exercise of the discretion under section 89K(1) requires that the following factors are also taken into account:

(a) the date on which the NOR was issued, and

(b) the response period within which the NOR should be issued, and

(c) the real event, circumstance or reason why the taxpayer failed to issue the NOR within the response period, and

(d) the taxpayer's compliance history in relation to the tax types under consideration (for example, has the taxpayer paid tax or filed a tax return or NOR late in the past?).

211. For example, a taxpayer issues a NOR to the Commissioner two days after the applicable response period has expired. The taxpayer does not provide a legitimate reason for the lateness. The taxpayer also has a history of filing late NORs within the minimal allowable lateness period (that is, up to two days outside the applicable response period) and has been advised on the calculation of the response period on more than one occasion.

212. Although the degree of lateness was minimal on each occasion, the Commissioner would not accept the taxpayer's NOR in this circumstance. This ensures that the section 89K(3)(b)(ii) exception is not treated as an extension of the response period in all circumstances.

213. The Commissioner will consider a taxpayer's application made under section 89K(1)(b) after receiving the relevant NOR or SOP. The responsible

officer will document the reasons for accepting or rejecting the taxpayer's application and advise the taxpayer of their decision in writing within 15 working days after Inland Revenue receives the application.

214. The taxpayer must provide reasons to support their claim that exceptional circumstances exist under section 89K(3). The taxpayer should address the factors referred to in paragraph 210. If the reasons provided are unclear, further information may be requested, giving the taxpayer an opportunity to provide that information before determining whether section 89K applies.

215. If the Commissioner rejects a taxpayer's application made under section 89K to treat a NOR or SOP as made within the response period, the taxpayer will be deemed to have accepted the proposed adjustment made in the Commissioner's NOPA. (Any decision that the Commissioner makes under section 89K is not a disputable decision.)

Receipt of a taxpayer's NOR

216. When Inland Revenue receives a taxpayer's NOR, it will usually be forwarded to the responsible officer within five working days. Upon receipt, the responsible officer will ascertain and record the following:

(a) the date on which the NOR was issued, and

(b) whether the NOR has been issued within two months starting on the date that the Commissioner's NOPA is issued, and

(c) the salient features of the NOR including any deficiencies in its content.

217. Where it is practicable, the Commissioner will advise the taxpayer or their tax agent by telephone or in writing within 10 working days the NOR has been received.

218. The Commissioner will make reasonable efforts to advise the taxpayer or their tax agent within one month after receiving the NOR whether it is being considered or has been accepted, rejected in full or in part.

219. If the NOR is accepted in full, the Commissioner will usually confirm (in writing) that the NOR has been accepted in full and, if applicable, a notice of assessment will be issued within one month.

220. If the Commissioner must investigate further before deciding to accept or reject a NOR, the responsible officer will regularly update the taxpayer or their agent on the progress of the further analysis or enquiry work that is undertaken.

Deficiencies in the content of the NOR

221. Where Inland Revenue has received a NOR that it considers is deficient (that is, the requirements under section 89G(2) may not be met), where it is possible the responsible Inland Revenue officer will take reasonable steps to have the taxpayer correct the information in the NOR before the response period expires.

222. The taxpayer will be advised as soon as practicable that the Commissioner considers that the NOR may not meet the requirements of section 89G(2) and why. They will also be advised that any additional or corrected information should be provided within the response period.

223. Taxpayers are encouraged to issue their NOR immediately after they have completed it because they could have insufficient time to rectify any deficiencies if the response period is due to expire.

224. Generally where the deficiencies are not able to be remedied but the NOR advances sufficient argument to allow the dispute to progress, then the Commissioner will continue with the dispute. The Commissioner's argument that the NOR is deficient will be incorporated into the Commissioner's SOP which will also fully argue the substantive issue.

225. However, if the NOR received is highly unsatisfactory the Commissioner is unlikely to continue with the dispute. This will be on the grounds that the NOR does not satisfy the requirements set out in section 89G(2).

226. A NOR is likely to be considered highly unsatisfactory only where the taxpayer's position is materially inconsistent and not capable of coherent explanation, or there is no observable explanation at all of the taxpayer's grounds for dispute. In these situations the taxpayer will be deemed to have accepted the proposed adjustment under section 89H(1), unless any of the exceptional circumstances under section 89K applies.

227. In considering the adequacy of the taxpayer's NOR, the Commissioner's view will not be based on the strength or weakness of the taxpayer's argument. The Commissioner will only be concerned with whether the NOR meets its statutory requirements.

228. The approach outlined above is consistent with that taken by the Court of Appeal in *CIR v Alam* and *Begum* (2009) 24 NZTC 23,564.

Conference phase

What is the conference phase of the disputes process?

229. The conference phase of the disputes process allows the taxpayer and Inland Revenue officers directly involved in the dispute to exchange material information relating to the dispute (if this has not already been done prior to the conference phase). More importantly it is an opportunity for the parties to the dispute to try to resolve the differences in their understanding of facts, laws and legal arguments.

230. The word "resolve" in this context is not limited to final resolution of the dispute. Settlement is a possibility but this is not the only objective of the conference phase. The parties may "resolve" part of the dispute by agreeing on some of the facts and clarifying some of the legal arguments, while agreeing to disagree on other matters, which will become the focus in the later phases of the disputes process.

231. Generally, if a dispute remains unresolved after the NOR phase, the conference phase will follow. However, the Commissioner will have fully considered the taxpayer's NOR including any new records, documents and information mentioned in that document before determining that the dispute remains unresolved.

232. The conference phase is an administrative process that aims to clarify and, if possible, resolve the dispute. However, the conference phase should not be used by either party for the purpose of delaying the completion of the disputes process. The conference phase can involve more than one meeting between the parties and it is not necessarily complete just because the parties have held the final meeting. For example, the parties may need further information or to consider further submissions made at the meeting.

Legal and other advisers attending a conference

233. If a dispute is not settled earlier, the parties can obtain expert legal or other advice during the conference phase in addition to advice previously obtained. These advisers can attend any meetings in relation to the dispute.

Conference facilitation

234. Conference facilitation is a new feature in the conference phase. A facilitated conference will involve an independent internal facilitator who will promote and encourage structured discussion between Inland Revenue officers and the taxpayer on an informed basis and with the *bona fide* intention of resolving the dispute. The conference facilitator will be a senior Inland Revenue officer who will not have been involved in the dispute or given advice on the dispute prior to the conference phase. The facilitator will have sufficient technical knowledge to understand and lead the conference meeting.

235. The conference facilitator will not be responsible for making any decision in relation to the dispute, except for determining when the conference phase has come to an end. In particular, it is not the role of the facilitator to undertake settlement of the dispute. If this possibility arises it is the responsibility of the taxpayer and the Inland Revenue officers involved in the dispute.

236. Having a conference facilitated is optional and a conference can be held without a facilitator but, conference facilitation will be offered to all taxpayers as part of the disputes process. The Commissioner's offer of a facilitated conference will be made in writing ("the conference facilitation letter") within one month from the date of issue of the taxpayer's NOR. The conference facilitation letter marks the commencement of the conference phase.

237. The format of the conference meeting need not be limited to a face-to-face meeting. The parties to the dispute may agree to hold a telephone or video conference. (For reasons of simplicity, the SPS refers to "meetings" to include these different conference formats.)

238. The taxpayer is expected to respond within two weeks from the date of the conference facilitation letter. The taxpayer should indicate whether they will attend the conference meeting, whether they will accept the conference facilitation offer, whether there are any special needs or requirements at the meeting and who else will be attending the meeting. If the taxpayer does not respond within this timeframe, the Inland Revenue officers involved in the dispute will contact the taxpayer about the conference facilitation letter.

Preparation for the conference meeting

239. When a taxpayer agrees to attend a conference meeting, Inland Revenue will contact the taxpayer within two weeks from the taxpayer's agreement, to establish a timeframe, and agree on how the meeting will be conducted.

240. Prior to the conference meeting, the taxpayer should inform Inland Revenue whether their advisors will attend the conference meeting.

241. The parties to the dispute may agree to exchange information relevant to the dispute before the conference meeting. A copy of that information will be provided to the facilitator. The Inland Revenue officers will provide the taxpayer a list of information

that has been given to the facilitator. The taxpayer may request a copy of any information on that list if it is not already in their possession. It is also crucial for the parties to exchange the information prior to the meeting if the agreed format of the conference is a telephone or video conference.

242. Inland Revenue may decide to concede the dispute after considering the taxpayer's information. The whole disputes process (including the conference phase) would come to an end in these cases.

243. The conference phase will generally be expected to be completed within three months, but this may vary depending on the facts and complexities of the specific case. A longer conference phase may be justified in some disputes if the parties are engaged in meaningful discussions.

244. An agenda will be useful for both parties at the conference meeting. An agreed agenda should divide the conference meeting into two parts. The first part of the meeting should involve an exchange of material information and discussion of contentious facts and issues relating to the dispute. Any procedural matters such as the timeframe for completing the disputes process, the adjudication process, time bar waivers and the possibility of opting out of the disputes process will also be discussed. The second part of the meeting, if applicable, would involve negotiation of possible areas of resolution of the dispute. Any communication made and any materials prepared for the purpose of negotiating a settlement or resolution during this part of the meeting will be treated as being on a "without prejudice" basis.

245. Where there is no agenda the conference facilitator will guide the taxpayer and the Inland Revenue officers to discuss the contentious facts and issues at the conference meeting.

246. Where the option of conference facilitation has been declined, the parties to the dispute should work out the appropriate structure at the conference meeting, bearing in mind that one of the aims of any conference is to reach agreement on some or all the facts and issues and thus, resolve the dispute.

At the conference meeting

Facilitated conference

247. The facilitator will:

(a) Explain the objectives of the conference phase on the basis of the agreed agenda.

(b) Remind the parties of any rules relating to the conference (these will generally have been set out in the conference facilitation letter).

(c) Clarify who the parties are at the conference meeting and the capacities they hold (eg, whether they are the authorised tax advisors; whether they have authority to settle the dispute at the meeting).

(d) Ask whether the parties agree to record the meeting discussions using audio or video technology. (Refer to *SPS 10/01: Recording Inland Revenue Interviews* or any replacement SPS.)

(e) Run through the agenda.

(f) Encourage the parties to present evidence in support of their perceived facts (either at the conference meeting or on a later date if the evidence cannot be provided at the time of the meeting). Where possible, encourage the parties to reach agreement on all the facts of the dispute. If no agreement can be made, encourage the parties to establish the common grounds and address the matters that they agree to disagree. These agreements will be recorded in writing. The agreements will be sent to the taxpayer to verify the correctness and sign by a specified date.

(g) Promote constructive discussion of only the contentious tax issues and where possible, encourage both parties to explore the issues, resolve or settle the dispute (subject to our internal revenue delegations and guidelines on settlement). If the contentious tax issues cannot be resolved, ask both parties to do one or more of the following:

- At the end of the conference meeting, ask the parties to consider whether the conference phase comes to an end. Consider whether there is need for another meeting, noting that another meeting can be justified if both parties need to exchange further information in support of their tax technical arguments but continuous meetings are discouraged if this is seen as a delaying tactic.
- Where the parties agree to end the conference phase and the facilitator considers that the objectives of the conference phase have been achieved, the facilitator can clearly signal the end of the conference phase to the parties.
- Agree on the timeframe for completing the disputes process and submitting the dispute to the adjudication process. This includes the timeframe for taxpayers to meet outstanding information requests and Inland Revenue officers' undertaking to provide copies of information relevant to the disputes. The agreed timeframe will also factor in time bar

waivers if given by the taxpayer and the time required for any court challenge that relates to documents, which are claimed to be protected by professional legal privilege and tax advice documents, which are claimed to be protected by the non-disclosure rights. Ask the taxpayer whether a time bar waiver will be given if the time bar applicable to the assessment in dispute is imminent.

- Clearly indicate whether the communication made and/or documents prepared for the purpose of negotiating potential settlement or resolution of the dispute will be treated as being on a "without prejudice" basis.
- Ask the taxpayer to consider whether the opt out process applies and advise the taxpayer of the right to opt out within the required timeframe, so that it is not necessary to complete the disputes process as required under section 89N and that the dispute will be more efficiently resolved by a hearing authority.

(h) Note that any agreement between the parties will be recorded in writing and signed either at the conference meeting by both parties or on a later date after the taxpayer has verified the correctness of the agreement.

(i) Note that the Inland Revenue officers directly involved in the dispute will remain as the first point of contact.

Unfacilitated conference

248. In an unfacilitated conference, the parties at the conference should agree on and perform tasks similar to those listed in paragraphs 247(a) to (h) above.

249. At the end of the conference meeting, it is important for the Inland Revenue officers and the taxpayer to discuss whether they consider that the conference phase has come to an end and record any agreement in writing.

After the conference meeting

250. The following is relevant only if the conference phase does not end at the meeting.

Facilitated conference

251. The facilitator will:

(a) follow up on the agreed matters including the agreed timeframe and exchange of information (but does not include enforcing the agreement between the taxpayer and the Inland Revenue officers directly involved in the dispute);

(b) assess any need to attend a further meeting;

(c) suggest to the parties that the conference phase has ended and ask them to reach an agreement on this matter, then clearly notify the parties of the date on which the conference phase has ended.

Unfacilitated conference

252. In a conference that did not have a facilitator, the Inland Revenue officers will perform these tasks. They may suggest to the taxpayer that the conference phase has ended after all the material information relating to the dispute has been exchanged and all the contentious facts and issues have been discussed. The parties will then agree in writing on the date on which the conference phase has ended. If the parties cannot agree on when to end the conference phase, the Investigations Manager will be responsible for making the decision on ending the conference phase after considering all the parties' relevant reasons and concerns.

End of the conference phase

253. It is important for the taxpayer and the Inland Revenue officers to be fully aware of when the conference phase comes to an end. The conference phase is not necessarily complete just because the parties have held the final meeting. For example, the parties may need further information or to consider further submissions made at the meeting. In most cases, it is expected that the parties involved in the dispute will agree on when the conference phase has ended. Such agreement will be put in writing.

Facilitated conference

254. After a facilitated conference, the facilitator will be responsible for clarifying the agreed end date of the conference phase with the parties.

255. If the facilitator considers that both the taxpayer and Inland Revenue officers have exchanged all the material information relevant to the dispute, have fully discussed the tax technical issues and have not resolved the dispute, the facilitator may suggest to the parties that the conference phase can come to its end.

256. If there is no agreement and the parties' reasons for continuing the conference phase are considered to be insufficient, the conference facilitator can make a decision to end the conference phase and notify the parties of that decision. The following are examples of strong indicators that the conference phase has come to its end:

(a) the taxpayer and/or the tax advisors stop contacting the Inland Revenue officers directly involved in the dispute for a few weeks;

(b) the parties did not exchange information notwithstanding that this had been agreed on at the conference meeting, thus leading to the exercise of the Commissioner's powers (eg section 17 notices);

(c) the parties agree to disagree with each other and express interest in progressing to the SOP phase;

(d) the taxpayer appears to be using delaying tactics at the conference phase when the issue in dispute is subject to an imminent time bar.

257. In rare situations, where conference facilitation is involved and the facilitator is concerned with the parties' decision to end the conference phase before achieving the objectives of the conference meeting, the facilitator may adjourn the meeting and discuss the concerns with the responsible Inland Revenue officers. The facilitator may also contact the taxpayer or the taxpayer's tax advisors to discuss whether the conference phase should come to its end. The facilitator will seek the parties' agreement as to whether or not the conference phase is complete.

Unfacilitated conference

258. Where no conference facilitation is involved, the taxpayer and the Inland Revenue officers will work out when to end the conference phase. They should consider whether the objectives of the conference phase have been achieved before reaching the agreement. If no agreement can be reached, the Investigations Manager will review the conduct of the parties during the conference phase and make a decision on whether the conference phase has come to an end.

After the conference phase

259. When a dispute remains unresolved after the conference phase has been completed, the Commissioner must issue a disclosure notice together with a SOP, unless the Commissioner and the taxpayer have agreed to the taxpayer opting out of the disputes process. The disclosure notice and Commissioner's SOP will generally be issued within three months from the end of the conference phase (see paragraphs 299 to 315 for further discussion on the timeframes for issue of the Commissioner's disclosure notice and SOP).

260. If the taxpayer seeks the Commissioner's agreement to opt out of the disputes process under section 89N(1)(c)(viii), they will be required to sign a declaration that all material information relating to the dispute has been provided to the Commissioner.

Opt out of the disputes process

261. Section 89N(1)(c)(viii) provides that the Commissioner and a taxpayer can agree in writing not to complete the disputes process if they are satisfied that the dispute can be more efficiently resolved at a hearing authority (referred to as "opt out").

262. A taxpayer may request to opt out of the remainder of the disputes process. If they do, a decision on whether or not the Commissioner will enter into an opt out agreement will be made by a senior Inland Revenue officer. In making a decision on opt out, that person will consult with Legal and Technical Services, the Litigation Management Unit, and the Office of the Chief Tax Counsel. The decision maker will consider the taxpayer's request with reference to all of the specific criteria listed and will also consider if any other factors exist which mean that the dispute can be resolved more efficiently at a hearing authority.

263. Before agreeing to a taxpayer's request to opt out the Commissioner must be satisfied that the taxpayer has participated meaningfully during the conference phase. In addition, the taxpayer must have signed a declaration that all material information has been provided to the Commissioner.

264. This means that the Commissioner will not agree to opting out unless there has been a conference.

265. In addition to attending the conference, the Commissioner considers that a taxpayer will have participated meaningfully during the conference phase where:

(a) the taxpayer has provided information as requested by Inland Revenue (if it has not already been provided prior to the conference phase); and

(b) the taxpayer has discussed the contentious facts and issues of the dispute with Inland Revenue. This discussion will have involved identifying and clarifying what the dispute turns on, seeking potential resolution of the dispute or reaching agreements to enable the dispute to move forward to the next phase if it remains unresolved.

266. If the taxpayer has participated meaningfully during the conference phase and signed a declaration that all material information has been provided the Commissioner will agree to the taxpayer's request to opt out of the disputes process in circumstances where one of the following applies:

(a) the total amount of tax in dispute is $75,000 or less except where the dispute is part of a wider dispute;

(b) the dispute turns on issues of fact (eg facts that are to be determined by reference to expert opinions or valuation) only;

(c) the dispute concerns facts and issues that are waiting to be resolved by a court; or

(d) the dispute concerns facts and issues that are similar to those considered by the Adjudication Unit of the Office of the Chief Tax Counsel ("OCTC") if similar issues have been considered in a dispute in the past.

267. Where the dispute does not fall within the criteria listed above at paragraph 266, the Commissioner may still agree to opt out of the disputes process if it is considered that the dispute can be resolved more efficiently at a hearing authority.

268. The taxpayer may request to opt out of the disputes process within two weeks from the end of the conference phase. The Commissioner will advise the taxpayer in writing within two weeks from the date of the request whether the request to opt out has been agreed to.

269. Where the opt out request has been agreed to and the dispute remains unresolved after taking into account the information and discussion during the conference phase, the Commissioner will issue an amended assessment.

270. When it is considered that the taxpayer does not meet the criteria for opting out of the disputes process, the taxpayer will be advised of the decision in writing.

(a) The $75,000 or less threshold

271. The Commissioner will agree to a taxpayer opting out of the disputes process if the total amount of core tax in dispute is $75,000 or less. The "$75,000 or less" threshold does not apply if the dispute is part of a wider dispute that involves a number of taxpayers. An example of this is a tax avoidance arrangement similar to the "Trinity forestry scheme" in *Accent Management Ltd v CIR* (2007) 23 NZTC 21,323; [2007] NZCA 230.

272. The "$75,000 or less" threshold excludes:

- shortfall penalties, either proposed in the same NOPA as the core tax or proposed in a separate NOPA;
- use of money interest that results from the Commissioner's proposed adjustment in the NOPA; and
- late payment penalties imposed on the taxpayer, if applicable.

273. In some disputes, the Commissioner may propose adjustments in respect of more than one tax type or more than one return period/income year. The "$75,000 or less" threshold applies to the net total amount of tax in the **same** dispute. The threshold will take into account the following:

- the proposed adjustments made by the Commissioner in the same NOPA for all return periods and/or income years and tax types;
- any variation of the amount of tax in dispute due to the Commissioner's partial acceptance of the taxpayer's NOR; and
- any variation of the net total amount of tax in dispute as agreed between the participants during the conference phase.

(b) The dispute turns on issues of fact only

274. The Commissioner will agree to a taxpayer's request to opt out if the dispute turns on issues of fact or evidence only.

275. The "issues of fact" requirement may apply where the disputed facts are to be determined by reference to expert opinions or valuation.

276. Disputes on tax avoidance issues will not meet the "issues of fact" requirement. In these disputes, case law requires consideration of issues such as whether the arrangement has used a specific provision in a way that cannot have been within the contemplation and purpose of Parliament when it enacted the provision. This will involve analysing mixed questions of law and fact.

(c) The dispute concerns facts and issues that are waiting to be resolved by a court

277. The opt out process is available if the facts and issues relating to the dispute are similar to those that are waiting to be resolved by a court. The Commissioner will agree to a taxpayer's request to opt out in those cases.

278. A taxpayer may become aware of a current court case that concerns facts and issues that they consider to be similar to their dispute. The Commissioner will consider this position when deciding whether to accept the taxpayer's opt out request. In considering a taxpayer's request, Inland Revenue will advise the taxpayer of its views as to the similarity, but will not comment on the merit of the current court case or the plaintiff's tax affairs due to the secrecy provisions of the TAA.

