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TAX INFORMATION Bulletin

CONTENTS

1 In summary

2 Legislation and determinations

2011 International tax disclosure exemption ITR21

Determination CFC 2011/01: Non-attributing active insurance CFC status (TOWER Insurance Limited)

Determination CFC 2011/02: Non-attributing active insurance CFC status (TOWER Insurance Limited)

9 Legal decisions – case notes

Further and better discovery

Deductibility of share losses

A further Trinity argument estopped

14 Questions we've been asked

QB 11/01: Residential investment property or properties in Australia owned by New Zealand resident – NRWT treatment of interest paid to Australian financial institution

QB 11/02: Deductibility of expenditure incurred by bloodstock breeders in respect of horses that they race

Inland Revenue
Te Tari Taake

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

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

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

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

Ref	Draft type/title	Description/background information	Comment deadline
SPS ED0132	Compulsory deductions from bank accounts	This draft SPS sets out Inland Revenue's practice on the use of deduction notices issued to banks requiring them to make deductions from their customers' accounts.	21 April 2011

Correction – to TIB Vol 23, No 1 (February 2011)

The first paragraph at the top of page 48 should read as follows (emphasis added to show changes):

LAQCs **with an early balance date of, for example, 31 December 2011**, choosing not to transition but to use the QC rules will have loss attribution for their income year ended 31 December **2011** but will no longer be able to attribute losses for their income year starting on 1 January **2012**.

IN SUMMARY

Legislation and determinations

2011 International tax disclosure exemption ITR21 2

The scope of the 2011 exemption is the same as the 2010 exemption.

Determination CFC 2011/01: Non-attributing active insurance CFC status (TOWER Insurance Limited) 7

This determination applies to TOWER Insurance Limited and grants non-attributing active CFC status to the specified insurance CFCs resident in Fiji for the 2009–10 and 2010–11 income years.

Determination CFC 2011/02: Non-attributing active insurance CFC status (TOWER Insurance Limited) 8

This determination applies to TOWER Insurance Limited and grants non-attributing active CFC status to the specified insurance CFCs resident in Papua New Guinea for the 2009–10 and 2010–11 income years.

Legal decisions – case notes

Further and better discovery 9

The Court upheld the Commissioner's complaint that the plaintiff, in its discovery affidavit, had failed to provide sufficient particulars of the steps taken in relation to obtaining potentially relevant documents. As well, the Court ordered the plaintiff to list individually the documents for which it claimed privilege.

Deductibility of share losses 9

The partnership invested in shares overseas and eventually lost all that was invested. The partnership claimed the loss and the partners to the partnership each claimed the deduction. The Commissioner denied the loss. The Taxation Review Authority found the expenditure was on revenue account and deductible.

A further Trinity argument estopped 11

It was held the assessments made were not prohibited due to the effect of section 114 of the Tax Administration Act 1994. Furthermore, the assessments were valid due to the presumption of validity and even if there was a technical error, the Taxation Review Authority had jurisdiction to consider the challenge to the assessments.

The Supreme Court judgment is binding on the disputant for the purposes of issue estoppel and could not be re-litigated. Despite the technical black-letter argument, the Trinity Scheme had been found to be tax avoidance. The challenge proceedings were therefore struck out.

Questions we've been asked

QB 11/01: Residential investment property or properties in Australia owned by New Zealand resident – NRWT treatment of interest paid to Australian financial institution 14

This QWBA clarifies Inland Revenue's position on whether New Zealand residents who borrow money from Australian financial institutions to purchase residential investment properties in Australia are liable for non-resident withholding tax (NRWT) on the interest payable. This item considers the same issues as QB 09/05, which is on the same topic. It is substantially the same as QB 09/05 but has been updated for the Australia–New Zealand Double Tax Agreement, which came into force in March 2010, and related domestic legislative amendments.

QB 11/02: Deductibility of expenditure incurred by bloodstock breeders in respect of horses that they race 20

A person who is in the business of breeding bloodstock and races horses as part of that business (for example, to enhance the value of those horses, or the stud), can claim a deduction for non-race related ("holding") costs, but none of the costs more directly associated with racing these horses.

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.

2011 INTERNATIONAL TAX DISCLOSURE EXEMPTION ITR21

Introduction

Section 61 of the Tax Administration Act 1994 ("TAA") requires taxpayers to disclose interests in foreign entities.

Section 61(1) of the TAA states that a person who has a control or income interest in a foreign company or an attributing interest in a foreign investment fund (FIF) at any time during the income year must disclose the interest held[1]. However, section 61(2) of the TAA allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of the international tax rules (as defined in section YA 1) contained in the Income Tax Act 2007 ("the ITA 2007").