279. In some cases, a taxpayer may not be aware at the time of issuing the NOR or during the conference phase of the existence of similar cases that are subject to court proceedings. The taxpayer may still request to opt out of the disputes process without this knowledge.

In considering the request, the decision maker will consult with the Litigation Management Unit to determine whether there are any current court cases that concern facts and issues that are considered to be similar to the taxpayer's dispute.

(d) The dispute concerns facts and issues that are similar to those considered by the Adjudication Unit

280. The opt out process is available if the facts and issues relating to the dispute are similar to those already considered by the Adjudication Unit. A taxpayer may request to opt out of the disputes process because a previous adjudication decision was in favour of the Commissioner and they consider it would be unlikely that the Commissioner's view will change. In considering the taxpayer's request, Inland Revenue will advise the taxpayer of its views as to the similarity, but will need to bear in mind the secrecy provisions of the TAA.

281. In some cases, a taxpayer may not be aware of similar disputes that have been considered by the Adjudication Unit when the taxpayer issues the NOR or participates at a conference meeting Inland Revenue officers may be aware of such other similar disputes, and may choose to advise the taxpayer that, should the taxpayer request an opt out, Inland Revenue would be very likely to agree. However, Inland Revenue will need to bear in mind the secrecy provisions of the TAA when considering other disputes.

Grounds of assessment where the Commissioner has agreed to opt out

282. In agreeing to the taxpayer's request for opt out the Commissioner will issue an amended assessment and a notice of assessment to the taxpayer. In doing so the Commissioner will have taken into account the information and legal arguments raised in the NOPA, the NOR and during the conference phase. The taxpayer can then challenge the assessment by commencing proceedings in a hearing authority within the applicable response period, ie two months of receipt of the notice of assessment.

283. As the evidence exclusion rule in section 138G does not apply, the Commissioner is not bound by the facts, evidence and propositions of law stated in the NOPA and NOR. The Commissioner is able to take into account the information and arguments raised during the conference phase.

284. In most opt out cases, the Commissioner's administrative practice is that even though the evidence exclusion rule does not apply, grounds of assessment which have not previously been referred to in the Commissioner's NOPA and the taxpayers' NOR will not be relied on if they have not been notified or sufficiently discussed during the conference phase.

285. Where the parties have agreed to opt out the Commissioner will send to the taxpayer at or near the time of issuing the assessment, a letter confirming briefly the grounds of assessment.

Progressing disputes through the disputes process where the dispute affects multiple taxpayers

286. Sometimes it is necessary for Inland Revenue to deal with a large number of taxpayers that are all affected by the same disputed matter. This can arise in situations where:

- the taxpayers are all investors in a particular scheme;
- the taxpayers have entered into similar arrangements and they have the same promoter;
- the taxpayers have entered into similar arrangements and they have the same tax agent;
- there exists a widespread but well-defined common problem involving many unrelated taxpayers (eg, taxpayers moving their private residence into an LAQC, or a number of taxpayers claiming non-deductible expenses such as fines for overloading).

287. Given Inland Revenue's limited resources, and bearing in mind taxpayer compliance costs it may not be appropriate for all the cases to proceed through the full disputes process.

288. The Commissioner's approach to the different situations which arise where a large number of taxpayers are all affected by the same disputed matter is outlined in the following paragraphs 289 to 298.

Situation 1: The Adjudication Unit has looked at an issue a number of times and consistently taken a view supporting the Commissioner

289. As discussed in detail previously at paragraphs 261 to 281, the Commissioner will agree to the taxpayer's request to opt out of the remaining parts of the disputes process if the facts and issues relating to the dispute are similar to those previously considered by the Adjudication Unit.

290. Therefore, in situations where the Adjudication Unit has looked at an issue a number of times and consistently taken a view supporting the Commissioner agreement between the parties to opt out is an option available to avoid the full disputes process.

291. In these circumstances the Commissioner will indicate to individual taxpayers that the dispute could be suitable for opt out but as this approach to a dispute requires the taxpayer to request opt out, they still have the choice to progress the dispute through the full disputes process.

292. It should be noted that before the Commissioner will agree to a taxpayer's request to opt out the Commissioner must be satisfied that the taxpayer has participated meaningfully during the conference phase. In addition, the taxpayer must have signed a declaration that all material information has been provided to the Commissioner.

Situation 2: There are a number of cases on the same issue under dispute. One case has been referred to the Adjudication Unit, who has still to reach a conclusion on the matter

293. In this situation it may be possible for other affected taxpayers and the Commissioner to merely agree, subject to statutory time bar issues, to place their case "on hold" while the Adjudication Unit undertakes its analysis.

294. However, care will need to be taken to ensure that the time bar will not be breached, and consideration should be given to obtaining a time bar waiver.

295. Again, as this approach requires the taxpayer to agree, the Commissioner can offer it to individual taxpayers but they still have the choice to progress the dispute through the full disputes process.

296. Taxpayers who agree to place their case "on hold" while adjudication considers the issues in question in relation to another taxpayer will not be bound by any decision reached by the Adjudication Unit and will be free to continue with their dispute should they wish.

Situation 3: The Adjudication Unit has previously looked at an issue and taken a view supporting the taxpayer

297. It is the Commissioner's policy that a finding for the taxpayer in the initial dispute will usually lead to the other disputes being withdrawn, particularly if the disputes are in respect of the same transaction.

298. However, in some situations further consideration of the issue is required at a national level before the Commissioner will apply the conclusions reached in a particular adjudication report more broadly to other taxpayers. In those cases, Inland Revenue officers may be advised that a specified or contrary approach (to that adopted by the Adjudication Unit) is to be followed pending further consideration of the issue at a national level.

Disclosure notice

299. The Commissioner must issue a disclosure notice under section 89M(1), unless the Commissioner:
    - (a) does not have to complete the disputes process because any of the exceptions under section 89N(1)(c) applies (see earlier discussion), or
    - (b) does not have to complete the disputes process because the High Court has made an order that the dispute resolution process can be truncated pursuant to an application made by the Commissioner under section 89N(3), or
    - (c) has already issued to the taxpayer a notice of disputable decision that includes or takes account of the adjustment proposed in the NOPA pursuant to section 89M(2).

300. When issuing a disclosure notice the Commissioner must also provide to the taxpayer the Commissioner's SOP (as discussed below) and include in the disclosure notice a reference to section 138G and a statement regarding the effect of the evidence exclusion rule pursuant to section 89M(3).

301. The Commissioner will usually advise the taxpayer two weeks before issuing the disclosure notice and SOP that these documents will be issued to them.

302. Where practicable, the Commissioner will contact the taxpayer shortly after the disclosure notice and SOP are issued to ascertain whether the taxpayer has received these documents.

303. If the taxpayer has not received the Commissioner's disclosure notice, for example, due to a postal error or an event or circumstance beyond the taxpayer's control, the Commissioner will issue another disclosure notice to the taxpayer. In this circumstance, the response period within which the taxpayer must respond with their SOP will commence from the date that the Commissioner issued the initial disclosure notice.

304. Where the taxpayer cannot issue a SOP within the applicable response period, they may issue a late SOP with an explanation of why it is late. The Commissioner will consider the late SOP in terms of the discretion under section 89K(1). (See paragraphs 204 to 206 for further discussion.)

Evidence exclusion rule

305. A disclosure notice is the document that triggers the application of the evidence exclusion rule. The Commissioner must explain the effect of the evidence exclusion rule and refer to section 138G in the disclosure notice. (See paragraph 328 for further discussion.)

Issue of a disclosure notice

306. The Commissioner can issue a disclosure notice at any time on or after the date that either party issues their NOPA.

307. Usually, the Commissioner will issue a disclosure notice after receiving a NOR, following the conference phase and in accordance with the timeframe agreed with the taxpayer.

308. Where a disclosure notice is issued earlier (for example, the facts are clear, the taxpayer has agreed on the disputed issues or a conference is not required) the reasons must be documented and explained to the taxpayer.

309. When deciding whether to issue a disclosure notice before the conference phase has been completed, Inland Revenue officers must be aware that, if the taxpayer discloses any new or novel matters in their SOP, they only have two months to reply under section 89M(8) barring a High Court application before the two-month period expires. (See section 89M(10).)

310. Where a dispute commenced by the Commissioner remains unresolved after the conference phase, an Inland Revenue officer will usually issue a disclosure notice together with a SOP:

- within **three months** from the end of the conference phase; or
- within **three months** from the date when the Commissioner advises that the taxpayer's opt out request has been declined;

subject to any further time allowed by an appropriate senior manager (see paragraphs 313 to 315).

311. The three-month timeframe will exclude any statutory holidays.

312. If the last day of the three-month timeframe falls on a weekend, Inland Revenue must issue the disclosure notice and the SOP by the next working day.

313. While the Commissioner is able to extend the three-month timeframe these extensions should be very rare, because in most disputes, the timeframe is considered to be sufficient for Inland Revenue officers to complete and issue to the taxpayer a disclosure notice and the Commissioner's SOP.

314. The ability for Inland Revenue to extend the three-month timeframe is provided for because it is recognised that even with good planning and the best endeavours of the Inland Revenue officers involved, there might be occasions on which the disclosure notice and the Commissioner's SOP cannot be issued within the three-month timeframe. This might occur when:

(a) the facts, issues, and law are complex, and/or

(b) the case involves an important issue of precedent and/or the Litigation Management Unit or external advisors are involved in advising on the Commissioner's SOP.

315. If it is considered that an extension of the timeframe is needed:

- approval will first be obtained from an appropriate senior Manager;
- the taxpayer will then be advised of the estimated date for issue of the Commissioner's SOP. Where the estimated date cannot be met, Inland Revenue will use its best endeavours to keep the taxpayer informed of the progress made in the completion of the Commissioner's SOP.

Statement of Position (SOP)

316. Pursuant to section 89M(3), when the Commissioner commences the disputes process, the Commissioner must issue a SOP to the taxpayer together with the disclosure notice.

317. When the disputed issue relates to a tax type that is subject to the statutory time bar (for example, income tax, GST) that falls within the current income year, the parties will endeavour to complete the disputes process before the time bar starts. The parties can agree to a statutory time bar waiver if they have issued a SOP to each other and there is insufficient time to complete the adjudication process.

318. However, if no such agreement is reached, section 89N(2)(b) allows the Commissioner to advance to the next stage if the Commissioner has considered the taxpayer's SOP and completed the compulsory elements of the disputes process. The Commissioner can amend the assessment by exercising the discretion under section 113.

319. Whether the Commissioner has adequately considered a SOP will depend on what is a reasonable length of time and level of analysis for that SOP given the circumstances of the case (for example, the length of the SOP and the complexity of the legal issues).

320. Thus a simple dispute could only take a couple of days to consider adequately while a complex dispute could take a few weeks. If the statutory time bar is imminent the Inland Revenue officer will consider the taxpayer's SOP urgently.

Contents of a SOP

321. Generally, the contents of a SOP are binding. This is because matters that proceed to court are subject to the "evidence exclusion rule" which limits the parties to the facts, evidence (excluding oral evidence), issues and propositions of law that either party discloses in their SOP unless a court order is made under section 138G(2) allowing new facts and evidence to be raised.

322. However, a mistaken description of facts, evidence, issues or propositions of law and submissions made in the SOP can later be amended if the parties agree to include additional information in the SOPs under section 89M(13).

323. Under section 89M(4) the SOP must be in the prescribed form (*IR 773 Statement of position*). The SOP must contain sufficient detail to fairly inform the taxpayer of the facts, evidence, issues and propositions of law that the Commissioner wishes to rely on.

324. The minimum content requirements for a SOP under section 89M(4) are an outline of the relevant facts, evidence, issues and propositions of law. However, to allow the Adjudication Unit to successfully reach a decision, the SOP must also contain full, complete and detailed submissions.

325. An outline that consists of a frank and complete discussion of the issues, law, arguments and evidence supporting the argument is implicit in the spirit and intent of the disputes process. (In very complex cases a full explanation of the relevant evidence and summary of less relevant evidence will be accepted.)

326. The disputes process does not require that relevant documents are discovered or full briefs of evidence or exhaustive lists of documents exchanged. Rather, providing an outline of relevant evidence in the SOP will ensure that both parties appreciate the availability of evidence in respect of the factual issues in dispute. The Commissioner should ensure that an outline of any expert evidence on which they intend to rely is included in the SOP.

327. Submissions made in the NOPA phase must be sufficiently concise to enable the parties to progress the dispute without incurring substantial expense. However, at the SOP phase, if the issues are unresolved and likely to proceed to a court for resolution, then full, complete and detailed submissions should be made.

328. Subject to section 138G(2), the evidence exclusion rule prevents the court considering arguments and evidence that are not included in:

(a) the SOP, or

(b) any additional information that:

(i) the Commissioner provides under section 89M(8), that is deemed to be part of the Commissioner's SOP under subsection (9), and

(ii) the parties provide pursuant to an agreement under section 89M(13), that is deemed to be part of the provider's SOP under subsection (14).

329. Section 89M(6B) reads:

> In subsections 4(b) and 6(b), **evidence** refers to the available documentary evidence on which the person intends to rely, but does not include a list of potential witnesses, whether or not identified by name.

330. Pursuant to section 89M(6B), only documentary evidence and not potential witnesses must be listed in the SOP. Any witnesses' identities will continue to be protected without undermining the effect of the evidence exclusion rule.

331. If the SOP discusses shortfall penalties it must also state any other appropriate penalties of lesser percentages and shortfall penalty reductions (for example, voluntary disclosure or previous behaviour reductions) as alternative arguments. This ensures that the appropriate penalties are assessed in all cases. However, the Commissioner cannot propose shortfall penalties at the SOP phase that have not previously been proposed in the Commissioner's NOPA.

Receipt of a taxpayer's SOP in response

332. Where the Commissioner has issued a disclosure notice and SOP, the taxpayer must, subject to section 89M(11), issue a SOP within the two-month response period that starts on the date that the disclosure notice was issued.

333. Therefore, the Commissioner cannot consider a document that the taxpayer purports to issue as a SOP before the Commissioner has issued the disclosure notice because it will not have been issued within the response period. The taxpayer should resubmit this document after the disclosure notice is issued.

334. Pursuant to section 89M(11), the taxpayer can apply to the High Court within the response period for more time to reply to the Commissioner's SOP. The taxpayer must show that they had not previously discussed the disputed issue with the Commissioner and, thus, it is unreasonable to reply to the Commissioner's SOP within the response period.

335. The Commissioner will make a reasonable effort to contact the taxpayer or their tax agent two weeks before the response period expires to determine whether the taxpayer will issue a SOP in response to the disclosure notice. Such contact can be made by telephone or in writing.

336. The taxpayer's SOP will be referred to the responsible officer within five working days after Inland Revenue receives it. Upon receipt, the responsible officer will ascertain and record the following:

(a) the date on which the SOP was issued, and

(b) whether the SOP has been issued within the relevant response period, and

(c) the SOP's salient features including any deficiencies in its content.

337. Where it is practicable, Inland Revenue will acknowledge the taxpayer's SOP as received within 10 working days after receiving it. However, the Commissioner will advise the taxpayer or their agent of any deficiencies in the SOP's content as soon as practicable.

338. A taxpayer who has issued a SOP outside the applicable response period can apply for consideration of exceptional circumstances under section 89K. The reasons for accepting or rejecting the application must be documented and the responsible officer will make reasonable efforts to advise the taxpayer of the decision in writing within 15 working days after Inland Revenue receives the taxpayer's application.

339. A taxpayer is deemed to have accepted the Commissioner's SOP if they do not reply to it with their own SOP within two months after the date that the disclosure notice is issued and none of the exceptional circumstances under section 89K apply. Where practicable, the Commissioner will usually advise the taxpayer that deemed acceptance has occurred within two weeks after the date that the response period for the disclosure notice expires.

The Commissioner's response

340. Pursuant to section 89M(8), the Commissioner can, within two months after the taxpayer's SOP is issued, provide to the taxpayer additional information in response to matters that they have raised in their SOP.

341. The Commissioner can only provide additional information in response to new or novel information or arguments that the taxpayer has raised in their SOP or agreed to add to their SOP under section 89M(13). The Commissioner cannot add further information simply because it was omitted from the Commissioner's SOP (for example, information that was received under a section 17 notice after the SOP was issued).

342. The additional information must be provided as far as possible in the same format as the SOP to which it relates (that is, in accordance with section 89M(4)). As mentioned above, the additional information can include documentary evidence but not lists of potential witnesses.

343. If the Commissioner intends to provide additional information to the taxpayer under section 89M(8), the Commissioner will usually advise the taxpayer or their tax agent of this within two weeks after the taxpayer's SOP is received. However, the timing of this advice can vary depending on the facts and complexity of the dispute. The additional information provided under section 89M(8) is deemed to be part of the Commissioner's SOP. Thus, the evidence exclusion rule under section 138G applies to the additional information.

344. The taxpayer cannot reply to the additional information that the Commissioner provides, unless the parties agree that additional information will be accepted under section 89M(13).

Agreement to include additional information

345. Either party can agree to include additional information in their SOP under section 89M(13) at any time during the disputes process including after the dispute has been referred to the Adjudication Unit. Although there is no statutory time limit, the Commissioner's practice is to allow one month (from the date that the Commissioner provides additional information under section 89M(8)) for such an agreement to be reached and information provided.

346. However, before agreeing to a request made by the taxpayer under section 89M(13) the Commissioner will consider the taxpayer's prior conduct and whether they could have provided the information earlier through the application of due diligence.

347. The Commissioner will usually also consider the materiality and relevance of the additional information and its capacity to help resolve the dispute and may decide to take it into account in coming to an assessment. In this circumstance, both parties will be expected to cooperate in resolving the relevance and accuracy of any such material. The Commissioner may wish to apply resources to verification and comment and this will be considered by the adjudicator.

348. If a taxpayer's request to include additional information in their SOP is declined, the reasons must be documented with detailed reference to the taxpayer's conduct, level of cooperation before the request was made and why the information was not provided earlier. The responsible officer will also advise the taxpayer or their tax agent of the reasons why their request was declined.

349. Any agreement to add further information to the SOP will be made subject to the taxpayer agreeing that the Commissioner can include a response to the additional information to the SOPs, if required, within an agreed timeframe.

350. Any additional information that the parties provide under section 89M(13) will be deemed to form part of the provider's SOP under section 89M(14). Thus, the evidence exclusion rule under section 138G applies to the additional information.

Preparation for adjudication

351. The Adjudication Unit is part of Inland Revenue's Office of the Chief Tax Counsel and represents the final step of the disputes process. The adjudicator's role is to review unresolved disputes by taking a fresh look at a tax dispute and the application of law to the facts in an impartial and independent manner and provide a comprehensive and technically accurate decision that will ensure the correctness of the assessment.

352. Generally, the adjudicator will make such a decision within three months after the case is referred to the Adjudication Unit. However, this will depend on the number of disputes that are before the Adjudication Unit, any allocation delays and the technical, legal and factual complexity of those disputes. (For further information on the timeframe for adjudication of disputes see the article titled "Adjudication Unit – Its role in the dispute resolution process" that was published in the *Tax Information Bulletin* Vol 19, No 10 (November 2007).)

353. The adjudication process is an administrative (rather than a legislative) one. Judicial comments have been made in *C of IR v Zentrum Holdings Limited and Another*, *Ch'elle Properties (NZ) Limited v CIR* (2004) 21 NZTC 18,618 and *ANZ National Bank Ltd and others v C of IR (No. 2)* (2006) 22 NZTC 19,835 indicating that, as a matter of law, it is not strictly necessary for Inland Revenue officers to send all disputes to the Adjudication Unit for review and Inland Revenue officers are not necessarily bound by the Adjudication Unit's decisions.

354. Notwithstanding the above judicial comments, if the parties have not agreed on all the issues at the end of the conference and disclosure phases or to opting out under section 89N(1)(c)(viii), it is the Commissioner's policy and practice that all disputes are to be sent to the Adjudication Unit for review, irrespective of the complexity or type of issues or amount of tax involved unless any of the following exceptions arise:

(a) the Commissioner has considered the taxpayer's SOP for the purposes of section 89N(2)(b) and referred the dispute to the Adjudication Unit for their preliminary consideration and the Adjudication Unit has determined that it has insufficient time to reach a decision in respect of the dispute before a statutory time bar would prevent an assessment from being increased (see paragraphs 318 to 320 for further discussion), or

(b) any of the legislative exceptions specified in section 89N(1)(c) apply (see paragraphs 152 to 195 for further discussion) so that the Commissioner can amend an assessment without first completing the disputes process, or

(c) the High Court has made an order that the disputes process can be truncated pursuant to an application made by the Commissioner under section 89N(3) (see paragraphs 182 to 193 for further discussion).

355. The decision not to refer the case to adjudication must be made by a senior person in Service Delivery (for example, at the time of writing the delegation was with Assurance Manager level or above). In respect of the first exception mentioned in paragraph 354(a) it is necessary that the parties have exchanged a SOP and it is a matter solely for the Adjudication Unit to determine whether it has insufficient time to fully consider the dispute.

356. If the dispute is to be referred to the Adjudication Unit, the Commissioner should not issue an assessment or amended assessment before the adjudication process is completed unless a time bar is imminent. In this circumstance, the responsible officer will prepare a cover sheet that will record all the documents that must be sent to the Adjudication Unit.

357. The cover sheet together with copies of the documents (NOPA, NOR, notice rejecting the NOR, conference notes, both parties' SOP, additional information, material evidence including expert opinions and a schedule of all evidence held) and any recordings of discussions held during the conference must be sent to the Adjudication Unit.

358. If the dispute is to be referred to adjudication, the responsible officer will issue a letter together with a copy of the cover sheet to the taxpayer before sending the submissions, notes and evidence to the Adjudication Unit. The cover sheet and letter are usually completed within one month after the date that the Commissioner's reply to the taxpayer's SOP (if any) is issued or the response period for the taxpayer's SOP expires.

359. The purpose of this letter is to seek concurrence on the materials to be sent to the adjudicator—primarily concerning documentary evidence that has been disclosed at the SOP phase. This letter will allow no more than 10 working days for a response.

360. Once the taxpayer has concurred on the materials to be sent to the Adjudication Unit, those materials will be so forwarded. However, if no response is received from the taxpayer the materials will be forwarded after the 10 working days allowed for the taxpayer's response have elapsed. The adjudicator may also contact the parties after the initial materials have been received to obtain further information.

361. Where an investigation has covered a number of issues, the cover sheet will outline any issues that the parties have agreed upon and any issues that are still disputed. The adjudicator will only consider the disputed issues and not those issues that have been agreed upon.

362. Generally, the adjudicator only considers the materials that the parties have submitted. They do not usually seek out or consider further information, unless it is relevant. The adjudicator may consider such additional information notwithstanding that the parties have not agreed that the provider can include this information in their SOP under section 89M(13).

363. However, any additional material that the parties have not disclosed in their SOP (or agreed to include in their SOP under section 89M(13)) cannot later be raised as evidence in court because the evidence exclusion rule in section 138G(1) will apply (as discussed in paragraphs 328 to 330).

Adjudication decision

364. Once a conclusion is reached, the Adjudication Unit will advise the taxpayer and responsible officer of the decision. The responsible officer will implement any of the Adjudication Unit's decisions and follow up procedures where required including issuing a notice of assessment to the taxpayer where applicable.

365. Where the Adjudication Unit makes a decision against the Commissioner, the Commissioner is bound by and cannot challenge that decision. The dispute will come to an end.

366. Where the Adjudication Unit makes a decision against the taxpayer, they can challenge the assessment (whether made by the Commissioner or taxpayer) or disputable decision if they are within the applicable response period.

367. If the Commissioner has commenced the disputes process, the taxpayer, if disagreeing with the adjudicator's decision and any later notice of assessment or amended assessment that is issued, can file proceedings in the general jurisdiction of the TRA or the High Court if any of the following conditions under section 138B(1) are met:

(a) the assessment includes an adjustment that the Commissioner has proposed and the taxpayer has rejected within the response period, or

(b) the assessment is an amended assessment that imposes a fresh or increases an existing liability.

368. A taxpayer can also challenge an assessment that the Commissioner issues before the dispute goes through the adjudication process (for example, when an exception under section 89N(1)(c) applies).

369. The taxpayer must file proceedings with the TRA or High Court within the two-month response period that starts on the date that the Commissioner issues the notice of assessment or amended assessment.

370. If applicable, the responsible officer will implement any decision made by the hearing authority and follow up procedures where required including issuing a notice of assessment or amended assessment to the taxpayer.

This Standard Practice Statement is signed on 8 November 2010.

Rob Wells
LTS Manager, Technical Standards

SPS 10/05: DISPUTES RESOLUTION PROCESS COMMENCED BY A TAXPAYER

Introduction

1. This Standard Practice Statement ("SPS") discusses a taxpayer's rights and responsibilities in respect of an assessment or other disputable decision when the taxpayer commences the disputes resolution process.
2. Unless specified otherwise, all legislative references in this SPS refer to the Tax Administration Act 1994 ("TAA").
3. Where the Commissioner commences the disputes resolution process, the Commissioner's practice is stated in SPS 10/04: *Disputes resolution process commenced by the Commissioner of Inland Revenue*.
4. The Commissioner regards this SPS as a reference guide for taxpayers and Inland Revenue officers. Where possible, Inland Revenue officers must follow the practices outlined in this SPS.
5. The disputes resolution process is designed to ensure that there is a full and frank communication between the parties in a structured way within strict time limits for the legislated phases of the process.
6. The disputes resolution process is designed to encourage an "all cards on the table" approach and the resolution of issues without the need for litigation. It aims to ensure that all the relevant evidence, facts and legal arguments are canvassed before a case goes to a court.
7. In accordance with the objectives of the disputes resolution process, the Commissioner (unless a statutory exception applies under section 89C or 89N(1)(c)) must go through the disputes resolution process before the Commissioner can issue an assessment.

Application

8. This SPS applies from 8 November 2010 and incorporates administrative changes to the disputes process which were implemented by Inland Revenue on 1 April 2010.
9. It replaces SPS 08/02: *Disputes resolution process commenced by a taxpayer*.
10. We acknowledge that Inland Revenue issued an officials' issues paper entitled "Disputes: a review" in July 2010. However, the outcome of that review has yet to be finally determined. This SPS represents the law and the Commissioner's administrative practice as it currently stands. If changes to the law and/or the Commissioner's administrative practice arise out of "Disputes: a review" this SPS will be reviewed and amended to reflect those changes.

Background

11. The tax dispute resolution procedures were introduced in accordance with the recommendations of the Richardson Committee in the *Report of the Organisational Review of the Inland Revenue Department* (April 1994) and were designed to reduce the number of disputes by:
    (a) promoting full disclosure, and
    (b) encouraging the prompt and efficient resolution of tax disputes, and
    (c) promoting the early identification of issues, and
    (d) improving the accuracy of decisions.
12. The disputes resolution process ensures that there is full and frank communication between the parties in a structured way within strict time limits for the legislated phases of the process.
13. The disputes resolution process is designed to encourage an "all cards on the table" approach and the resolution of issues without the need for litigation. It aims to ensure that all the relevant evidence, facts, and legal arguments are canvassed before a case goes to court.
14. The early resolution of a dispute is intended to be achieved through a series of steps specified in the TAA. The main elements of those steps are the issue of:
    (a) A notice of proposed adjustment ("NOPA"): this is a notice that either the Commissioner or taxpayer issues to the other advising that an adjustment is sought in relation to the taxpayer's assessment, the Commissioner's assessment or other disputable decision (the prescribed form is the *IR 770 Notice of proposed adjustment*). A NOPA is the formal document which begins the disputes process.
    (b) A notice of response ("NOR"): this must be issued by the recipient of a NOPA if they disagree with it (the preferred form is the *IR 771 Notice of response*).
    (c) A notice rejecting the Commissioner's NOR: this must be issued by the taxpayer if they disagree with the Commissioner's NOR (there is no prescribed form for a notice rejecting the Commissioner's NOR).
    (d) A disclosure notice and statement of position ("SOP"): the issue of a disclosure notice by the Commissioner triggers the requirement for the taxpayer to provide a SOP to continue the dispute. Each SOP must provide an outline of the facts,

STANDARD PRACTICE STATEMENTS

evidence, issues and propositions of law with sufficient details to support the positions taken. Each party must issue a SOP (the preferred form is the *IR 773 Statement of position*). The SOPs are important documents because they limit the facts, evidence, issues and propositions of law that either party can rely on if the case proceeds to court to what is included in the SOPs (unless a hearing authority makes an order that allows a party to raise new facts or evidence under section 138G(2)).

15. There are also two administrative phases in the disputes process—the conference and adjudication phases. If the dispute has not been already resolved after the NOR phase, the Commissioner's practice will be to hold a conference. A conference can be a formal or informal discussion between the parties to clarify and, if possible, resolve the issues.

16. If the dispute remains unresolved after the conference phase and the exchange of SOPs, the Commissioner will usually refer the dispute to adjudication, except in limited circumstances. Adjudication involves Inland Revenue independently considering a dispute and is the final phase in the disputes process before the taxpayer's assessment is amended (if it is to be amended) following the exchange of the SOPs.

17. Timely progression of disputes through the disputes process may require the use of the Commissioner's information gathering powers (particularly section 17) before and/or during the disputes process.

18. Inland Revenue has a quality assurance review process known as Core Task Assurance ("CTA") which is designed to ensure that key pieces of work (including NORs and SOPs) are subject to an independent review by Legal & Technical Services before being issued. Given the importance of the disputes process to the Commissioner and to taxpayers, Inland Revenue officers are required to get CTA approval of disputes documents prior to issue.

Glossary

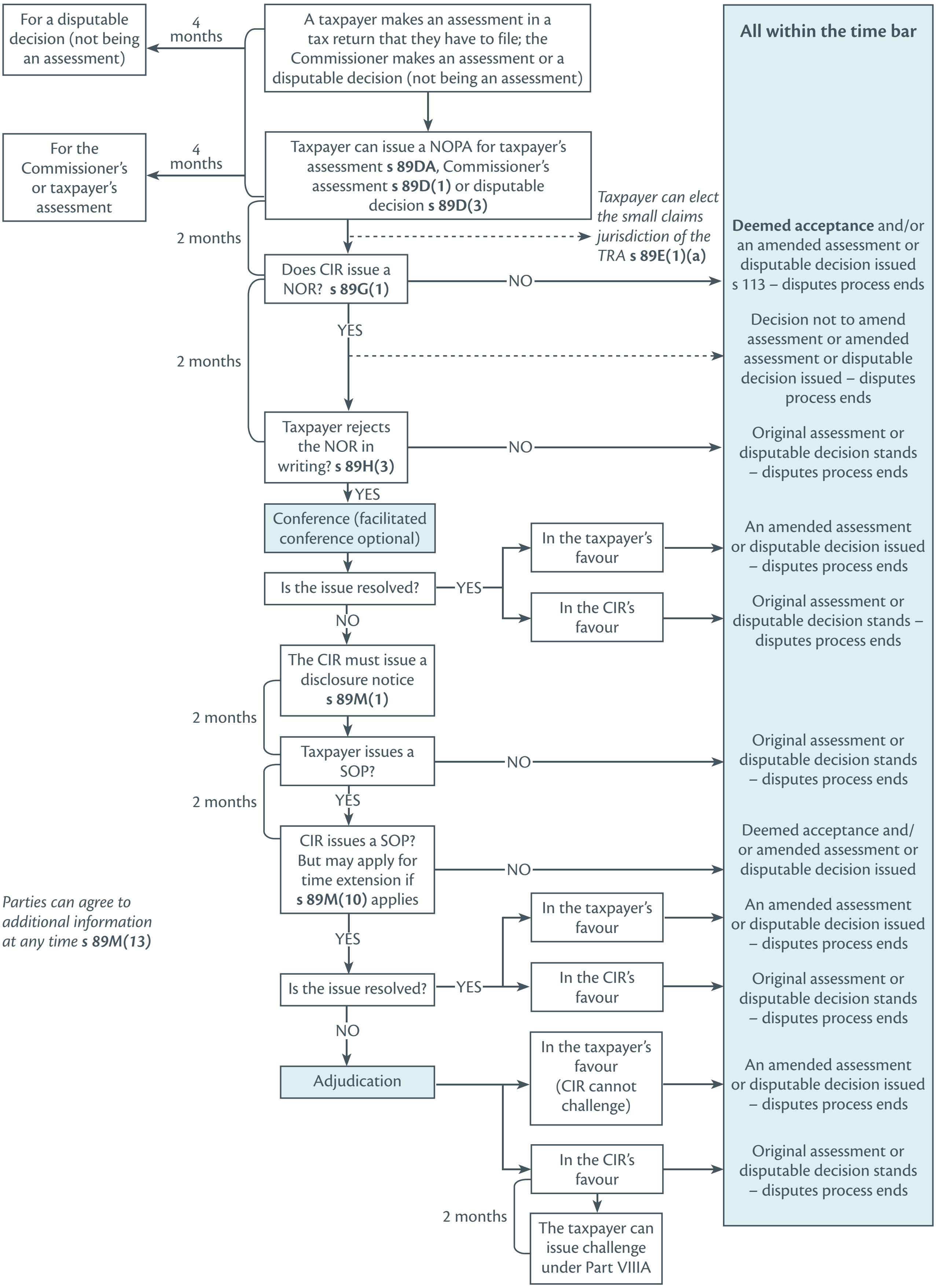
19. The following abbreviations are used throughout this SPS:

- NOPA – Notice of Proposed Adjustment
- NOR – Notice of Response
- SOP – Statement of Position
- Disputes Process – Disputes Resolution Process
- TRA – Taxation Review Authority.

Diagram of disputes process

The disputes resolution process is set out in the following diagram.

Disputes resolution process commenced by a taxpayer



Summary of key actions and indicative administrative timeframes

20. Set out below is a summary of the key actions and administrative timeframes where a disputes process is commenced by a taxpayer.

21. These key actions and timeframes are intended to be administrative guide lines for Inland Revenue officers. Any failure to meet these administrative timeframes will not invalidate subsequent actions of the Commissioner or prevent the case from going through the disputes process.

Paragraph in the SPS	Key actions	Indicative timeframes
	The taxpayer's NOPA	
39, 48, 60, 71 and 77	A taxpayer's response period for issuing a NOPA in respect of an assessment or other disputable decision.	Within four months from the date that the assessment or other disputable decision is issued.
108	The Commissioner forwards and assigns the taxpayer's NOPA to the responsible officer.	Usually within five working days after the taxpayer's NOPA is received.
110	The Commissioner acknowledges the receipt of the taxpayer's NOPA (either by telephone or in writing).	Usually within 10 working days after the taxpayer's NOPA is received.
111	The Commissioner advises that the taxpayer's NOPA is deficient, but the applicable response period has not expired.	Immediately after the Inland Revenue officer becomes aware of the deficiency.
129	The Commissioner considers the application of "exceptional circumstances" under section 89K, where a taxpayer's NOPA has been issued outside the applicable response period.	Usually within 15 working days after receiving the taxpayer's application.
	The Commissioner's NOR	
136	The Commissioner advises the taxpayer (either by telephone or in writing) whether the Commissioner intends to issue a NOR.	Usually within 10 working days before the response period for the taxpayer to issue a NOPA expires.
135	The Commissioner has issued and the taxpayer has received a NOR.	Within two months starting on the date that the taxpayer's NOPA is issued.
	The taxpayer's written rejection of the Commissioner's NOR	
154	The Commissioner confirms whether the taxpayer will reject the Commissioner's NOR.	Usually two weeks before the response period for the Commissioner's NOR expires.
155	The taxpayer rejects the Commissioner's NOR in writing.	Within two months after the date that the Commissioner's NOR is issued.
157	Inland Revenue forwards the taxpayer's rejection of the Commissioner's NOR to the responsible officer.	Usually within five working days after receiving the taxpayer's rejection.
157	The Commissioner acknowledges receipt of the taxpayer's rejection of the Commissioner's NOR.	Usually within 10 working days after receiving the taxpayer's rejection.
153	The taxpayer is deemed to accept the Commissioner's NOR, because they have failed to reject it within the applicable response period and none of the "exceptional circumstances" apply.	At the end of the two month period starting on the date of issue of the Commissioner's NOR.
158	The Commissioner will advise the taxpayer in writing that they are deemed to accept the Commissioner's NOR.	Within two weeks after the response period for the Commissioner's NOR has ended.
	Conference phase	
167	The Commissioner will write to the taxpayer to initiate the conference phase and to offer a facilitated conference.	The Commissioner's offer of a facilitated conference will be made in writing within one month after the Commissioner receives the taxpayer's rejection of the Commissioner's NOR. The conference letter marks the start of the conference phase timeframe.
169	The taxpayer will advise Inland Revenue whether they will attend the conference meeting, and whether they will accept the conference facilitation offer.	Usually within two weeks of receipt of the conference facilitation letter. If the taxpayer does not respond within this timeframe, the Inland Revenue officers involved in the dispute will contact the taxpayer about the letter.
239	When a taxpayer agrees to attend a conference meeting, Inland Revenue will contact the taxpayer to establish a timeframe, and agree on how the meeting will be conducted.	Usually within two weeks following the taxpayer's agreement to a conference.
174	Conference meeting(s) and further information exchange between Inland Revenue and the taxpayer.	The suggested average timeframe of the conference phase is three months, subject to the facts and complexity of the dispute.

Paragraph in the SPS	Key actions	Indicative timeframes
	Disclosure notice	
301	The Commissioner advises the taxpayer that a disclosure notice will be issued.	Usually within two weeks before the date that the disclosure notice is issued.
211	The Commissioner issues a disclosure notice to the taxpayer.	Usually within one month of the end of the conference phase.
	Taxpayer's SOP	
214	The taxpayer must issue a SOP within the response period for the disclosure notice.	Within two months after the date that the disclosure notice is issued, unless any of the "exceptional circumstances" under section 89K applies.
229	The Commissioner confirms whether the taxpayer will issue a SOP.	Usually 10 working days before the response period for the disclosure notice expires.
229	The Commissioner forwards the taxpayer's SOP to the responsible officer.	Usually within five working days after the taxpayer's SOP is received.
230	The Commissioner acknowledges the receipt of the taxpayer's SOP.	Usually within 10 working days after the taxpayer's SOP is received.
230	The Commissioner advises that the taxpayer's SOP is deficient, but the two-month response period has not expired.	Inland Revenue officers will advise the taxpayer or their agent as soon as they become aware of the deficiency.
231	The Commissioner considers whether "exceptional circumstances" under section 89K apply, where the taxpayer has issued a SOP outside the applicable response period.	Usually within 15 working days after the taxpayer's application is received.
232	The dispute is treated as if it was never commenced, if the taxpayer fails to issue a SOP within the applicable response period and none of the "exceptional circumstances" apply.	Usually 10 working days after the response period for the disclosure notice expires.
	The Commissioner's SOP	
233	The Commissioner issues a SOP in response to the taxpayer's SOP.	Within two months after the date that the taxpayer's SOP is issued, unless an application has been made to the High Court under section 89M(10).
345	The Commissioner considers a taxpayer's request to include additional information in the SOP.	Usually within one month after the date that the Commissioner's SOP is issued.

Paragraph in the SPS	Key actions	Indicative timeframes
	Adjudication	
258	The Commissioner prepares a cover sheet and issues a letter (with a copy of the cover sheet) to the taxpayer to seek concurrence on the materials to be sent to the adjudicator.	Usually within one month after the response period for the taxpayer's SOP expires.
259	The taxpayer responds to the Commissioner's letter.	Within 10 working days after the date that the letter is issued.
260	The Commissioner forwards materials relevant to the dispute to the Adjudication Unit.	Usually when the Commissioner receives the taxpayer's response or within 10 working days after the date that the Commissioner's letter is issued.
249	Adjudication of the disputes case.	Usually within 3 months after the date that the Adjudication Unit receives the disputes files, depending on the number of disputes that are before the Adjudication Unit, any allocation delays and the technical, legal and factual complexity of those disputes.
267	The taxpayer can file challenge proceedings.	Within two months of the adjudication decision.

STANDARD PRACTICE AND ANALYSIS

Assessment

Taxpayer's assessment

22. Section 92(1) reads:

> A taxpayer who is required to furnish a return of income for a tax year must make an assessment of the taxpayer's taxable income and income tax liability and, if applicable for the tax year, the net loss, terminal tax or refund due.

23. Section 92(1) applies to tax on income derived in:

(a) the 2005–06 and later tax years for a taxpayer whose income year matches the tax year, and

(b) the corresponding income year for a taxpayer whose income year is different from the 2005–06 and later tax years.

24. If a taxpayer has to file an income tax return they must make an assessment of their taxable income and income tax liability and, if applicable, the net loss, terminal tax or refund due. The definition of disputable decision in section 3(1) includes an assessment made by a taxpayer.

25. Similar requirements apply to a taxpayer who must file a GST return under the Goods and Services Tax Act 1985 ("the GST Act"). For a GST return period that begins on or after 1 April 2005, the taxpayer must make an assessment of the amount of GST payable. Section 92B(1) reads:

> A taxpayer who is required under the Goods and Services Tax Act 1985 to provide a GST tax return for a GST return period must make an assessment of the amount of GST payable by the taxpayer for the return period.

26. Pursuant to sections 92(2) and 92B(2) the assessment date for an income tax or GST assessment made by a taxpayer is the date that Inland Revenue receives the taxpayer's tax return.

27. When the taxpayer's assessment is received, the Commissioner's practice is to stamp, either electronically or manually, the tax return with the date of receipt. This date is then entered into Inland Revenue's computerised database and a return acknowledgment form is sent to the taxpayer or agent. This practice ensures that the taxpayer will have a clear record of when their assessment was made.

28. Under section 92B(3) for a GST assessment and section 92(6) for an income tax assessment, a taxpayer cannot make an assessment of the amount of tax payable for a return period in their tax return if the Commissioner has previously made an assessment of the tax that is payable for that return period. This is commonly known as a "default assessment" and involves the Commissioner making a default determination that estimates the taxpayer's tax liability (for example, if they have missed a return filing deadline).

29. For further discussion regarding how a taxpayer can dispute a default assessment see paragraphs 42 to 54.

The commissioner's assessment

30. Notwithstanding section 92(1) and subject to the statutory time bar in sections 108 and 108A, the Commissioner can sometimes issue a notice of assessment to a taxpayer.

31. The Commissioner cannot make an assessment without first issuing a NOPA to a taxpayer, unless an exception under section 89C to the requirement for issuing a NOPA applies.

32. The exceptions under section 89C are explained in SPS 10/04: *Disputes resolution process commenced by the Commissioner of Inland Revenue* or any replacement SPS. The Commissioner must ensure that any assessment is made in accordance with section 89C. However, if, on a rare occasion, an assessment was made in breach of section 89C, it will still be regarded as being valid under section 114(a).

33. If the Commissioner issues an assessment without first issuing a NOPA, the taxpayer can issue a NOPA to the Commissioner under section 89D(1).