To balance the revenue forecasting and risk assessment needs of the Commissioner with the compliance costs of taxpayers providing the information, the Commissioner has issued an international tax disclosure exemption under section 61(2) of the TAA that applies for the income year corresponding to the tax year ended 31 March 2011. This exemption may be cited as "International Tax Disclosure Exemption ITR21" and the full text appears at the end of this item.

Scope of exemption

The scope of the 2011 exemption is the same as the 2010 exemption.

Application date

This exemption applies for the income year corresponding to the tax year ending 31 March 2011.

Summary

In summary, the 2011 international tax disclosure exemption **removes** the requirement of a resident to disclose:

- an interest of less than 10% in a foreign company that is not an attributing interest in a FIF, or is an attributing interest in a FIF in respect of which no FIF income or loss arises under either section CQ 5(1)(d) or section DN 6(1)(d) of the ITA 2007
- if the resident **is not** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country, and the fair dividend rate or comparative value method of calculation is used
- if the resident **is** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10% and the fair dividend rate or comparative value method is used. The resident is instead required to disclose the end-of-year New Zealand dollar market value of such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

The 2011 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

Explanation

Generally, residents who hold an income interest or a control interest in a foreign company, or an attributing interest in a FIF are required to disclose these interests to the Commissioner. These interests are considered in further detail below.

Attributing interest in a FIF

A resident is required to disclose an attributing interest in a FIF where FIF income or a FIF loss arises through the use of one of the following calculation methods:

- branch equivalent, accounting profits, deemed rate of return or cost methods; or
- fair dividend rate or comparative value methods where the resident is a "widely-held entity"; or
- fair dividend rate or comparative value methods, the resident is not a widely-held entity and the country in which the attributing interest is incorporated or otherwise tax resident in a country that New Zealand **does not** have a double tax agreement in force as at 31 March 2011.

[1] In the case of partnerships, disclosure needs to be made by the individual partners in the partnership. The partnership itself is not required to disclose.

The 35 countries that New Zealand does have a double tax agreement in force as at 31 March 2011 are listed below.

Australia	India	Russian Federation
Austria	Indonesia	Singapore
Belgium	Ireland	South Africa
Canada	Italy	Spain
Chile	Japan	Sweden
China	Korea	Switzerland
Czech Republic	Malaysia	Taiwan
Denmark	Mexico	Thailand
Fiji	Netherlands	United Arab Emirates
Finland	Norway	United Kingdom
France	Philippines	United States of America
Germany	Poland	

No disclosure is required by non-widely-held taxpayers for attributing interests in FIFs that are incorporated or otherwise tax resident in a tax treaty country, if the fair dividend rate or comparative value methods of calculation are used.

A "widely-held entity" for the purposes of this disclosure is an entity which is a:

- portfolio investment entity (this includes a portfolio investment-linked life fund); or
- widely-held company; or
- widely-held superannuation fund, or
- widely-held group investment fund ("GIF")

Portfolio investment entity, widely-held company, widely-held superannuation fund and widely-held GIF are all defined in section YA 1 of the ITA 2007.

The disclosure required by widely-held entities of attributing interests in FIFs which use the fair dividend rate or the comparative value method of calculation is that, for each calculation method, they disclose the end-of-year New Zealand dollar market value of investments split by the jurisdiction in which the attributing interest in a FIF is held, listed, organised or managed, in the event that tax residence is not easily determined. A further option of a split by currency in which the investment is held, will also be accepted as long as it is a reasonable proxy—that is at least 90–95% accurate—for the underlying jurisdictions in which the FIF is held, listed, organised or managed. For example, investments denominated in euros will not be able to meet this test and so euro-based investments will need to be split into the underlying jurisdictions.

FIF interests

The types of interests that fall within the scope of section 61(1) of the TAA are:

- rights in a foreign company or anything deemed to be a company for the purposes of the ITA (eg, a unit trust)
- an entitlement to benefit from a foreign superannuation scheme
- an entitlement to benefit from a foreign life insurance policy
- an interest in an entity specified in schedule 25, part A of the ITA (no entities were listed when this issue of the *Tax Information Bulletin* went to press).