Notice of proposed adjustment (NOPA)

Situations where a taxpayer can issue a NOPA to the Commissioner

34. A taxpayer can issue a NOPA to the Commissioner in the following situations:

Situation 1: NOPA in respect of the Commissioner's assessment

35. Section 89D(1) reads:

> If the Commissioner—
>
> (a) issues a notice of assessment to a taxpayer; and
>
> (b) has not previously issued a notice of proposed adjustment to the taxpayer in respect of the assessment, whether or not in breach of section 89C,—
>
> the taxpayer may, subject to subsection (2), issue a notice of proposed adjustment in respect of the assessment.

36. When the Commissioner issues to a taxpayer a notice of assessment that does not relate to a "default assessment" (as discussed in paragraph 28) without first issuing a NOPA, the taxpayer can issue to the Commissioner a NOPA in respect of the assessment. A taxpayer's response to a default assessment is discussed in Situation 2.

37. A taxpayer's NOPA is not an assessment. It is an initiating action that allows open and full communication between the parties. A NOPA forms a basis for ensuring that the Commissioner does not issue an assessment without some formal and structured dialogue with the taxpayer in respect of the grounds upon which the Commissioner is issuing any assessment or amended assessment (*McIlraith v CIR* (2007) 23 NZTC 21,456).

38. If the Commissioner has issued an assessment the taxpayer can issue a NOPA under section 89D(1) in respect of any of the considerations that were relevant to making the assessment. This could include preliminary decisions which are necessary to make the assessment, for example, a decision made by the Commissioner under section 89C (*MR Forestry (No 1) Trust Ltd v CIR* (2006) 22 NZTC 19,954).

39. The taxpayer must issue the NOPA within the applicable "response period" as defined in section 89AB. Generally, this will be within the four-month period that starts on the date that the Commissioner issues the assessment unless the Commissioner accepts a late NOPA under section 89K(1). However, this response period is subject to the exception discussed in Situation 6.

40. For example, if the Commissioner's notice of assessment is issued on 7 April 2008, under section 89D(1) the taxpayer must issue a NOPA in the prescribed form in respect of the assessment on or before 6 August 2008.

41. The taxpayer's right to issue a NOPA under section 89D(1) is unaffected, even if, in a very rare circumstance, the Commissioner made the assessment in breach of section 89C. The assessment will be deemed to be valid under section 114(a).

Situation 2: NOPA in respect of the Commissioner's default assessment

42. If a taxpayer has not filed a tax return, the Commissioner can make a default assessment under section 106(1) without first issuing a NOPA to the taxpayer.

43. Section 89D(2) reads:

> A taxpayer who has not furnished a return of income for an assessment period may dispute the assessment made by the Commissioner only by furnishing a return of income for the assessment period.

44. A taxpayer that intends to dispute a default assessment through the disputes process must:

(a) pursuant to section 89D(2) provide a tax return for the period to which the default assessment relates notwithstanding that the tax return cannot include the taxpayer's assessment (section 89D(2A)), and

(b) issue a NOPA to the Commissioner in respect of the default assessment within the applicable response period. Generally, this will be within the four-month period that starts on the date that the Commissioner issues the default assessment.

45. Similar rules apply to a NOPA that a taxpayer issues in respect of a GST default assessment.

46. Section 89D(2C) reads:

> A taxpayer who has not provided a GST tax return for a GST return period may not dispute the assessment made by the Commissioner other than by providing a GST return for the GST return period.

47. Where a taxpayer has not filed a GST return, the Commissioner can make a GST default assessment without first issuing a NOPA to the taxpayer.

48. If a taxpayer wants to dispute a GST default assessment through the disputes process, they must:

(a) provide a GST return for the periods to which the GST default assessment relates pursuant to section 89D(2C), notwithstanding that the tax return cannot include the taxpayer's assessment (section 89D(2D)), and

(b) issue a NOPA to the Commissioner in respect of the GST default assessment,

within the applicable response period. That is, within four months from the date that the default assessment is issued.

49. The legislative requirement to provide a tax return in respect of a default assessment made by the Commissioner when issuing a NOPA is an additional requirement of the disputes process. This ensures that the taxpayer has provided the requisite statutory information before they dispute the assessment.

50. If the Commissioner agrees with taxpayer's tax return and NOPA, the Commissioner will amend the default assessment by exercising the discretion under section 113 subject to the statutory time bar in section 108 or 108A and any other relevant limitations on the exercise of that discretion.

51. However, if the Commissioner disagrees with the taxpayer's tax return and NOPA the Commissioner cannot amend the default assessment. Instead, the Commissioner must issue a NOR to the taxpayer within the relevant response period to continue the disputes process.

52. The taxpayer cannot commence a dispute or challenge proceedings in a hearing authority by simply filing the tax return to which the default assessment relates. The taxpayer must issue a NOPA with their tax return.

53. If a NOPA is not issued, the Commissioner cannot be compelled to amend the default assessment on receipt of the taxpayer's tax return. However, the Commissioner will amend the assessment under section 113 on the basis of the information provided in the tax return subject to the statutory time bar in section 108 and any other relevant limitations on the exercise of that discretion if this would ensure that the assessment was correct. (See SPS 07/03: *Requests to amend assessments* for further details.) Any amended assessment will be the Commissioner's assessment in this circumstance.

54. The Commissioner can decide not to amend the default assessment by exercising the discretion under section 113 on the basis of the tax return provided.

Situation 3: NOPA in respect of a deemed assessment made under section 80H

55. Section 89D(2B) reads:

> A taxpayer to whom section 80F applies who has not furnished an amended income statement for an assessment period may dispute a deemed assessment under section 80H only by furnishing an amended income statement for the assessment period.

56. Section 89D(2B) applies to a taxpayer who derives income solely from salary, wages, interest and dividends and who will receive an income statement from the Commissioner under section 80D(1).

57. Generally, where the taxpayer considers that the income statement is incorrect, they must advise the Commissioner of the reasons and provide the relevant information to correct the income statement under section 80F(1). This must be done within the statutory time limit. That is, the later of:

(a) the taxpayer's terminal tax date for the tax year to which the income statement relates, and

(b) two months after the date that the income statement is issued.

58. If the taxpayer does not provide the relevant information within the statutory time limit, they will be treated as having filed a tax return under section 80G(2) and made an assessment under section 80H in respect of that income statement. In this case, the date of the deemed assessment under section 80H will be the date that the statutory time limit under section 80F expires.

59. Pursuant to section 89D(2B), the taxpayer cannot issue to the Commissioner a NOPA in respect of the deemed assessment made under section 80H without first satisfying their statutory obligation to file an amended income statement for the assessment period.

60. If a taxpayer wants to dispute a deemed assessment under section 80H, they must:

(a) provide an amended income statement for the assessment period, and

(b) issue a NOPA to the Commissioner in respect of the assessment within the applicable response period (that is, four months after the date that the deemed assessment is issued.)

Situation 4: NOPA in respect of a disputable decision that is not an assessment

61. Under section 89D(3) a taxpayer can issue a NOPA in respect of a disputable decision that is not an assessment. Section 89D(3) reads:

> If the Commissioner—
>
> (a) issues a notice of disputable decision that is not a notice of assessment; and
>
> (b) the notice of disputable decision affects the taxpayer,—
>
> the taxpayer, or any other person who has the standing under a tax law to do so on behalf of the taxpayer, may issue a notice of proposed adjustment in respect of the disputable decision.

62. For the purpose of section 89D(3) a person with standing under a tax law to issue a NOPA on behalf of the taxpayer includes a tax advisor and an approved advisor group.

63. Section 3(1) defines a "disputable decision" to include:

> (b) a decision of the Commissioner under a tax law, except for a decision—
>
> (i) to decline to issue a binding ruling under Part VA; or
>
> (ii) that cannot be the subject of an objection under Part VIII; or
>
> (iii) that cannot be challenged under Part VIIIA; or
>
> (iv) that is left to the Commissioner's discretion under sections 89K, 89L, 89M(8) and (10) and 89N(3)

64. A "decision of the Commissioner under a tax law" generally refers to a tax law that specifically confers a discretion or power on the Commissioner. Paragraph (b)(iii) excludes from the definition of "disputable decision" any decision that cannot be challenged under Part VIIIA.

65. For example, if the Commissioner:

(a) decides not to exercise the discretion under section 113 to amend a taxpayer's income tax assessment, or

(b) makes a decision under section 108A(3) regarding the application of the time bar, or

(c) does not agree to a time bar waiver under section 108B,

section 138E(1)(e)(iv) (within Part VIIIA) provides that these decisions cannot be challenged. Therefore, these decisions are not disputable decisions for the purposes of section 89D(3). However, under section 89D(1), the taxpayer can issue a NOPA in respect of the initial assessment if the Commissioner has not previously issued a NOPA in respect of that assessment.

66. A decision made by the Commissioner under section 108(2) (to increase an assessment) is not of itself, and in the absence of an assessment, a disputable decision. Any challenge to the correctness of the decision must be brought in the context of a challenge to the assessment itself (*Vinelight Nominees Ltd & Anor v Commissioner of Inland Revenue (No 2)* (2005) 22 NZTC 19,519).

67. Paragraph (b)(iv) of the definition of "disputable decision" in section 3(1) also excludes any decision that is left to the Commissioner's discretion arising under sections 89K, 89L, 89M(8) and(10), and 89N(3).

68. For example, the Commissioner does not exercise the discretion under section 89K(1) to accept a late NOPA that a taxpayer has issued outside the applicable response period. This decision not to exercise the discretion in the taxpayer's favour is not a disputable decision.

69. The exceptions specified in paragraph (b) of the definition of "disputable decision" ensure that only substantive issues are disputed as disputable decisions and the procedural components of the disputes process do not, in themselves, give rise to disputes although they may be amenable to judicial review.

70. The following examples illustrate what is a disputable decision:

    (a) A taxpayer who is a natural person can dispute the Commissioner's decision made under section YD 1 of the Income Tax Act 2007 ("ITA 2007") that they are a New Zealand resident for taxation purposes.

    (b) Under section RD 3(5) of the ITA 2007, the Commissioner can determine whether, and to what extent, a payment is subject to PAYE. This determination cannot be challenged by the taxpayer and, therefore, is excluded from the definition of "disputable decision" under section 3(1)(b)(iii). However, an employer or employee can dispute an assessment of tax deductions on the basis that a section RD 3(5) determination on which it is founded is wrong in fact or law.

71. The taxpayer must issue the NOPA to the Commissioner within the applicable response period. Generally, this will be within the four-month period that starts on the date that the Commissioner issues the notice of disputable decision or notice revoking or varying a disputable decision that is not an assessment unless the Commissioner allows a late NOPA under section 89K(1).

Situation 5: NOPA in respect of a taxpayer's assessment

72. Section 89DA(1) reads:

    A taxpayer may issue a notice of proposed adjustment in respect of an assessment made by the taxpayer for a tax year or a GST return period if the Commissioner has not previously issued a notice of proposed adjustment to the taxpayer in respect of the assessment.

73. If a taxpayer needs to file an income tax return they must also make an assessment of their taxable income and income tax liability under section 92(1) unless the Commissioner has previously made an assessment for that tax year (section 92(6)).

74. Section 89DA(1) also applies to a taxpayer's GST assessment for a return period. A taxpayer who has to file a GST return must also make an assessment of the amount of GST payable for the return period under section 92B(1).

75. The date on which a taxpayer's assessment of income tax is made is the date on which the taxpayer's return of income is received at an office of the Department (section 92(2)). A taxpayer's assessment of the amount of GST payable is made on the date on which the taxpayers of GST tax return is received at an office of the Department (section 92B(2)).

76. Pursuant to section 89DA(1), a taxpayer can issue to the Commissioner a NOPA in respect of their own tax assessment.

77. The taxpayer's NOPA must be issued within the applicable response period as defined in section 89AB. Generally, this will be within the four-month period that starts on the date that the Commissioner receives the taxpayer's assessment unless the Commissioner allows a late NOPA under section 89K(1).

78. The date that the Commissioner receives the taxpayer's assessment will be determined under section 14B. For example, under section 14B(8), the Commissioner will receive a NOPA that the taxpayer sends by post on the date that it would have been delivered in the ordinary course of post.

Situation 6: NOPA that relates solely to a research and development tax credit

79. Under section 89DA(3), a taxpayer can also issue a NOPA that relates solely to a research and development expenditure tax credit arising from a notice of assessment that they have previously issued for the 2008–09 tax year.

80. The NOPA must be issued within the period that starts on the date on which the Commissioner receives the taxpayer's assessment and ends two years after the latest date on which a taxpayer can provide a return of income for the 2008–09 tax year. This response period is an exception to the general response period that applies for disputing taxpayer assessments.

81. As the research and development expenditure tax credit has been repealed from the 2009–10 tax year onwards this response period has limited application it is not intended to discuss it further in this SPS.

Contents of a taxpayer's NOPA

82. A NOPA is the document that commences the disputes process. It is intended to identify the true points of contention and explain the legal or technical aspects of the issuer's position in relation to the proposed adjustment in a formal and understandable manner. This will ensure that information relevant to the dispute is quickly made available to the parties. Section 89F(1) and (3) specifies the content requirements for any NOPA that a taxpayer may issue.

83. Section 89F reads:

    (1) A notice of proposed adjustment must—

    (a) contain sufficient detail of the matters described in subsections (2) and (3) to identify the issues arising between the Commissioner and the disputant; and

(b) be in the prescribed form.

…

(3) A notice of proposed adjustment issued by a disputant must—

(a) identify the adjustment or adjustments proposed to be made to the assessment; and

(b) provide a statement of the facts and the law in sufficient detail to inform the Commissioner of the grounds for the disputant's proposed adjustment or adjustments; and

(c) state how the law applies to the facts; and

(d) include copies of the documents of which the disputant is aware at the time that the notice is issued that are significantly relevant to the issues arising between the Commissioner and the disputant.

84. The prescribed form for a NOPA as required under section 89F(1)(b) is the *IR 770 Notice of proposed adjustment* form that can be found on Inland Revenue's website: **www.ird.govt.nz** A handwritten NOPA in this form is acceptable. Additional information can also be attached to the prescribed form.

85. If the Commissioner receives a NOPA that is not in the prescribed form or has insufficient detail under section 89F(1)(a) the Commissioner's practice will be to advise the taxpayer that the NOPA must be in the prescribed form or include sufficient information. If this occurs on the last day of the response period the Commissioner will consider any resubmitted NOPA under section 89K(1)(a)(iii) provided that the lateness is minimal (see paragraph 124).

86. If the taxpayer's NOPA does not satisfy the content requirements under section 89F(1)(a) and (3) the Commissioner can reject the NOPA and not issue a NOR (see paragraphs 111 to 118).

87. When issuing a NOPA, the taxpayer must state the facts and law in sufficient detail, state how the law applies to the facts, and include copies of the documents that are significantly relevant to the dispute and known to the taxpayer when they issue the NOPA.

88. The Commissioner cannot treat a tax return provided by the taxpayer as a NOPA because it will not satisfy the requirements in section 89F(1) and (3).

89. Section 89F(3)(b) requires that the taxpayer's NOPA states the key facts and law concisely and in sufficient detail. The term "sufficient detail" means that the document must contain adequate analysis of the law and facts that are relevant to the dispute. This means sufficient discussion of the law to enable the Commissioner to clearly understand the proposed adjustment.

90. The Commissioner considers that it is necessary that the taxpayer provides "a statement of the facts and law in sufficient detail" to ensure that they have fully considered issues before they raise them in their NOPA and to reduce further administrative and compliance costs.

Identify the proposed adjustment – section 89F(3)(a)

91. The taxpayer must identify the proposed adjustment in their NOPA. This includes for each proposed adjustment:

(a) the amount or impact of the adjustment, and

(b) the tax year or period to which the proposed adjustment relates.

92. The proposed adjustment should be set out as specifically as possible. For example:

- "increase the 2007 repairs and maintenance expenditure by $3,000";
- "increase the GST input tax deduction by $4,000 in the August 2007 return period".

Provide a statement of the facts and law in sufficient detail – section 89F(3)(b)

Facts

93. To provide a brief and accurate statement of facts, the taxpayer must focus on the material factual matters relevant to the legal issues. The taxpayer must include the facts necessary for proving all the arguments raised in support of each adjustment, including any facts that are inconsistent with any argument that the Commissioner has previously raised.

94. The taxpayer should endeavour to disclose all the relevant material facts clearly and with adequate amounts of detail relative to the complexity of the issues. The taxpayer is best suited to do this because they are usually very familiar with the background and facts that relate to the dispute. Disclosing the background and facts at the NOPA phase helps to resolve the dispute at an earlier stage. However, the taxpayer should not overstate the facts with irrelevant detail or repetition.

95. In complex cases, the Commissioner expects the taxpayer to explain the relevant facts clearly and methodically. The taxpayer should also assist the Commissioner to understand the background and facts of the dispute, so as to facilitate a speedy resolution of the case. The taxpayer should explain the facts and law in sufficient detail to inform the Commissioner of the grounds for the adjustment. It is unhelpful and

can cause delays if the Commissioner has to second guess the factual bases of the taxpayer's case.

96. For example, in a dispute that involves a complex financial arrangement, the taxpayer should explain each element of it. This includes explaining the background to the financial arrangement, identifying the parties involved, highlighting the relevant clauses in an agreement, etc.

Law

97. Each proposed adjustment should stipulate the relevant section or sections that the taxpayer relies on and including, if a section has multiple independent parts, the applicable subsection(s).

98. It is important that the taxpayer includes an adequate amount of analysis of the applicable legal principles or tests in their NOPA. If possible these should be supported by case authorities with full citations. For example, in a dispute that involves the tax treatment of a trade-tie payment, the taxpayer must apply the legal principles from a leading case such as *Birkdale Service Station v CIR* (2000) 19 NZTC 15,981. However, it is not necessary to laboriously describe large numbers of precedent cases on the same issue or include extracts from each.

How the law applies to the facts – section 89F(3)(c)

99. The taxpayer must apply the legal arguments to the facts. This ensures that the proposed adjustment is not a statement that appears out of context in relation to the rest of the document. The Commissioner considers that the application of the law to the facts should logically support the proposed adjustment and be stated clearly and in detail.

100. The taxpayer should present the materials and arguments on which they intend to rely or on which reliance will be placed. That is, if more than one argument supports the same or a similar outcome, all arguments should be made and supported by evidence. For each proposition of law, it is recommended that the NOPA makes a clear link to an outline of supporting facts.

Include copies of the relevant documents that support the adjustment – section 89F(3)(d)

101. The taxpayer must provide full copies of the documents that they know are significantly relevant to the dispute and in existence when they issue the NOPA. This ensures that the Commissioner has all the relevant information necessary to respond to the NOPA.

102. For example:

(a) A taxpayer proposes an adjustment to GST input tax credits in their NOPA. The taxpayer must provide copies of the relevant tax invoices as documentary evidence in their NOPA.

(b) A taxpayer's dispute involves a sale of land transaction. The taxpayer must provide a copy of the sale and purchase agreement and other relevant correspondence between the vendor and the purchaser as documentary evidence in their NOPA.

103. In some cases, new documentary evidence can emerge, as the dispute progresses. For example, the documentation is quite old and may have been misplaced. The taxpayer may be unaware of these documents when the NOPA was issued. The parties should then exchange this new evidence when it becomes known or available.

104. Where a taxpayer is aware of a particular document that is significantly relevant to their dispute, but cannot obtain a copy of it, the taxpayer should include the following matters in their NOPA:

(a) the nature of the document and its relevance to the dispute, and

(b) the reasonable steps that the taxpayer has taken to obtain a copy of the document, and

(c) the expected date that the document will be made available to the Commissioner.

105. However, this practice should not be treated as dispensing with the requirements under section 89F(3)(d). The Commissioner still expects the taxpayer will send copies of the relevant documents mentioned in their NOPA as soon as they become available.

Election of the small claims jurisdiction of the Taxation Review Authority

106. Under section 89E(1), a taxpayer issues can elect in their NOPA that the TRA acting in its small claims jurisdiction hears any unresolved dispute that arises from the NOPA, if the following requirements are met:

(a) the taxpayer's NOPA is issued under section 89D or 89DA (see discussion at paragraphs 34 to 81), and

(b) the amount in dispute is $30,000 or less.

107. A taxpayer's election under section 89E(1), is irrevocable and is binding on them. In this circumstance, the full disputes process does not have to be followed.

Receipt of a taxpayer's NOPA

108. Inland Revenue will usually assign a taxpayer's NOPA to the responsible officer within five working days after it is received.

109. After receiving the NOPA, the responsible officer will determine and record the following:

(a) the date on which the NOPA was issued, whether the NOPA has been issued within the applicable response period and the date by which the Commissioner's response must be issued, and

(b) the NOPA's salient features including any deficiencies in its content.

110. Where practicable, Inland Revenue will advise the taxpayer or their tax agent that it has received the NOPA by telephone or in writing within 10 working days.

Deficiencies in the contents of a NOPA

111. Where Inland Revenue has received a NOPA that it considers deficient (that is, the requirements under section 89F(1)(a) and (3) may not be met), the responsible Inland Revenue officer will take reasonable steps to have the taxpayer correct the information in the NOPA before the response period expires.

112. The taxpayer will be advised as soon as practicable that the Commissioner considers that the NOPA may not meet the requirements of section 89F(1)(a) and (3) and why. They will also be advised that any additional or corrected information should be provided within the response period.

113. Taxpayers are encouraged to issue their NOPA immediately after they have completed it because they could have insufficient time to rectify any deficiencies if the response period is due to expire.

114. Generally where the deficiencies are not able to be remedied but the NOPA advances sufficient argument to allow the dispute to progress, then the Commissioner will continue with the dispute. The argument that the NOPA is deficient will be incorporated into the Commissioner's SOP and the Commissioner will also fully argue the substantive issue.

115. However, if the NOPA received is highly unsatisfactory the Commissioner is unlikely to continue with the dispute. This will be on the grounds that the NOPA does not satisfy the requirements set out in section 89F(1)(a) and (3).

116. A NOPA is likely to be considered highly unsatisfactory only where the taxpayer's position is materially inconsistent and not capable of coherent explanation, or there is no observable explanation at all of the taxpayer's grounds for dispute. In these situations the dispute will be treated as if it has never commenced (unless the taxpayer resubmits a late NOPA and the Commissioner accepts it under one of the exceptional circumstances under section 89K).

117. In considering the adequacy of the taxpayer's NOPA, the Commissioner's view will not be based on the strength or weakness of the taxpayer's argument. The Commissioner will only be concerned with whether the NOPA meets its statutory requirements.

118. The approach outlined above is consistent with that taken by the Court of Appeal in *CIR v Alam and Begum* (2009) 24 NZTC 23,564.

NOPA that a taxpayer has issued outside the applicable response period

119. Unless an "exceptional circumstance" arises under any of the circumstances specified in section 89K(1), the Commissioner cannot accept a NOPA that a taxpayer issues under section 89D or 89DA outside the applicable response period.

Exceptional circumstances under section 89K

120. The legislation defines exceptional circumstances very narrowly. The cases on "exceptional circumstances", such as *Treasury Technology Holdings Ltd v CIR* (1998) 18 NZTC 13,752, *Milburn NZ Ltd v CIR* (1998) 18 NZTC 14,005, *Fuji Xerox NZ Ltd v CIR* (2001) 17,470 (CA), *Hollis v CIR* (2005) 22 NZTC 19,570, and *Balich v CIR* (2007) 23 NZTC 21,230 are also relevant. The case law confirms that the Commissioner should apply the definition of "exceptional circumstances" in sections 89K(3) and 138D consistently.

121. The following guidelines have emerged from the case law:

(a) a taxpayer's misunderstanding or erroneous calculation of the applicable response period will usually not be regarded as an event or circumstance beyond the taxpayer's control under section 89K(3)(a);

(b) an agent's failure to advise their client that they have received a notice of assessment or other relevant documents that causes the taxpayer to respond outside the applicable response period will not generally be considered to be an exceptional circumstance under section 89K(3)(b) (*Hollis v CIR*); and

(c) an exceptional circumstance can arise if the taxpayer has relied on misleading information that the Commissioner has given them that causes them to respond outside the applicable response period (*Hollis v CIR*).

122. The Commissioner will only accept a late NOPA on rare occasions. See *Tax Information Bulletin* Vol 8, No 3 (August 1996) for some examples of situations that can be considered "exceptional circumstances" beyond a taxpayer's control.

123. Section 89K(3) reads:

> For the purpose of subsection (1),—
>
> (a) an **exceptional circumstance** arises if—
>
> (i) an event or circumstance beyond the control of a disputant provides the disputant with a reasonable justification for not rejecting a proposed adjustment, or for not issuing a notice of proposed adjustment or statement of position, within the response period for the notice:
>
> (ii) a disputant is late in issuing a notice of proposed adjustment, notice of response or statement of position but the Commissioner considers that the lateness is minimal, or results from 1 or more statutory holidays falling in the response period:
>
> (b) an act or omission of an agent of a disputant is not an exceptional circumstance unless—
>
> (i) it was caused by an event or circumstance beyond the control of the agent that could not have been anticipated, and its effect could not have been avoided by compliance with accepted standards of business organisation and professional conduct; or
>
> (ii) the agent is late in issuing a notice of proposed adjustment, notice of response or statement of position but the Commissioner considers that the lateness is minimal, or results from 1 or more statutory holidays falling in the response period.

124. The statutory holiday exception is self-explanatory. The Commissioner can also accept a late NOPA where the Commissioner considers that the lateness is minimal, that is, the document was only one to two days late.

125. For example, the response period ends on a Saturday and the taxpayer provides a NOPA on the following Tuesday. The Commissioner treats the response period as ending on Monday on the basis of section 35(6) of the Interpretation Act 1999 and accepts that the lateness of the NOPA was minimal. That is, the Commissioner received the NOPA within one to two days of Monday, the last day of the response period. If the response period ended on Friday and the taxpayer provided the NOR on the following Monday, the Commissioner would also accept that the lateness is minimal.

126. Besides the degree of lateness, the Commissioner will consider the following factors when exercising the discretion under section 89K(1):

(a) the date on which the NOPA was issued, and

(b) the response period within which the NOPA should be issued, and

(c) the real event, circumstance or reason why the taxpayer did not issue the NOPA within the applicable response period, and

(d) the taxpayer's compliance history in relation to the tax types under consideration (for example, the taxpayer may have a history of paying tax late or filing late tax returns or NOPAs in the past).

127. For example, a taxpayer issues a NOPA to the Commissioner two days after the applicable response period has expired. The taxpayer does not provide a legitimate reason for the lateness. The taxpayer also has a history of filing late NOPAs within the minimal allowable lateness period (that is, up to two days outside the applicable response period) and has been advised on the calculation of the response period each time.

128. Although the degree of lateness was minimal each time, the Commissioner would not accept the taxpayer's NOPA in this circumstance. This ensures that the section 89K(3)(b)(ii) exception is not treated as an extension of the response period in all circumstances.

129. The Commissioner will consider a taxpayer's application made under section 89K(1) after receiving the relevant NOPA. The responsible officer will document the reasons for accepting or rejecting the taxpayer's application and advise them of their decision in writing within 15 working days after Inland Revenue receives their application.

130. If the Commissioner rejects a taxpayer's application made under section 89K(1), the Commissioner can still consider the validity of the taxpayer's tax position in terms of the practice for applying the discretion under section 113. See SPS 07/03: *Requests to amend assessments* for details of this practice. However, the Commissioner's decision to reject an application made under section 89K(1) is not a disputable decision for the purposes of section 89D(3).

Timeframes to complete the disputes process

131. If a taxpayer has issued a NOPA to the Commissioner and the dispute remains unresolved, when practicable, the parties should negotiate a timeframe to ensure that the dispute is progressed in a timely and efficient way.

132. Agreeing to a timeframe is not statutorily required but, rather, is a critical administrative requirement that requires both parties to be ready to progress matters. The parties should endeavour to meet the agreed timeframe. If there are delays in the progress of the dispute the responsible officer must manage the delay including any relationship with internal advisers and liaise with the taxpayer.

133. If the negotiated timeframe cannot be achieved, the Commissioner must enter into continuing discussions with the taxpayer, either to arrange a new

timeframe, or otherwise keep them advised of when the disclosure notice will be issued. Therefore, the failure to negotiate or adhere to an agreed timeframe will not prevent the case from progressing through the disputes process in a timely manner.

134. In addition to the above administrative practice, the Commissioner is bound by section 89N. Under section 89N(2), if the parties cannot agree on the proposed adjustment, the Commissioner cannot amend the assessment without completing the disputes process (that is, consider the taxpayer's SOP), unless any of the exceptions in section 89N(1)(c) apply. These exceptions are explained in SPS 10/04: *Disputes resolution process commenced by the Commissioner of Inland Revenue* or any replacement SPS.

Notice of response (NOR)

The Commissioner's response to a taxpayer's NOPA: NOR

135. If the Commissioner disagrees with the taxpayer's proposed adjustment, then, under section 89G(1) the Commissioner must advise the taxpayer that any or all of their proposed adjustments are rejected by issuing a NOR within the applicable response period. That is, within two months starting on the date that the taxpayer's NOPA is issued. The Commissioner interprets this to mean that the taxpayer must receive the NOR within this period. For example, if a taxpayer issues a NOPA on 9 April 2010, the Commissioner must advise the taxpayer of its rejection by issuing to them a NOR and they must receive that NOR on or before 8 June 2010.

136. Where practicable, the Commissioner will make reasonable efforts to contact the taxpayer or their tax agent within 10 working days before the response period expires to advise whether the Commissioner intends to issue a NOR to them in response to their NOPA. Such contact may be made by telephone or letter.

137. The Commissioner must issue the NOR to the taxpayer (section 14(3)(a)) or a representative authorised to act on their behalf (section 14(3)(b)). In respect of the latter, it is a question of fact whether the recipient is authorised to receive the NOR on the taxpayer's behalf. The taxpayer must ensure that their NOPA stipulates the name of the person or agent that they have nominated to receive any NOR issued by the Commissioner (*CIR v Thompson* (2007) 23 NZTC 21,375).

138. If a tax agent sends a NOPA to the Commissioner although the tax agent would appear to have authority to receive the Commissioner's NOR, the Commissioner's practice will be to contact the tax agent to confirm whether the agent can accept service of the NOR.

139. Section 89G(2) specifies the content requirements for a NOR. The Commissioner must state concisely in the NOR:

(a) the facts or legal arguments in the taxpayer's NOPA that the Commissioner considers are wrong, and

(b) why the Commissioner considers that those facts and arguments are wrong, and

(c) any facts and legal arguments that the Commissioner relies upon, and

(d) how the legal arguments apply to the facts, and

(e) the quantitative adjustment to any figures proposed in the taxpayer's NOPA that results from the facts and legal arguments that the Commissioner relies upon.

140. Under section 89G(2)(e), the requirement for a quantitative adjustment establishes the extent to which the Commissioner considers that the adjustment in the taxpayer's NOPA is incorrect. This amount need not be exact, although, every attempt should be made to ensure that it is as accurate as possible. The amount in dispute can be varied, as the dispute progresses. For example, if the parties agree on new figures at the conference phase.

141. The Commissioner considers that Inland Revenue has a statutory obligation to inform the taxpayer adequately. Therefore, any NOR that the Commissioner issues to reject the adjustment proposed in the taxpayer's NOPA must be relatively brief but sufficiently detailed to explain all the relevant facts, quantitative adjustments, issues and law.

Deemed acceptance

142. Section 89H(2) reads:

> If the Commissioner does not, within the response period for a notice of proposed adjustment issued by a disputant, reject an adjustment contained in the notice, the Commissioner is deemed to accept the proposed adjustment and section 89J applies.

143. If the Commissioner issues a NOR outside the two-month response period, the Commissioner is deemed to have accepted the adjustment proposed in the taxpayer's NOPA under section 89H(2). This will finish the dispute and the Commissioner must issue an assessment or amended assessment to the taxpayer pursuant to section 89J(1) (see the discussion in paragraphs 148 to 152).

144. However, the Commissioner is not precluded from later exercising the discretion under section 113 and issuing to the taxpayer an amended assessment that

reflects another adjustment for a different issue to that previously accepted under section 89H(2) for the same tax period.

Exception to deemed acceptance

145. Notwithstanding section 89H(2), the Commissioner can apply to the High Court for an order that a NOR can be issued outside the two-month response period under section 89L(1). Section 89L only applies if an exceptional circumstance has occurred or prevented the Commissioner from issuing a NOR to the taxpayer within the response period. The Commissioner will endeavour to apply the requirement for exceptional circumstances in section 89L(1)(a) consistently with the similar requirement in section 89K(1)(a) (see discussion in paragraphs 120 to 130).

146. Under section 89L(3), an "exceptional circumstance":

   (a) is an event or circumstance beyond the control of the Commissioner or an officer of the Department that provides the Commissioner with a reasonable justification for not rejecting an adjustment proposed by a disputant within the response period; and

   (b) without limiting paragraph (a), includes a change to a tax law, or a new tax law, or a decision of a court in respect of a tax law, that is enacted or made within the response period.

147. For example:

   (a) A flood damaged an Inland Revenue office during the applicable response period for a taxpayer's NOPA. The taxpayer's NOPA was lost in the flood. The Inland Revenue officer could not obtain another copy of the NOPA within the applicable response period. The absence of information has prevented the Commissioner from forming a view on the subject matter in dispute. The Commissioner can apply for a High Court order under section 89L for further time to issue a NOR.

   (b) A taxpayer issues to the Commissioner a NOPA that claims additional tax depreciation on computer software. During the two-month response period, a High Court decision was made in respect of another taxpayer. The High Court held that a depreciation claim amounted to tax avoidance and should be disallowed. The Commissioner can apply to the High Court for further time to issue a NOR to the taxpayer, so as to consider the full effect of the High Court decision.

   (c) The Inland Revenue officer to whom a taxpayer's NOPA was assigned is absent on annual leave for the remainder of the response period. The Inland Revenue officer does not arrange for another officer to prepare and issue a NOR to the taxpayer within the response period. The Commissioner is deemed to accept the NOPA under section 89H(2). In this circumstance, the Commissioner does not consider that an exceptional circumstance prevented the Inland Revenue officer from rejecting the adjustment within the response period for the purpose of section 89L(1)(a).

Implication of section 89J

148. Under section 89J(1), if the Commissioner accepts or is deemed to accept any adjustment that is proposed in a taxpayer's NOPA, the Commissioner must include or take account of the adjustment in:

   (a) a notice of assessment, and

   (b) any further notice of assessment or amended assessment,

   that is issued to the taxpayer unless the Commissioner has applied to the High Court for an order that a notice can be issued rejecting the proposed adjustment under section 89L(1).

149. In this circumstance, the Commissioner's practice will be not to later issue a NOPA that purports to reverse any proposed adjustment previously accepted under section 89H(2) because section 89J(1) prevents the Commissioner from issuing to the taxpayer a further amended assessment that does not include or take into account the previously accepted adjustment.

150. However, pursuant to section 89J(2) the Commissioner can issue a notice of assessment or amended assessment that does not include or take into account an adjustment that the Commissioner has, or is deemed to have accepted, if the Commissioner considers that, in relation to the adjustment, the taxpayer:

   (a) was fraudulent, or

   (b) willfully misled the Commissioner.

151. If the Commissioner considers that section 89J(2) applies following deemed acceptance under section 89H(2) the Commissioner cannot resume the earlier disputes process but can later issue a NOPA in respect of any of the adjustments proposed in the earlier disputes process.

152. Any opinion that the Commissioner forms under section 89J(2) must be honestly held, based on a correct understanding of the relevant grounds and reasonably justifiable on the basis of the facts and law available. An opinion formed by the Commissioner under section 89J(2) is a disputable decision for the purposes of section 89D(3).

Rejection of the Commissioner's NOR

153. If the Commissioner has issued a NOR under section 89G(1) that rejects the adjustment proposed in the taxpayer's NOPA, the taxpayer must reject the Commissioner's NOR within the applicable response period. That is, within two months starting on the date that the Commissioner issues the NOR. Otherwise, the taxpayer is deemed to have accepted the Commissioner's NOR under section 89H(3) and the dispute will finish.

154. The Commissioner will make reasonable efforts to contact the taxpayer or their tax agent two weeks before the response period for the Commissioner's NOR expires to determine whether the taxpayer will reject the Commissioner's NOR in writing. Such contact can be made by telephone or in writing.

155. The taxpayer must reject the Commissioner's NOR in writing. The written rejection must be issued within the response period and can be in any form. The taxpayer does not have to expressly reject each of the rejections of proposed adjustments that are included in the Commissioner's NOR. The taxpayer's written rejection must simply make it clear that the taxpayer rejects the Commissioner's NOR.

156. For example, in certain circumstances, the Commissioner can treat a notice of proceedings and statement of claim that the taxpayer serves on the Commissioner within the response period to commence challenge proceedings as a valid rejection in writing of the Commissioner's NOR.

157. Where practicable, the taxpayer's written rejection will be referred to the responsible officer within five working days after Inland Revenue has received it and acknowledged as received within 10 working days.

158. If deemed acceptance occurs (that is, the taxpayer has not rejected the Commissioner's NOR in writing), the Commissioner will make reasonable efforts to advise the taxpayer of this within two weeks after the response period to the Commissioner's NOR has expired.

159. Under section 138B(3) a taxpayer can file challenge proceedings upon receipt of the Commissioner's NOR. This does not automatically end the disputes process. However, the Commissioner's practice is to treat a notice of proceedings and statement of claim that the taxpayer serves on the Commissioner within the response period commencing challenge proceedings as also being a request for the Commissioner's agreement to opt out of the disputes process under section 89N(1)(c)(viii). The Commissioner will agree to the taxpayer opting out in these circumstances as it is considered that once a challenge is filed the dispute will be resolved more efficiently at a hearing authority.

Conference phase

What is the conference phase of the disputes process?

160. The conference phase of the disputes process allows the taxpayer and Inland Revenue officers directly involved in the dispute to exchange material information relating to the dispute (if this has not already been done prior to the conference phase). More importantly it is an opportunity for the parties to the dispute to try to resolve the differences in their understanding of facts, laws and legal arguments.

161. The word "resolve" in this context is not limited to final resolution of the dispute. Settlement is a possibility but this is not the only objective of the conference phase. The parties may "resolve" part of the dispute by agreeing on some of the facts and clarifying some of the legal arguments, while agreeing to disagree on other matters, which will become the focus in the later phases of the disputes process.

162. Generally, if a dispute remains unresolved after the NOR phase, the conference phase will follow.

163. The conference phase is an administrative process that aims to clarify and, if possible, resolve the dispute. However, the conference phase should not be used by either party for the purpose of delaying the completion of the disputes process. The conference phase can involve more than one meeting between the parties and it is not necessarily complete just because the parties have held the final meeting. For example, the parties may need further information or to consider further submissions made at the meeting.

Legal and other advisers attending a conference

164. If a dispute is not settled earlier, the parties can obtain expert legal or other advice during the conference phase in addition to advice previously obtained. These advisers can attend any meetings in relation to the dispute.

Conference facilitation

165. Conference facilitation is a new feature in the conference phase. A facilitated conference will involve an independent internal facilitator who will promote and encourage structured discussion between Inland Revenue officers and the taxpayer on an informed basis and with the *bona fide* intention of resolving the dispute. The conference facilitator will be a senior Inland Revenue officer who will not have been involved in the dispute or given advice on the dispute prior to the conference phase. The facilitator will have sufficient technical knowledge to understand and lead the conference meeting.

166. The conference facilitator will not be responsible for making any decision in relation to the dispute, except for determining when the conference phase has come to an end. In particular, it is not the role of the facilitator to undertake settlement of the dispute. If this possibility arises it is the responsibility of the taxpayer and the Inland Revenue officers involved in the dispute.

167. Having a conference facilitated is optional and a conference can be held without a facilitator but, conference facilitation will be offered to all taxpayers as part of the disputes process. The Commissioner's offer of a facilitated conference will be made in writing ("the conference facilitation letter") within one month from the date of issue of the taxpayer's rejection of the Commissioner's NOR. The conference facilitation letter marks the commencement of the conference phase.

168. The format of the conference meeting need not be limited to a face-to-face meeting. The parties to the dispute may agree to hold a telephone or video conference. (For reasons of simplicity, the SPS refers to "meetings" to include these different conference formats.)

169. The taxpayer is expected to respond within two weeks from the date of the conference facilitation letter. The taxpayer should indicate whether they will attend the conference meeting, whether they will accept the conference facilitation offer, whether there are any special needs or requirements at the meeting and who else will be attending the meeting. If the taxpayer does not respond within this timeframe, the Inland Revenue officers involved in the dispute will contact the taxpayer about the conference facilitation letter.

Preparation for the conference meeting

170. When a taxpayer agrees to attend a conference meeting, Inland Revenue will contact the taxpayer within two weeks from the taxpayer's agreement to establish a timeframe and agree on how the meeting will be conducted.

171. Prior to the conference meeting, the taxpayer should inform Inland Revenue whether their advisors will attend the conference meeting.

172. The parties to the dispute may agree to exchange information relevant to the dispute before the conference meeting. A copy of that information will be provided to the facilitator. The Inland Revenue officers will provide the taxpayer a list of information that has been given to the facilitator. The taxpayer may request a copy of any information on that list if it is not already in their possession. It is also crucial for the parties to exchange the information prior to the meeting if the agreed format of the conference is a telephone or video conference.

173. Inland Revenue may decide to concede the dispute after considering the taxpayer's information. The whole disputes process (including the conference phase) would come to an end in these cases.

174. The conference phase will generally be expected to be completed within three months, but this may vary depending on the facts and complexities of the specific case. A longer conference phase may be justified in some disputes if the parties are engaged in meaningful discussions.

175. An agenda will be useful for both parties at the conference meeting. An agreed agenda should divide the conference meeting into two parts. The first part of the meeting should involve an exchange of material information and discussion of contentious facts and issues relating to the dispute. Any procedural matters such as the timeframe for completing the disputes process, the adjudication process, time bar waivers and the possibility of opting out of the disputes process will also be discussed. The second part of the meeting, if applicable, would involve negotiation of possible areas of resolution of the dispute. Any communication made and any materials prepared for the purpose of negotiating a settlement or resolution during this part of the meeting will be treated as being on a "without prejudice" basis.

176. Where there is no agenda the conference facilitator will guide the taxpayer and the Inland Revenue officers to discuss the contentious facts and issues at the conference meeting.

177. Where the option of conference facilitation has been declined, the parties to the dispute should work out the appropriate structure at the conference meeting, bearing in mind that one of the aims of any conference is to reach agreement on some or all the facts and issues and thus, resolve the dispute.

At the conference meeting

Facilitated conference

178. The facilitator will:

(a) Explain the objectives of the conference phase on the basis of the agreed agenda.

(b) Remind the parties of any rules relating to the conference (these will generally have been set out in the conference facilitation letter).

(c) Clarify who the parties are at the conference meeting and the capacities they hold (eg, whether they are the authorised tax advisors; whether they have authority to settle the dispute at the meeting).

(d) Ask whether the parties agree to record the meeting discussions using audio or video technology. (Refer to *SPS 10/01: Recording Inland Revenue Interviews* or any replacement SPS.)

(e) Run through the agenda.

(f) Encourage the parties to present evidence in support of their perceived facts (either at the conference meeting or on a later date if the evidence cannot be provided at the time of the meeting). Where possible, encourage the parties to reach agreement on all the facts of the dispute. If no agreement can be made, encourage the parties to establish the common grounds and address the matters that they agree to disagree. These agreements will be recorded in writing. The agreements will be sent to the taxpayer to verify the correctness and sign by a specified date.

(g) Promote constructive discussion of only the contentious tax issues and where possible, encourage both parties to explore the issues, resolve or settle the dispute (subject to our internal revenue delegations and guidelines on settlement). If the contentious tax issues cannot be resolved, ask both parties to do one or more of the following:

- At the end of the conference meeting, ask the parties to consider whether the conference phase comes to an end. Consider whether there is need for another meeting, noting that another meeting can be justified if both parties need to exchange further information in support of their tax technical arguments but continuous meetings are discouraged if this is seen as a delaying tactic.
- Where the parties agree to end the conference phase and the facilitator considers that the objectives of the conference phase have been achieved, the facilitator can clearly signal the end of the conference phase to the parties.
- Agree on the timeframe for completing the disputes process and submitting the dispute to the adjudication process. This includes the timeframe for taxpayers to meet outstanding information requests and Inland Revenue officers' undertaking to provide copies of information relevant to the disputes. The agreed timeframe will also factor in time bar waivers if given by the taxpayer and the time required for any court challenge that relates to documents, which are claimed to be protected by professional legal privilege and tax advice documents, which are claimed to be protected by the non-disclosure rights. Ask the taxpayer whether a time bar waiver will be given if the time bar applicable to the assessment in dispute is imminent.
- Clearly indicate whether the communication made and/or documents prepared for the purpose of negotiating potential settlement or resolution of the dispute will be treated as being on a "without prejudice" basis.
- Ask the taxpayer to consider whether the opt out process applies and advise the taxpayer of the right to opt out within the required timeframe, so that it is not necessary to complete the disputes process as required under section 89N and that the dispute will be more efficiently resolved by a hearing authority.

(h) Note that any agreement between the parties will be recorded in writing and signed either at the conference meeting by both parties or on a later date after the taxpayer has verified the correctness of the agreement.

(i) Note that the Inland Revenue officers directly involved in the dispute will remain as the first point of contact.

Unfacilitated conference

179. In an unfacilitated conference, the parties at the conference should agree on and perform tasks similar to those listed in paragraphs 247(a) to (h) above.

180. At the end of the conference meeting, it is important for the Inland Revenue officers and the taxpayer to discuss whether they consider that the conference phase has come to an end and record any agreement in writing.

After the conference meeting

181. The following is relevant only if the conference phase does not end at the meeting.

Facilitated conference

182. The facilitator will:

(a) follow up on the agreed matters including the agreed timeframe and exchange of information (but does not include enforcing the agreement between the taxpayer and the Inland Revenue officers directly involved in the dispute);

(b) assess any need to attend a further meeting;

(c) suggest to the parties that the conference phase has ended and ask them to reach an agreement on this matter, then clearly notify the parties of the date on which the conference phase has ended.

Unfacilitated conference

183. In a conference that did not have a facilitator, the Inland Revenue officers will perform these tasks. They may suggest to the taxpayer that the conference phase has ended after all the material information relating to the dispute has been exchanged and all the contentious facts and issues have been discussed. The parties will then agree in writing on the date on which the conference phase has ended. If the parties cannot agree on when to end the conference phase, the Investigations Manager will be responsible for making the decision on ending the conference phase after considering all the parties' relevant reasons and concerns.

End of the conference phase

184. It is important for the taxpayer and the Inland Revenue officers to be fully aware of when the conference phase comes to an end. The conference phase is not necessarily complete just because the parties have held the final meeting. For example, the parties may need further information or to consider further submissions made at the meeting. In most cases, it is expected that the parties involved in the dispute will agree on when the conference phase has ended. Such agreement will be put in writing.

Facilitated conference

185. After a facilitated conference the facilitator will be responsible for clarifying the agreed end date of the conference phase with the parties.

186. If the facilitator considers that both the taxpayer and Inland Revenue officers have exchanged all the material information relevant to the dispute, have fully discussed the tax technical issues and have not resolved the dispute, the facilitator may suggest to the parties that the conference phase can come to its end.

187. If there is no agreement and the parties' reasons for continuing the conference phase are considered to be insufficient, the conference facilitator can make a decision to end the conference phase and notify the parties of that decision. The following are examples of strong indicators that the conference phase has come to its end:

(a) the taxpayer and/or the tax advisors stop contacting the Inland Revenue officers directly involved in the dispute for a few weeks;

(b) the parties did not exchange information notwithstanding that this has been agreed on at the conference meeting, thus leading to the exercise of the Commissioner's powers (eg, section 17 notices);

(c) the parties agree to disagree with each other and express interest in progressing to the SOP phase;

(d) the taxpayer appears to be using delaying tactics at the conference phase when the issue in dispute is subject to an imminent time bar.

188. In rare situations, where conference facilitation is involved and the facilitator is concerned with the parties' decision to end the conference phase before achieving the objectives of the conference meeting, the facilitator may adjourn the meeting and discuss the concerns with the responsible Inland Revenue officers. The facilitator may also contact the taxpayer or the taxpayer's tax advisors to discuss whether the conference phase should come to its end. The facilitator will seek the parties' agreement as to whether or not the conference phase is complete.

Unfacilitated conference

189. Where no conference facilitation is involved, the taxpayer and the Inland Revenue officers will work out when to end the conference phase. They should consider whether the objectives of the conference phase have been achieved before reaching the agreement. If no agreement can be reached, the Investigations Manager will review the conduct of the parties during the conference phase and make a decision on whether the conference phase has come to an end.

190. When a dispute remains unresolved after the conference phase has been completed, the Commissioner must issue a disclosure notice under section 89M(1).

Progressing disputes through the disputes process where the dispute affects multiple taxpayers

191. Sometimes it is necessary for Inland Revenue to deal with a large number of taxpayers that are all affected by the same disputed matter. This can arise in situations where:

- the taxpayers are all investors in a particular scheme;
- the taxpayers have entered into similar arrangements and they have the same promoter;
- the taxpayers have entered into similar arrangements and they have the same tax agent;
- there exists a widespread but well-defined common problem involving many unrelated taxpayers (eg, taxpayers moving their private residence into an LAQC, or a number of taxpayers claiming non-deductible expenses such as fines for overloading).

192. Given Inland Revenue's limited resources, and bearing in mind taxpayer compliance costs it may not be

appropriate for all the cases to proceed through the full dispute process.

193. The Commissioner's approach, in the context of taxpayer initiated disputes, to the different situations which arise where a large number of taxpayers are all affected by the same disputed matter is outlined in the following paragraphs.

Situation 1: There are a number of cases on the same issue under dispute. One case has been referred to the Adjudication Unit, who has still to reach a conclusion on the matter

194. In this situation it may be possible for other affected taxpayers and the Commissioner to merely agree, subject to statutory time bar issues, to place their case "on hold" while the Adjudication Unit undertakes its analysis.

195. However, care will need to be taken to ensure that the time bar will not be breached, and consideration should be given to obtaining a time bar waiver.

196. Again, as this approach requires the taxpayer to agree, the Commissioner can offer it to individual taxpayers but they still have the choice to progress the dispute through the full disputes process.

197. Taxpayers who agree to place their case "on hold" while adjudication considers the issues in question in relation to another taxpayer will not be bound by any decision reached by the Adjudication Unit and will be free to continue with their dispute should they wish.

Situation 2: The Adjudication Unit has looked at an issue before and taken a view supporting the taxpayer

198. It is the Commissioner's policy that a finding for the taxpayer in previous dispute(s) will usually lead to the other disputes being withdrawn, particularly if the disputes are in respect of the same transaction.

199. However, in some situations further consideration of the issue is required at a national level before the Commissioner will apply the conclusions reached in a particular adjudication report more broadly to other taxpayers. In those cases, Inland Revenue officers may be advised that a specified or contrary approach (to that adopted by the Adjudication Unit) is to be followed pending further consideration of the issue at a national level.

Disclosure notice

200. The Commissioner must issue a disclosure notice under section 89M(1), unless the Commissioner:

(a) does not have to complete the disputes process because any of the exceptions under section 89N(1)(c) apply (see the discussion in SPS 10/04: *Disputes resolution process commenced by the Commissioner of Inland Revenue* or any replacement SPS), or

(b) does not have to complete the disputes process because the High Court has made an order that the dispute resolution process can be truncated pursuant to an application made by the Commissioner under section 89N(3), or

(c) has already issued to the taxpayer a notice of disputable decision that includes or takes into account the adjustment proposed in the NOPA pursuant to section 89M(2). Section 89M(1) and (2) reads:

> (1) Unless subsection (2) applies, and subject to section 89N, the Commissioner must issue a disclosure notice in respect of a notice of proposed adjustment to a disputant at the time or after the Commissioner or the taxpayer, as the case may be, issues the notice of proposed adjustment.
>
> (2) The Commissioner may not issue a disclosure notice in respect of a notice of proposed adjustment if the Commissioner has already issued a notice of disputable decision that includes, or takes account of, the adjustment proposed in the notice of proposed adjustment.

201. The meaning of disputable decision is discussed in paragraphs 61 to 71.

202. The Commissioner will usually advise the taxpayer two weeks before a disclosure notice is issued that it will be issued to them.

203. Where practicable, the Commissioner will contact the taxpayer shortly after the disclosure notice and SOP are issued to ascertain whether they have received these documents.

204. If the taxpayer has not received the Commissioner's disclosure notice, for example, due to a postal error or an event or circumstance beyond the taxpayer's control, the Commissioner will issue another disclosure notice to the taxpayer. In this circumstance, the response period within which the taxpayer must respond with their SOP will commence from the date that the Commissioner issued the initial disclosure notice.

205. Where the taxpayer cannot issue a SOP within the applicable response period, they should issue a late SOP with an explanation of why it is late. The Commissioner will consider the late SOP in terms of the discretion under section 89K(1) (see paragraphs 120 to 130 for details).

Evidence exclusion rule

206. A disclosure notice is the document that can trigger the application of the evidence exclusion rule under section 138G(1). This rule restricts the evidence that the parties can raise in court challenges to matters disclosed in their SOP. (Both parties can refer to evidence raised by either party.)

207. Any disclosure notice that the Commissioner issues will explain the effect of the evidence exclusion rule and refer to section 138G.

208. Section 89M(6B) defines "evidence" for the purposes of the evidence exclusion rule to mean the available documentary evidence and not lists of potential witnesses. Therefore, the identities of both parties' witnesses in sensitive cases will continue to be protected, without undermining the effect of the evidence exclusion rule.

Issue of a disclosure notice

209. The Commissioner can issue a disclosure notice at any time on or after the date that the taxpayer issues a NOPA because there is no statutory timeframe specifying when the notice must be issued.

210. The Commissioner does not have to issue a disclosure notice to a taxpayer when they ask for one to be issued. However, the Commissioner will usually discuss such a request with the taxpayer and advise whether a disclosure notice will be issued and, if not, the reasons why and the implications for the dispute.

211. Generally, the Commissioner's practice is to issue a disclosure notice after the exchange of a NOPA, NOR, notice rejecting the NOR, the conclusion of the conference phase and in accordance with any timeframe agreed with the taxpayer. The Commissioner will usually issue a disclosure notice within one month after the conference phase has been completed.

212. When possible, the responsible officer should use the relevant statutory power under the TAA to obtain any information needed to complete the conference or disclosure phases. This will ensure that the disputes process is conducted in a timely and efficient manner. If the Commissioner is waiting for information to be provided pursuant to a statutory power Commissioner will defer issuing a disclosure notice to ensure that any information provided by the taxpayer can be included in the Commissioner's SOP.

213. If a disclosure notice is issued earlier (for example, the facts are clear, the taxpayer agrees, or a conference is not required) the reasons must be documented and explained to the taxpayer.

Taxpayer's Statement of Position (SOP)

214. Pursuant to section 89M(5), once the Commissioner has issued a disclosure notice, the taxpayer must issue to the Commissioner a SOP within the two-month response period that starts on the date that the disclosure notice is issued.

215. The Commissioner cannot consider a document that the taxpayer purports to issue as a SOP before the Commissioner has issued the disclosure notice because it would have been issued outside the applicable response period. The taxpayer must submit another SOP after the disclosure notice is issued to satisfy their obligation under section 89M(5).

216. Unless an "exceptional circumstance" in section 89K applies, if the taxpayer issues a SOP to the Commissioner outside the response period, the Commissioner will treat the dispute as if it was never commenced. The Commissioner does not have to issue an assessment to include or take account of the taxpayer's proposed adjustment. Section 89M(7)(b) reads:

> (7) A disputant who does not issue a statement of position in the prescribed form within the response period for the statement of position, is treated as follows:
>
> …
>
> (b) if the disputant has proposed the adjustment to the assessment, the disputant is treated as not having issued a notice of proposed adjustment.

Content of a taxpayer's SOP

217. The content of a SOP is binding. If the matter proceeds to court, then pursuant to section 138G(1) the parties can only rely on the facts, evidence (excluding oral evidence), issues and propositions of law that either party discloses in their SOP barring an application by the parties to the court to include new information under section 138G(2).

218. The taxpayer's SOP must be in the prescribed form (the *IR 773 Statement of position* form that can be found on Inland Revenue's website: **www.ird.govt.nz**) and include sufficient detail to fairly inform the Commissioner of the facts, evidence, issues and propositions of law on which the taxpayer wishes to rely. In particular, the taxpayer must clarify what tax laws are being relied on and advise if any of these are different to those relied on in the taxpayer's NOPA.

219. However, if the Commissioner receives a SOP that is not in the prescribed form (as described in paragraph 218) the Commissioner's practice will be to advise the taxpayer that the SOP must be in the prescribed form. If this occurs on the last day of the response period

the Commissioner will consider the resubmitted SOP under section 89K(1)(a)(iii) provided that the lateness is minimal.

220. Section 89M(6) reads:

> A disputant's statement of position in the prescribed form must, with sufficient detail to fairly inform the Commissioner,—
>
> (a) give an outline of the facts on which the disputant intends to rely; and
>
> (b) give an outline of the evidence on which the disputant intends to rely; and
>
> (c) give an outline of the issues that the disputant considers will arise; and
>
> (d) specify the propositions of law on which the disputant intends to rely.

221. The minimum content requirement for a SOP is an outline of the relevant facts, evidence, issues and propositions of law. To allow the Adjudication Unit to successfully reach a decision, the outline in the SOP must contain full, complete and detailed submissions.

222. An outline that consists of a frank and complete discussion of the issues, law, arguments and evidence supporting the arguments is implicit in the spirit and intent of the disputes process. (In very complex cases the taxpayer should provide a full explanation of the relevant evidence.)

223. The disputes process does not require that relevant documents are discovered or full briefs of evidence or exhaustive lists of documents exchanged. Rather, providing an outline of relevant evidence in the SOP will ensure that both parties appreciate the availability of evidence in respect of the factual issues in dispute. The taxpayer should include an outline of any expert evidence on which they intend to rely in the SOP.

224. If the Commissioner considers that the SOP has insufficient detail to allow a correct assessment to be made the SOP can be treated as not complying with the requirements of section 89M(6).

225. Subject to any order made by the court under section 138G(2), the evidence exclusion rule found in section 138G(1) prevents a hearing authority from considering arguments and evidence that are not included in:

(a) the SOP, or

(b) any additional information that:

(i) the Commissioner provides under section 89M(8), that is deemed to be part of the Commissioner's SOP under subsection (9), or

(ii) the parties provide pursuant to an agreement under section 89M(13), that is deemed to be part of the provider's SOP under subsection (14).

226. Section 89M(6B) reads:

> In subsection 4(b) and 6(b), evidence refers to the available documentary evidence on which the person intends to rely, but does not include a list of potential witnesses, whether or not identified by name.

227. Pursuant to section 89M(6B), the SOP must list any documentary evidence but not potential witnesses. Any witnesses' identities will continue to be protected without undermining the effect of the evidence exclusion rule.

Receipt of a taxpayer's SOP

228. If a taxpayer has issued a SOP the Commissioner can accept the SOP or issue a SOP in response to the taxpayer's SOP. Furthermore, section 89N(2) allows the Commissioner to amend an assessment under section 113 after the Commissioner has considered the SOP. (However, the Commissioner's practice is to send the dispute through the adjudication process. See paragraphs 248 to 263 for details.)

229. The Commissioner will make reasonable efforts to contact the taxpayer or their tax agent 10 working days before the response period expires to determine whether the taxpayer will issue a SOP in response to the disclosure notice. Such contact will be made by telephone or in writing. The taxpayer's SOP will be referred to the responsible officer within five working days after Inland Revenue receives it. Upon receipt of the SOP, the responsible officer will ascertain and record the following:

(a) the date on which the SOP was issued, and

(b) whether the SOP has been issued within the relevant response period, and

(c) the salient features of the SOP including any deficiencies in its content.

230. Where practicable, the Commissioner will acknowledge that the taxpayer's SOP is received within 10 working days after it is received. However, the Commissioner will advise the taxpayer or their agent of any deficiencies in the SOP's content as soon as they become aware of the deficiency. They will be further advised when the response period expires that those deficiencies must be rectified and whether the Commissioner intends to provide any additional information to the taxpayer.

231. Where a SOP is issued outside the applicable response period, the taxpayer can apply for consideration of exceptional circumstances under section 89K. The reasons for accepting or rejecting the application must be documented and the responsible officer will make a reasonable effort to advise the taxpayer of the decision

in writing within 15 working days after Inland Revenue has received the taxpayer's application.

232. If the taxpayer issues a SOP outside the applicable response period and none of the exceptional circumstances under section 89K apply, the dispute will be treated as if it was never commenced (see paragraph 216). Where practicable, the Commissioner must advise the taxpayer of this within 10 working days after the response period for the disclosure notice has expired.

Commissioner's SOP in response

233. When the taxpayer has issued a NOPA, section 89M(3) allows the Commissioner to issue a disclosure notice without a SOP. If the dispute remains unresolved the Commissioner's practice is to issue a SOP that addresses and responds to the substantive items in the taxpayer's SOP within the applicable response period (that is, within two months starting on the date that the taxpayer issued their SOP).

234. However, in very rare circumstances the Commissioner may not issue a SOP in response to the taxpayer's SOP. For example, where an assessment must be issued because a statutory time bar is imminent, an exception arises under section 89N(1)(c) or the High Court has made an order that the disputes process can be truncated pursuant to an application made under section 89N(3).

235. If there is insufficient time to provide a SOP in response the Commissioner can apply to the High Court for further time to reply to the taxpayer's SOP under section 89M(10) if the application is made before the response period expires and the Commissioner considers that it is unreasonable to reply within the response period because of the number, complexity or novelty of matters raised in the taxpayer's SOP.

236. Such applications are expected to be rare but can arise if the taxpayer is less than co-operative with supplying information and/or has failed to maintain proper and adequate records.

237. The Commissioner's SOP must be in the form that the Commissioner has prescribed under section 35(1) and include sufficient details to fairly inform the taxpayer of the facts, evidence, issues and propositions of law on which the Commissioner wishes to rely.

238. Section 89M(4) reads:

> The Commissioner's statement of position in the prescribed form must, with sufficient detail to fairly inform the disputant,—
>
> (a) give an outline of the facts on which the Commissioner intends to rely; and
>
> (b) give an outline of the evidence on which the Commissioner intends to rely; and
>
> (c) give an outline of the issues that the Commissioner considers will arise; and
>
> (d) specify the propositions of law on which the Commissioner intends to rely.

239. If the Commissioner has issued a SOP, the Commissioner can also provide to a taxpayer additional information in response to matters raised in their SOP under section 89M(8) within two months starting on the date that the taxpayer's SOP is issued.

240. However, the Commissioner's practice is to issue a SOP to the taxpayer towards the end of the response period to allow sufficient time for gathering any further information in response and considering the SOP's content. This minimises the occasions when additional information needs to be provided under section 89M(8) as the information in question will be in the SOP. In any event, as any additional information must be provided within the same response period as the Commissioner's SOP in most case it will be unlikely that the Commissioner will be able to issue additional information within the response period.

241. The taxpayer cannot reply to the Commissioner's SOP (or any additional information provided) unless the Commissioner agrees to accept additional information under section 89M(13).

Agreement to include additional information

242. The parties can agree to include additional information in their SOP under section 89M(13) at any time during the disputes process including after the dispute has been referred to the Adjudication Unit. Although there is no statutory time limit, the Commissioner's practice is to allow one month (from the later of the date that the Commissioner issues a SOP or provides any additional information under section 89M(8)) for such an agreement to be reached and information provided.

243. However, before agreeing to a request made by the taxpayer under section 89M(13) the Commissioner will consider the taxpayer's prior conduct and whether they could have provided the information earlier through the application of due diligence.

244. The Commissioner will usually also consider the materiality and relevance of the additional information and its capacity to help resolve the dispute and may decide to take it into account in coming to an assessment. In this circumstance, both parties will be expected to cooperate in resolving the relevance and accuracy of any such material. The Commissioner may

wish to apply resources to verification and comment and this will be considered by the adjudicator.

245. If a taxpayer's request to add additional information to their SOP is declined, the reasons must be documented with detailed reference to the taxpayer's conduct, level of cooperation before the request was made and why the information was not provided earlier. The responsible officer will also advise the taxpayer or their tax agent of the reasons why their request was declined.

246. Any agreements to add further information to the SOP will be made subject to the taxpayer agreeing that the Commissioner can also include responses to the additional information to the SOP under section 89M(13), if required.

247. Any additional information that the parties provide under section 89M(13) will be deemed to form part of the provider's SOP under section 89M(14). Thus, the evidence exclusion rule under section 138G(1) applies to the additional information.

Preparation for adjudication

248. The Adjudication Unit is part of the Office of the Chief Tax Counsel and represents the final step in the disputes process. The adjudicator's role is to review unresolved disputes by taking a fresh look at the tax dispute and the application of law to the facts in an impartial and independent manner and provide a comprehensive and technically accurate decision that will ensure the correctness of the assessment.

249. Generally, the adjudicator will make such a decision within three months after the case is referred to the Adjudication Unit. However, this will depend on the number of disputes that are before the Adjudication Unit, any allocation delays and the technical, legal and factual complexity of those disputes. (For further information on the timeframe for adjudication of disputes see the article titled "Adjudication Unit – Its role in the dispute resolution process" that was published in the *Tax Information Bulletin* Vol 19, No 10 (November 2007).)

250. Judicial comments have been made in *C of IR v Zentrum Holdings Limited and Another, Ch'elle Properties (NZ) Limited v CIR* (2004) 21 NZTC 18,618 and *ANZ National Bank Ltd and others v C of IR (No. 2)* (2006) 22 NZTC 19,835 indicating that, as a matter of law, it is not strictly necessary for Inland Revenue officers to send all disputes to the Adjudication Unit for review, and Inland Revenue officers are not necessarily bound by the Adjudication Unit's decisions.

251. Notwithstanding the above judicial comments, if the parties have not agreed on all the issues at the end of the conference and disclosure phases or to truncate the disputes process under section 89N(1)(c)(viii), it is the Commissioner's policy and practice that all disputes are to be sent to the Adjudication Unit for review, irrespective of the complexity or type of issues or amount of tax involved unless any of the following exceptions arise:

(a) the Commissioner has considered the taxpayer's SOP for the purposes of section 89N(2)(b) and referred the dispute to the Adjudication Unit for their preliminary consideration and the Adjudication Unit has determined that it has insufficient time to reach a decision in respect of the dispute before a statutory time bar would prevent the Commissioner from subsequently increasing the assessment (see paragraph 255 for further discussion), or

(b) any of the legislative exceptions specified in section 89N(1)(c) apply (see SPS 10/04: *Disputes resolution process commenced by the Commissioner of Inland Revenue* for further discussion) so that the Commissioner can amend an assessment without first completing the disputes process, or

(c) the High Court has made an order that the disputes process can be truncated pursuant to an application made by the Commissioner under section 89N(3).

252. Inland Revenue officers will adequately consider the facts and legal arguments in the taxpayer's SOP before deciding whether to amend the assessment. It is expected that this will occur only in very rare circumstances.

253. Whether the Commissioner has adequately considered a SOP will depend on what is a reasonable length of time and level of analysis for that SOP given the circumstances of the case (for example, the length of the SOP and the complexity of the legal issues).

254. Thus a simple dispute could take only a couple of days to consider adequately while a complex dispute could take a few weeks.

255. The decision not to refer the case to adjudication must be made by a senior person in Service Delivery (for example, at the time of writing the delegation was with Assurance Manager level or above). In respect of the first exception mentioned in paragraph 251(a) it is necessary that the parties have exchanged a SOP and it is a matter solely for the Adjudication Unit to determine whether it has insufficient time to fully consider the dispute.

256. If the dispute is to be referred to the Adjudication Unit, the Commissioner should not issue an assessment or amended assessment before the adjudication process is completed unless a time bar is imminent. The responsible officer will prepare a cover sheet that records all the documents that must be sent to the Adjudication Unit.

257. The cover sheet together with copies of the documents (NOPA, NOR, notice rejecting the NOR, conference notes, both parties' SOP, additional information, material evidence including expert opinions and a schedule of all evidence held) and any recordings of discussions held during the conference must be sent to the Adjudication Unit.

258. When the dispute is to be referred to adjudication, the responsible officer will issue a letter and copy of the cover sheet to the taxpayer before sending the submissions, notes and evidence to the Adjudication Unit. The cover sheet and letter is usually completed within one month after the date that the Commissioner issues the SOP or provides additional information under section 89M(8).

259. The purpose of this letter is to seek the taxpayer's concurrence on the materials to be sent to the adjudicator—primarily in regard to the documentary evidence that has been disclosed at the SOP phase. This letter will allow the taxpayer no more than 10 working days from when it is received to provide a response.

260. Once the taxpayer has concurred on the materials to be sent to the Adjudication Unit, those materials will usually be so forwarded. However, if the taxpayer does not provide a response the materials will be forwarded within 10 working days after the date that the letter is issued to the taxpayer advising that the materials will be sent to the Adjudication Unit. The adjudicator can also contact the parties after the initial materials have been received to obtain further information.

261. Where an investigation has covered multiple issues, the cover sheet will outline any issues that the parties have agreed upon and any issues that are still disputed. The adjudicator can then consider the disputed issues and not reconsider those issues that have been agreed upon.

262. Generally, the adjudicator only considers the materials that the parties have submitted. They do not usually seek out or consider further information, unless it is relevant. The adjudicator may consider such additional information notwithstanding that the parties have not agreed that the provider can include this information in their SOP under section 89M(13).

263. However, any additional material that the parties have not included in their SOP (or is not deemed to be included in their SOP under section 89M(14)) cannot later be raised by the parties as evidence in the TRA or a hearing authority because of the evidence exclusion rule in section 138G(1).

Adjudication decision

264. Once a conclusion is reached, the Adjudication Unit will advise the taxpayer and responsible officer of the decision. The responsible officer will implement the Adjudication Unit's recommendations and follow up procedures where required, including issuing a notice of assessment to the taxpayer where applicable.

265. If the Adjudication Unit makes a decision that is not in the Commissioner's favour, the Commissioner is bound by and cannot challenge that decision. The dispute will come to end. The Commissioner will issue an assessment or amended assessment to the taxpayer to reflect the decision.

266. If a taxpayer commences the disputes process, they can file challenge proceedings in the general jurisdiction of the TRA, its small claims jurisdiction (if the taxpayer so elects in their NOPA under section 89E(1)) or the High Court within the applicable response period if any of the following conditions are met:

   (a) the Commissioner or taxpayer has issued an assessment that was the subject of an adjustment that the taxpayer proposed and Commissioner rejected within the applicable response period and the Commissioner has later issued an amended assessment to the taxpayer (section 138B(2)), or

   (b) the Commissioner or taxpayer has issued an assessment that was the subject of an adjustment that the taxpayer proposed and the Commissioner rejected within the applicable response period by a NOR or other written disputable decision and the Commissioner has not issued an amended assessment (section 138B(3)), or

   (c) the Commissioner or taxpayer has issued a disputable decision that is not an assessment that was the subject of an adjustment that the taxpayer proposed and the Commissioner rejected within the applicable response period (section 138C).

267. A taxpayer must file proceedings with the TRA or High Court within the two-month response period that starts on the date that the Commissioner issues:

   (a) the amended assessment if the challenge proceedings are filed under section 138B(2), or

(b) the written disputable decision rejecting the taxpayer's proposed adjustment if the challenge proceedings are filed under section 138B(3), or

(c) the written disputable decision rejecting the taxpayer's proposed adjustment if the challenge proceedings are filed under section 138C.

268. If applicable, the responsible officer will implement any decision made by the hearing authority and follow up procedures where required including issuing a notice of assessment or amended assessment to the taxpayer.

This Standard Practice Statement is signed on 8 November 2010.

Rob Wells
LTS Manager, Technical Standards

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.

FOREIGN CURRENCY AMOUNTS – CONVERSION TO NEW ZEALAND DOLLARS

This article provides the exchange rates acceptable to Inland Revenue for converting foreign currency amounts to New Zealand dollars under the controlled foreign company (CFC) and foreign investment fund (FIF) rules for the six months ending 30 September 2010.

The Income Tax Act 2007 ("2007 Act") requires foreign currency amounts to be converted into New Zealand dollars applying one of the following methods:

- actual rate for the day for each transaction (including close of trading spot exchange rate on the day), or
- rolling 12-month average rate for a 12-month accounting period or income year (see the table C**urrency rates 6 months ending 30 September 2010 – rolling 12-month average**), or
- mid-month actual rate as the basis of the rolling average for accounting periods or income years greater or lesser than 12 months (see the table **Currency rates 6 months ending 30 September 2010 – mid-month actual**).

New legislation was enacted in September 2010 with effect from 1 April 2008 which permits the Commissioner to set currency rates and approve methods of calculating exchange rates. The Commissioner can set rates for general use by taxpayers or for specific taxpayers. The Commissioner's ability to set rates and approve methods applies in all circumstances, ie, where the Act does not contain a specific currency conversion rule (sections YF 1(5) and (6), or in circumstances where the Act provides a rate or method for currency conversion (section YF 2).

Inland Revenue uses wholesale rates from Bloomberg for rolling 12-month average, mid-month actual and end of month. These rates are provided in three tables.

You must apply the chosen conversion method to all interests for which you use the FIF or CFC calculation method in that and each later income year.

To convert foreign currency amounts to New Zealand dollars for any country listed, divide the foreign currency amount by the exchange rate shown. Round the exchange rate calculations to four decimal places wherever possible.

If you need an exchange rate for a country or a day not listed in the tables, please contact one of New Zealand's major trading banks.

Note: All section references relate to the Income Tax Act 2007.

Actual rate for the day for each transaction

The actual rate for the day for each transaction can be used in the following circumstances:

- Where the 2007 Act does not provide a specific currency conversion rule, then foreign currency amounts can be converted by applying the close of trading spot exchange rate on the date that the transaction which is required to be measured or calculated occurs (section YF 1(2)).
- Where a person chooses to use the actual rate for the day of the transaction when calculating their FIF income or loss when applying either: the comparative value method, fair dividend rate method, deemed rate of return method or the cost method (section EX 57(2)(a)).
- Where a person chooses to use the close of trading spot exchange rate to convert foreign income tax paid by a CFC (section LK 3(a)).

Unless the actual rate is the 15th or the last day of the month, these rates are not supplied by Inland Revenue.

The table **Currency rates 6 months ending 30 September 2010 – month end** provides exchange rates for the last day of the month. These are provided for convenience to assist taxpayers who may need exchange rates on those days.

Currency rates 6 months ending 30 September 2010 – rolling 12-month average table

This table is the average of the mid-month exchange rate for that month and the previous 11 months, ie, the 12-month average. This table should be used where the accounting period or income year encompasses 12 complete months.

This table can be used to convert foreign currency amounts to New Zealand dollars for:

- FIF income or loss calculated under the accounting profits method (section EX 49(8)); comparative value method, the fair dividend rate method, the deemed rate of return method or cost method (section EX 57)

- branch equivalent income or loss calculated under the CFC and FIF rules (section EX 21(4)) for accounting periods of 12 months
- foreign tax credits calculated under the branch equivalent method for a CFC or FIF under section LK 3(b) for accounting periods of 12 months.

Currency rates 6 months ending 30 September 2010 – mid-month actual table

This table sets out the exchange rate on the 15th day of the month, or if no exchange rates were quoted on that day, on the preceding working day on which they were quoted. This table can be used as the basis of the rolling average where the accounting period or income year is less than or greater than 12 months (see Example 4). You can also use the rates from this table as the actual rate for any transactions arising on the 15th of the month.

This table can be used as the basis of the rolling average for calculating:

- branch equivalent income or loss calculated under the CFC or FIF rules (section EX 21(4)) for accounting periods of less than or greater than 12 months
- a person's FIF income or loss under: the comparative value method, the fair dividend rate method, the deemed rate of return method or cost method (section EX 57(2)(b)) for accounting periods or income years of less than or greater than 12 months
- foreign tax credits calculated under the branch equivalent method for a CFC or FIF under section LK 3(b) for accounting periods of less than or greater than 12 months.

Example 1

A taxpayer with a 30 September balance date purchases shares in a Philippine company (which is a FIF but does produce a guaranteed yield) on 7 September 2010. Its opening market value on 1 October 2010 or its closing market value on 30 September 2010 is PHP 350,000. Using the comparative value method and applying the actual rate for the day (section EX 57(2)(a)), the opening market value is converted as follows:

PHP 350,000 ÷ 32.2373 = $10,856.99

(In this example, the rate selected is the month-end rate for September 2010 for PHP. Refer to the table "Currency rates 6 months ending 30 September 2010 – month end".)

Example 2

A CFC resident in Hong Kong has an accounting period ending on 30 June 2010. Branch equivalent income for the period 1 July 2009 to 30 June 2010 is 200,000 Hong Kong dollars (HKD), which converts to:

HKD 200,000 ÷ 5.4945= $36,400.37

(In this example, the rate selected is the rolling 12-month average rate for June 2010 for HKD. Refer to the table "Currency rates 6 months ending September 2010 – rolling 12-month average".)

Example 3

A resident individual with a 30 September 2010 accounting period acquires a FIF interest in a Japanese company on 1 October 2009 for 10,500,000 yen. The interest is sold in September 2010 for 10,000,000 yen. Using the comparative value method and applying section EX 57(2)(b), these amounts are converted as:

JPY 10,500,000 ÷ 64.5675 = $162,620.51

JPY 10,000,000 ÷ 64.5675 = $154,876.68

(In this example, the rolling 12-month rate for September 2010 has been applied to both calculations.)

Example 4

A CFC resident in Singapore was formed on 21 April 2010 and has a balance date of 30 September 2010. During the period 1 May 2010 to 30 September 2010, branch equivalent income of 500,000 Singaporean dollars was derived. For the conversion to New Zealand dollars the taxpayer chooses the method set out in section EX 21(4)(b).

1. Calculating the average monthly exchange rate for the complete months May–September 2009:

   0.9815 + 0.9718 + 1.0021 + 0.9619 + 0.9782 = 4.8955

   4.8955 ÷ 5 = 0.9791
2. Round exchange rate to four decimal places: 0.9791
3. Conversion to New Zealand currency:

   SGD 500,000 ÷ 0.9791 = $510,673.07

(In this example, the rates are from the table "Currency rates 6 months ending September 2010 – mid-month actual", from May to September 2010 inclusive for SGD.)

Currency rates 6 months ending 30 September 2010 – rolling 12-month average

Currency	Code	15/04/2010	15/05/2010	15/06/2010	15/07/2010	15/08/2010	15/09/2010
Australia Dollar	AUD	0.7941	0.7955	0.7966	0.7980	0.7960	0.7929
Bahrain Dinar	BHD	0.2609	0.2647	0.2669	0.2694	0.2703	0.2711
Britain Pound	GBH	0.4313	0.4397	0.4468	0.4532	0.4568	0.4602
Canada Dollar	CAD	0.7388	0.7424	0.7425	0.7453	0.7445	0.7440
China Yuan	CNY	4.7267	4.7967	4.8350	4.8783	4.8917	4.9017
Denmark Kroner	DKK	3.6380	3.7236	3.7911	3.8555	3.9029	3.9533
Euporean Community Euro	EUR	0.4888	0.5003	0.5094	0.5181	0.5244	0.5311
Fiji Dollar	FJD	1.3543	1.3649	1.3738	1.3814	1.3830	1.3838
French Polynesia Franc	XPF	58.2824	59.6480	60.7268	61.7661	62.5155	63.3293
Hong Kong Dollar	HKD	5.3675	5.4483	5.4945	5.5478	5.5669	5.5851
India Rupee	INR	32.4644	32.7214	32.9242	33.1301	33.1536	33.1229
Indonesia Rupiah	IDR	6642.5392	6670.8175	6670.1708	6672.7008	6639.2867	6604.5275
Japan Yen	JPY	63.7775	64.5858	64.7675	64.9850	64.6892	64.5675
Korea Won	KOR	820.5452	826.4252	831.2962	835.2204	835.1243	834.5443
Kuwait Dinar	KWD	0.1987	0.2017	0.2034	0.2054	0.2061	0.2068
Malaysia Ringit	MYR	2.3664	2.3814	2.3863	2.3881	2.3755	2.3598
Norway Krone	NOK	4.1185	4.1679	4.1992	4.2283	4.2501	4.2755
Pakistan Rupee	PKR	57.5853	58.5962	59.3127	60.0884	60.4834	60.8795
Phillipines Peso	PHP	32.3402	32.6789	32.8431	33.0695	33.0193	32.8711
PNG Kina	PGK	1.8443	1.8746	1.8981	1.9264	1.9340	1.9413
Singapore Dollar	SGD	0.9787	0.9887	0.9929	0.9980	0.9965	0.9947
Solomon Islands Dollar*	SBD	5.4879	5.5657	5.6091	5.6592	5.6758	5.6891
South Africa Rand	ZAR	5.3059	5.3259	5.3426	5.3629	5.3356	5.3359
Sri Lanka Rupee	LKR	79.4184	80.3917	80.9668	81.6350	81.7383	81.8485
Sweden Krona	SEK	5.0140	5.0837	5.1227	5.1446	5.1762	5.1999
Swiss Franc	CHF	0.7302	0.7423	0.7509	0.7561	0.7573	0.7576
Taiwan Dollar	TAI	22.3728	22.6323	22.7805	22.9523	22.9717	22.9933
Thailand Baht	THB	23.1292	23.3505	23.4436	23.5618	23.5145	23.4020
Tonga Pa'anga*	TOP	1.3401	1.3549	1.3603	1.3683	1.3728	1.3757
United States Dollar	USD	0.6922	0.7023	0.7080	0.7147	0.7170	0.7192
Vanuatu Vatu	VUV	69.6383	70.2571	70.7029	71.1680	71.2929	71.5445
West Samoan Tala*	WST	1.7579	1.7692	1.7776	1.7756	1.7700	1.7689

Notes to table:

All currencies are expressed in NZD terms, ie, 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross-rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

Currency rates 6 months ending 30 September 2010 – mid-month actual

Currency	Code	15/04/2010	15/05/2010	15/06/2010	15/07/2010	15/08/2010	15/09/2010
Australia Dollar	AUD	0.7618	0.7983	0.8077	0.8245	0.7907	0.7795
Bahrain Dinar	BHD	0.2684	0.2665	0.2635	0.2751	0.2661	0.2758
Britain Pound	GBH	0.4594	0.4862	0.4720	0.4719	0.4527	0.4681
Canada Dollar	CAD	0.7134	0.7323	0.7166	0.7575	0.7354	0.7505
China Yuan	CNY	4.8600	4.8300	4.7700	4.9500	4.8000	4.9300
Denmark Kroner	DKK	3.9038	4.2560	4.2144	4.1971	4.1233	4.1845
Euporean Community Euro	EUR	0.5245	0.5716	0.5668	0.5637	0.5534	0.5621
Fiji Dollar	FJD	1.3559	1.3768	1.3870	1.4243	1.3740	1.3899
French Polynesia Franc	XPF	62.5166	68.0988	67.5006	67.2919	65.9975	67.0523
Hong Kong Dollar	HKD	5.5241	5.5057	5.4453	5.6685	5.4863	5.6818
India Rupee	INR	31.6346	31.9705	32.5427	34.0160	33.0067	33.9232
Indonesia Rupiah	IDR	6,417.5900	6,455.2600	6,380.5500	6,595.5700	6,334.5500	6,557.1000
Japan Yen	JPY	66.2300	65.4000	63.9200	63.7500	60.8300	62.7300
Korea Won	KOR	790.3472	810.7877	859.2546	872.7679	839.5492	847.9236
Kuwait Dinar	KWD	0.2055	0.2053	0.2034	0.2102	0.2033	0.2101
Malaysia Ringit	MYR	2.2740	2.2576	2.2856	2.3343	2.2358	2.2797
Norway Krone	NOK	4.1690	4.4121	4.4500	4.4925	4.3866	4.4541
Pakistan Rupee	PKR	59.8802	59.5238	59.8802	62.5000	60.6061	62.8931
Phillipines Peso	PHP	31.6097	31.8574	32.2876	33.7606	31.9763	32.3444
PNG Kina	PGK	1.8661	1.9683	1.9702	2.0305	1.9194	1.9801
Singapore Dollar	SGD	0.9781	0.9815	0.9718	1.0021	0.9619	0.9782
Solomon Islands Dollar*	SBD	5.5414	5.5796	5.4989	5.7526	5.5537	5.7873
South Africa Rand	ZAR	5.2022	5.3381	5.3092	5.5092	5.1578	5.1956
Sri Lanka Rupee	LKR	81.3008	80.6452	79.3651	82.6446	79.3651	81.9672
Sweden Krona	SEK	5.0851	5.4696	5.4206	5.2998	5.2584	5.1846
Swiss Franc	CHF	0.7520	0.8018	0.7919	0.7593	0.7418	0.7335
Taiwan Dollar	TAI	22.3158	22.3730	22.5629	23.4448	22.5433	23.2599
Thailand Baht	THB	22.9358	22.8905	22.6497	23.5207	22.5173	22.5537
Tonga Pa'anga*	TOP	1.3838	1.3933	1.3495	1.4039	1.3872	1.3913
United States Dollar	USD	0.7119	0.7072	0.6990	0.7297	0.7059	0.7315
Vanuatu Vatu	VUV	69.9301	71.9424	72.4638	74.0741	71.4286	72.4638
West Samoan Tala*	WST	1.7279	1.7406	1.7571	1.7955	1.7412	1.7525

Notes to table:

All currencies are expressed in NZD terms, ie, 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross-rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

Currency rates 6 months ending 30 September 2010 – month end

Currency	Code	30/04/2010	31/05/2010	30/06/2010	31/07/2010	31/08/2010	30/09/2010
Australia Dollar	AUD	0.7832	0.8045	0.8145	0.8021	0.7849	0.7593
Bahrain Dinar	BHD	0.2741	0.2566	0.2581	0.2737	0.2635	0.2768
Britain Pound	GBH	0.4761	0.4679	0.4581	0.4627	0.4554	0.4672
Canada Dollar	CAD	0.7400	0.7108	0.7282	0.7476	0.7449	0.7558
China Yuan	CNY	4.9600	4.6500	4.6400	4.9200	4.7600	4.9100
Denmark Kroner	DKK	4.0695	4.1138	4.1672	4.1444	4.1042	4.0135
Euporean Community Euro	EUR	0.5466	0.5530	0.5596	0.5563	0.5513	0.5386
Fiji Dollar	FJD	1.3976	1.3611	1.3749	1.3955	1.3656	1.3732
French Polynesia Franc	XPF	65.0902	66.0163	66.7755	66.4388	65.7778	64.2284
Hong Kong Dollar	HKD	5.6441	5.2987	5.3327	5.6387	5.4374	5.6975
India Rupee	INR	32.2384	31.5564	31.8083	33.7316	32.9024	33.0155
Indonesia Rupiah	IDR	6550.1500	6315.3000	6198.7000	6510.2500	6312.0600	6559.8500
Japan Yen	JPY	68.2100	62.1100	60.5400	62.7800	58.8600	61.3300
Korea Won	KOR	808.1041	819.7385	843.0642	858.2825	837.4840	835.6868
Kuwait Dinar	KWD	0.2099	0.1981	0.1994	0.2085	0.2015	0.2090
Malaysia Ringit	MYR	2.3148	2.2195	2.2160	2.3101	2.2016	2.2670
Norway Krone	NOK	4.2926	4.3960	4.4531	4.4111	4.4051	4.3157
Pakistan Rupee	PKR	60.9756	58.1395	58.4795	62.1118	59.8802	63.2911
Phillipines Peso	PHP	32.3256	31.4901	31.8717	33.0455	31.7071	32.2373
PNG Kina	PGK	1.9984	1.9330	1.8917	1.9637	1.8793	1.9647
Singapore Dollar	SGD	0.9964	0.9524	0.9581	0.9876	0.9478	0.9666
Solomon Islands Dollar*	SBD	5.7237	5.3065	5.3959	5.7525	5.5482	5.8079
South Africa Rand	ZAR	5.3714	5.2297	5.2523	5.2907	5.1548	5.1129
Sri Lanka Rupee	LKR	82.6446	77.5194	77.5194	81.9672	78.7402	81.9672
Sweden Krona	SEK	5.2707	5.3142	5.3363	5.2351	5.1620	4.9498
Swiss Franc	CHF	0.7833	0.7856	0.7376	0.7559	0.7096	0.7215
Taiwan Dollar	TAI	22.7675	21.7567	22.0021	23.2005	22.4033	22.9288
Thailand Baht	THB	23.5481	22.1299	22.2226	23.4063	21.8587	22.2851
Tonga Pa'anga*	TOP	1.4134	1.3418	1.3369	1.4024	1.3614	1.3866
United States Dollar	USD	0.7270	0.6805	0.6847	0.7260	0.6990	0.7343
Vanuatu Vatu	VUV	72.4638	71.4286	71.4286	73.5294	70.9220	70.9220
West Samoan Tala*	WST	1.7620	1.8108	1.7291	1.7720	1.7268	1.7409

Notes to table:

All currencies are expressed in NZD terms, ie, 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross-rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

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.

"INCOME SPLITTING" CASE HELD BY THE HIGH COURT NOT TO BE TAX AVOIDANCE

Case	Philippa Catherine White v CIR
Decision date	12 October 2010
Act(s)	Income Tax Act 2007
Keywords	Income splitting, arrangement, tax avoidance, structuring, personal services, diversion

Summary

The High Court held that the amalgamation of the disputant's medical practice and her husband's business into a single corporate entity did not give rise to an impugned tax avoidance arrangement.

Impact of decision

The decision of the High Court in *Philippa White v CIR* is relevant to the course of litigation in the *Penny v CIR* ([2010] NZCA 231) appeal which is currently before the Supreme Court. In the recent *White* decision, his Honour Justice Heath has found that the disputant's diversion of personal services income through a corporate structure did not amount to tax avoidance.

The same issue (albeit on different facts) is before the Supreme Court in the *Penny* appeal. The Commissioner remains of the view, notwithstanding the recent *White* decision, that such arrangements **may** amount to tax avoidance.

The Commissioner has decided that the *White* case will be appealed. The Commissioner also awaits the final determination of the Courts in the *Penny* matter. In the meantime, he refers any person inquiring as to his view of such matters to his Revenue Alert 10/01.

Facts

1. The Appellant is an anaesthetist in public and private practice. Her husband provided quality assurance services as an employee and privately. On 1 November 2002 the couple restructured their business affairs. One reason for the restructuring was to protect their family after concerns were expressed about exposure to claims which could be made by clients against private professional services being provided.
2. The restructuring involved an arrangement whereby a family trust owned assets including horticultural land, an avocado orchard and business assets relating to the private services provided by the Appellant and her husband. A company Wharfedale Limited ("Wharfedale") was established and the disputant and her husband each held a 35% share in the company. Wharfedale leased the avocado orchard business from the Trust.
3. On 1 November 2002 the Appellant ceased being self-employed in her private anaesthetist practice and took up employment in the newly incorporated Wharfedale, which had taken over the running of her private practice. Her services were then provided to the clients of Wharfedale, those services being exactly the same as she had been providing when in private practice. However, instead of receiving a substantial income commensurate with her skills and exertions, she received no salary from Wharfedale for 5 months work in 2003 and only $4,875 in the year ended 31 March 2004 for 12 months work.
4. The reason given for the lack of salary was that Wharfedale was not making sufficient income to enable her to be remunerated at the same rate as she had been when in private practice. The avocado orchard business which was owned by Wharfedale was operating at a loss. One of the larger overheads for the avocado orchard business was the rental paid for the orchard, which was owned by the family trust. The Appellant claimed that the orchard returns were less

than expected due to poor cropping results and lower than expected prices.

5. As part of his defence in the Taxation Review Authority (TRA) the Commissioner drew the attention of the TRA to the fact that Wharfedale appeared to be paying above normal market rates to lease the orchard. The Appellant claimed that rent was not an issue raised by the Commissioner in his Statement of Position and he was therefore excluded from presenting evidence regarding a market rent.
6. In the TRA Barber DCJ found that the structures implemented by the Appellant left her "unremunerated in a manner which was artificial and contrived and has no sensible reality" TRA 04/08.

Decision

7. In his decision Heath J initially looked at the concerns of Barber DCJ which appeared to be the effective assignment of the Appellant's income from personal exertion to Wharfedale; that it was not "credible nor commercially acceptable" that an experienced anaesthetist would work for a company for virtually nothing, and that the reduction in income tax was not a "merely incidental purpose" of the arrangement.
8. Heath J quoted *Ben Nevis Forestry Ventures Limited v CIR* [2009] 2NZLR (SC), at [106]:

> Put at the highest level of generality, a specific provision is designed to give the taxpayer a tax advantage if its use falls within its ordinary meaning. **That will be a permissible tax advantage**. The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the [Income Tax Act 2007]. **Such uses give rise to an impermissible tax advantage which the Commissioner may counteract**. The general anti-avoidance provision and its associated reconstruction power provide explicit authority for the Commissioner and New Zealand courts to avoid what has been done to reconstruct tax avoidance arrangements.
>
> [Emphasis added]

9. His Honour noted that by using the rubrics "permissible" and "impermissible" the majority in the Supreme Court were discarding the distinction drawn between "tax avoidance" and "tax mitigation" in *Challenge Corporation Limited v CIR* [1986] 2 NZLR 513 (PC). He then stated that in his view "the terminology signals a need to scrutinise a particular transaction to ascertain whether its purpose fell inside or outside of the intended scope of a specific provision that confers a tax advantage".
10. He also noted that in *Ben Nevis* the court indicated that factors which would help determine tax avoidance included:
    - the manner in which an arrangement is carried out
    - the role of the relevant parties and their relationship with the taxpayer
    - the economic and commercial effect of documents and transactions, measured against the actual consequences of implementation of the arrangement
    - whether the taxpayer gains the benefit of a specific provision "in an artificial or contrived way".

    The use made of the specific provisions in the Income Tax Act 2007 ("the Act") also needed to be considered "in the light of the commercial reality and economic effect" of their use and were not limited to "purely legal considerations".
11. Heath J referred to *Glenharrow Holdings Limited v CIR* [2009] 2 NZLR 359 (SC) and acknowledged that the "purpose or effect" of an arrangement was not equated to motive but rather the end result. He acknowledged that the test was objective and indicated that the Court's inability to focus on the intention of the parties was "counter-intuitive".
12. However, he then referred to the findings of Woodhouse P in *Challenge Corporation v CIR* [1986] 2 NZLR 513 (CA) and Harrison J in *Westpac Banking Corporation v CIR* (2009) 24 NZTC (HC) and concluded:

> … evidence of a subjective nature from the taxpayer and others may assist the Court in determining issues of avoidance. However, its use must be restricted to providing the context in which the arrangement was brought into being, in order to assist the Court to understand any genuine commercial arrangements involved.

13. The recent Court of Appeal decision in *CIR v Penny* [2010] NZCA 231 was considered. His Honour distinguished the Appellant's case by noting that the companies operated by Mr Penny and Mr Hooper "did have sufficient money to pay salaries". He did however refer to the *Penny* decision and quoted Randerson J at [126]:

> It will be a matter of assessing all the circumstances including the extent and nature of any artificiality or contrivance in order to determine whether any particular arrangement is within or outside contemplation of Parliament in enacting the tax legislation. **Where there are legitimate reasons such as those discussed at [98] above for adopting a salary markedly below commercial levels, a challenge by the Commissioner may be unlikely to succeed. Nor would I expect the**

Commissioner to interfere in marginal circumstances. The difference here is that salaries were adopted at levels far below ordinary commercial expectations that, in the absence of legitimate reasons for doing so, there is a strong implication of tax avoidance.

[Emphasis added]

14. Heath J concluded that the TRA erred in holding there was a tax avoidance arrangement. He began with the premise that a "rounded" assessment of what occurred was required, in order to determine whether the tax advantages gained were "permissible" or "impermissible". He accepted that the Appellant's subjective intentions were not determinative in ascertaining the purpose or effect of the arrangement. But he considered it necessary to look at the nature of the arrangement and how it was carried into effect to determine whether the purpose or effect was to obtain an "impermissible tax advantage".

15. After revisiting the facts and the TRA decision, Heath J concluded that Judge Barber's real concern was with "an injection of personal/exertion professional income into a family company experiencing losses from business activities so that it did not remunerate as an employee in a fair and commercial manner". Justice Heath's response was "… at the time the arrangements were entered into, it was not expected that financial losses would be caused from business activities … Further the reason that no money was available for Wharfedale to pay a salary to Dr White was because income had to be diverted to pay real (not contrived) debts". He also found that in arranging her affairs the Appellant "did nothing more than obtain the advantage that Parliament intended would flow to someone in her position".

16. His honour further stated that "the elements of the tax avoidance arrangement on which Judge Barber relied, reveal nothing out of the ordinary". He agreed with Ellen France J who dissented in *Penny*, noting that the arrangement was an "acceptable business practice and the opposite of artifice or contrivance". He also noted that decision by the Court of Appeal in *Grieve v CIR* [1984] 1 NZLR 101 (CA) at paragraph 110 which states:

> It is not for the Courts or the Commissioner to confine the recognition of businesses to those that are always profitable or to do so only as long as they operate at a profit.

17. While he acknowledged that *Grieve* related to a test to determine the ambit of the word "business", Heath J also noted that it also helped provide a more general insight into the scheme and purpose of the Act.

18. Heath J found that there was not a purpose of "obtaining an impermissible tax advantage" but that even if that conclusion was wrong the purpose or effect of the arrangement was "merely incidental".

19. Heath J saw no need to decide on the issue of orchard rent, nor was there any need to address the issue of reconstruction.

COMMISSIONER'S RIGHT TO WITHHOLD REFUNDS CONFIRMED BY SUPREME COURT

Case	Contract Pacific Limited v Commissioner of Inland Revenue
Decision date	16 November 2010
Acts	Goods and Services Tax Act 1985, Tax Administration Act 1994
Keywords	Section 46 (GST Act), GST return, notice requirements, investigation and information

Summary

The Supreme Court confirmed that once notice has been given by the Commissioner under either section 26(4) or 46(5) of the Goods and Services Tax Act 1985 (GST Act), the 15-day working limit set out in section 46(1)(a) to pay the refund no longer applies and no refund is payable until the Commissioner is relevantly satisfied pursuant to section 46(1)(b) of the GST Act.

Impact of decision

This decision has clarified the Commissioner's position with regard to section 46 and confirms that once notice is given under either subsections (4) or (5), no refund is payable until the Commissioner is relevantly satisfied pursuant to section 46(1)(b).

The decision has also confirmed that if the Commissioner makes a timely request for information under section 46(4) (as opposed to the notification of an investigation under section 46(5)) but later determines that a fuller investigation is required, the Commissioner is not required to pay the refund should any notification of such investigation occur outside the initial 15 working days.

In addition, the Court confirmed that if the Commissioner makes an initial information request within 15 working days, the refund is not payable should he make a subsequent request for further information outside the time limit set down in section 46(4)(b).

Facts

At all relevant times, Contract Pacific Ltd (Contract Pacific) carried on the business of an inbound tour operator, selling New Zealand-based holiday packages to overseas wholesalers who then sold to overseas retailers. Those retailers in turn sold the packages to tourists set to visit New Zealand.

Between July 1993 and April 1999, Contract Pacific included GST in the sale prices for the services it sold to overseas wholesalers.

In May 1999, the law was changed to remove any ambiguity over liability to include GST in the sale prices for New Zealand-based services sold to overseas persons for the purpose of on-sale to New Zealand-bound visitors.

On 26 June 2000, Contract Pacific filed a GST return in which it sought a readjustment and refund of the GST it had paid between 1 July 1993 and 30 April 1999.

On 10 July 2000, the Commissioner advised that the GST refund had been withheld pending investigation of the readjustment claim.

During a meeting between the parties on 19 January 2001, the Commissioner requested the taxpayer provide further information about the refund claim. This was provided by letter dated 24 January 2001.

Through an administrative error, a notice of assessment and refund cheque for $7,542,295.51 were issued on 5 February 2001. On 9 February 2001, the Commissioner became aware of the error and took steps to stop payment on the refund cheque before it was presented.

On 24 October 2001, the Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001 (2001 Act), was passed with retrospective effect. The general effect of section 241 of the 2001 Act was to make clear there was and always had been liability to pay GST on services provided to overseas persons. A savings provision (section 241(6)) was enacted that exempted a small category of persons from this effect. Contract Pacific would come within this savings provision if the circumstances of receiving the refund cheque in error meant it had been "paid a refund".

After the enactment of the 2001 Act, the Commissioner entered into written agreements with various GST claimants, including Contract Pacific, pursuant to section 89I of the Tax Administration Act 1994 (TAA) to resolve the claims for readjustments for GST paid on facilitation fees and quantification of the Commissioner's liability to pay use-of-money interest.

On 11 December 2001, the Commissioner sent a letter to Contract Pacific which stated that the Commissioner's investigation into the inbound tour operator component of the taxpayer's GST affairs had been completed, resulting in the reassessment of the periods ended 28 February 2001 and 30 April 2001 to allow a refund that reflected the overpaid GST for the period 30 June 1993 to 30 April 2001.

On 18 April 2005, Contract Pacific wrote to the Commissioner requesting payment of $6,281,767 plus interest, being the balance of the stopped refund cheque of $7,542,295.51 after the payment of the facilitation fee credit adjustment was deducted. The Commissioner rejected the claim.

Contract Pacific later sued the Commissioner on the cheque issued in error on 5 February 2001, arguing that the Commissioner had breached section 46 of the GST Act and had paid the taxpayer a refund for the purposes of the savings provision of the 2001 Act.

High Court judgment

The High Court ((2009) 24 NZTC 23,092) confirmed that the Commissioner had issued a notice under section 46(2)(a) of the GST Act, notifying his intention to investigate the matter, and had done so within the 15-day time limit prescribed in section 46(5). However, the High Court held that as the Commissioner had also made requests for information pursuant to that investigation, and these were made outside the prescribed time limits in section 46(4), he had "lost his authority to withhold the disputed refund".

The High Court also held that the cheque issued by the Commissioner was valuable consideration, and therefore the position was "unaffected by section 241(6) of the 2001 Act". However, Duffy J did conclude that in any event, under the common law, the cheque was a "payment" for the purposes of section 241(6)(a).

Court of Appeal judgment

The Court of Appeal ((2010) 24 NZTC 24,006) allowed the Commissioner's appeal and set aside the High Court judgment. The Court of Appeal concluded that the Commissioner, when investigating Contract Pacific's GST return, had satisfied the time limits contained in section 46(5) of the GST Act and therefore there was no obligation to make a refund.

The Court also concluded that the Commissioner's investigation is not subject to any limitation, curtailment or restriction. Accordingly, if in the course of the investigation the Commissioner requires additional information, he can request it and such request will not engage section 46(2)(b).

The Court also confirmed there will be investigations that are complex and require a number of information requests, and there will be others only requiring additional information that has been overlooked. The Court held that "it is not sensible for these two different kinds of inquiries to be governed by the same approach. The more expansive must necessarily include the narrower process".

Contract Pacific appealed to the Supreme Court.

Decision

The Supreme Court dismissed the appeal.

Issue one – section 46 of the GST Act

The Supreme Court confirmed that while the purpose of section 46 is to require the Commissioner to act promptly in processing and paying refunds, the tax system would be subject to abuse if the Commissioner was required in all cases to pay first and investigate later.

The Court held that the provision seeks to balance these two policy considerations by providing the 15-day time limit to either pay the refund or give the taxpayer notice. The Court confirmed, referring to the decision of *Commissioner of Inland Revenue v Sea Hunter Fishing Ltd* (2002) 20 NZTC 17,478, that if the Commissioner does not give notice under either subsections (4) or (5) within 15 working days he will be required to issue the refund regardless of whether he is relevantly satisfied that the refund is payable.

However, the Court held that once notice is given under either subsections (4) or (5), the 15-day working limit set out in section 46(1)(a) to pay the refund no longer applies and no refund is payable until the Commissioner is relevantly satisfied pursuant to section 46(1)(b).

The Supreme Court agreed with the Court of Appeal that an investigation, as contemplated by subsections 46(1)(b) and 46(2), includes the request of information from the taxpayer (the registered person) and must sensibly encompass all or any of the wide powers available to the Commissioner under the TAA.

The Court also rejected Contract Pacific's argument that while the Commissioner was able to request information from third parties pursuant to his investigation at any time without breaching section 46, he was not able to request information after 15 working days from the taxpayer (being the registered person) without having to release the refund. The Court confirmed that this would place the Commissioner in the position of being unable to seek information from the most obvious and perhaps only source to complete the investigation; the registered person.

The Court held that the two processes in section 46 are not entirely discrete in that "the greater includes the lesser; it does not exclude it".

The Court ultimately held that as the Commissioner had given notice pursuant to section 46(5) within 15 working days, the governing provision was section 46(1)(b). Consequently, the Commissioner was not required to pay the refund until he was relevantly satisfied pursuant to section 46(1)(b).

The Court also considered the position where the Commissioner's initial notice is a request for information followed by the commencement of an investigation and confirmed that in that situation the Commissioner should not be expected to have to pay the refund should he ultimately decide the return warrants investigation. The Court referred to Simon France J's decision in *Riccarton Construction Ltd v Commissioner of Inland Revenue* (2010) 24 NZTC 24,191 and confirmed that it was a "commonsense and practical approach to the section". Blanchard J noted that if it were otherwise, there would be little reason in providing for any other step in section 46(2) other than an investigation since the Commissioner would be a significant risk if he merely requested information and indeed "would be foolish to do so".

The Court recognised that the result of this interpretation is there are also no equivalent sanctions should the Commissioner not issue any subsequent requests for information under section 46(4)(b) within 15 working days of receiving the initial information. The Court stated that it assumed the Commissioner would still continue to employ that procedure in routine inquiries to ensure reasonable expedition.

Blanchard J also noted that the section was poorly drafted and requires remedial construction.

Issue two – section 241(6) of the 2001 Act

As the Court found in favour of the Commissioner in relation to section 46, the Court considered it unnecessary to address the second issue.

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 public 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.

GET YOUR TIB SOONER ON THE INTERNET

This *Tax Information Bulletin (TIB)* is also available on the internet in PDF at **www.ird.govt.nz**

The *TIB* index is also available online at **www.ird.govt.nz/aboutir/newsletters/tib/** (scroll down to the bottom of the page). The website has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you would prefer to get the *TIB* from our website, please email us at **tibdatabase@ird.govt.nz** and we will take you off our mailing list.

You can also email us to advise a change of address or to request a paper copy of the *TIB*.