However, the following interests are exempt (under sections EX 31 to EX 43 of the ITA) from being an attributing interest in a FIF and do not have to be disclosed:

- an income interest of 10% or more in a CFC (although separate disclosure is required of this as an interest in a foreign company)
- certain interests in Australian resident companies listed on an approved index of the Australian Stock Exchange and required to maintain a franking account (refer to the IR 871 form that can be found on Inland Revenue's website **www.ird.govt.nz** (keywords: other exemptions)
- an interest in an Australian unit trust that has an RWT proxy with either a high turnover or high distributions
- an interest of 10% or more in a foreign company that is treated as resident in a country or territory specified in the grey list
- an interest in certain grey-list companies (only interests in Guinness Peat Group plc qualify for this exemption)
- an interest in an employment-related foreign superannuation scheme
- certain foreign pensions or annuities (see Inland Revenue's booklet *Overseas private pensions (IR 257)* for more information)
- an interest in certain venture capital investments in New Zealand resident start-up companies that migrate to a grey list country
- an interest in certain grey-list companies owning New Zealand venture capital companies
- an interest in certain grey-list companies resulting from shares acquired under a venture investment agreement
- an interest in certain grey-list companies resulting from the acquisition of shares under an employee share scheme

- an interest held by a natural person in a foreign entity located in a country where exchange controls prevent the person deriving any profit or gain or disposing of the interest for New Zealand currency or consideration readily convertible to New Zealand currency.

Interests in foreign entities held by a natural person not acting as a trustee also do not have to be disclosed if the total cost of the interests remains under $50,000 at all times during the income year. This disclosure exemption is made because no FIF income under section CQ 5 of the ITA or FIF loss under section DN 6 arises in respect of these interests.

Format of disclosure

The forms for the disclosure of FIF interests are as follows:

- IR 439 form for the accounting profits method
- IR 440 form for the branch equivalent method
- IR 443 form for the deemed rate of return method
- IR 445 form for the fair dividend rate method (for widely-held entities)
- IR 446 form for the comparative value method (for widely-held entities)
- IR 447 form for the fair dividend rate method (for individuals or non-widely-held entities)
- IR 448 form for the comparative value method (for individuals or non-widely-held entities)
- IR 449 form for the cost method.

The IR 445 and IR 446 forms, which reflect the disclosure for fair dividend rate and comparative value for widely-held entities must be completed online. As discussed above this disclosure is by country rather than by individual investment as is the general requirement of section 61. In order to be exempt from the general requirements, the alternative disclosure must be made electronically. We note that currently only 10 disclosures can be made on an individual IR 445 or IR 446. For disclosures in excess of 10, more than one form should be filed.

The IR 447, IR 448 and IR 449 forms, applying to the fair dividend rate and comparative value methods for individuals or non widely-held entities as well as the cost method for all taxpayers may be completed online. The online forms can be found at **www.ird.govt.nz** "Get it done online", "Foreign investment fund disclosure".

Until the proposed extension of the active income exemption is passed into law, a transitional measure for non-portfolio FIFs using the branch equivalent or accounting profits, namely an alternative to using the IR 439 and IR 440 forms is acceptable for the income year corresponding to the tax year ending 31 March 2011.

For each calculation method, an acceptable alternative disclosure will be a schedule outlining all the FIF interests of a particular taxpayer and must, as a minimum, include the following information:

- details of the taxpayer filing the form, including name, IRD number, contact details
- details of the FIF, including name, business activity, balance date, country of residence, address
- nature of the taxpayer's FIF interest (ie, shares or units)
- details of the taxpayer's income interest percentage (including details of the measurement basis used)
- currency the financial statements were prepared in
- calculation of FIF income or loss including conversion rate and NZD conversion calculation
- details of any loss offset or loss to carry forward
- details of any foreign tax credit available (including details of NZD conversion calculation).

A scanned copy of the audited financial statements of the FIF must also accompany the schedule(s).

The alternative disclosure schedules and audited financial accounts should be sent to the following email address: **439440disclosure@ird.govt.nz**

The alternative disclosure schedule filed must also be printed, dated and signed by the taxpayer as true and correct. This should be held on file by the taxpayer and may be requested by the Commissioner.

Income interest of 10% or more in a foreign company

A resident is required to disclose an income interest of 10% or more in a foreign company. This obligation to disclose applies to all foreign companies regardless of the country of residence. For this purpose, the following interests need to be considered:

a) an income interest held directly in a foreign company

b) an income interest held indirectly through any interposed foreign company

c) an income interest held by an associated person (not being a controlled foreign company) as defined by the parts of subpart YB of the ITA that apply for the purposes of the "1988 version provisions".

To determine whether a resident has an income interest of 10% or more for CFCs, sections EX 14 to EX 17 of the ITA should be applied. To determine whether a resident has an income interest of 10% or more in any entity that is not a CFC, for the purposes of this exemption, sections EX 14 to EX 17 should be applied to the foreign company as if it were a CFC.

Format of disclosure

In 2010 due to differing balance dates, some taxpayers were still applying the old CFC rules while others were applying the new rules involving an active income exemption. As a result there were differing disclosure requirements. This is no longer the case as the new CFC rules now apply to all taxpayers.

Disclosure of all interests in a controlled foreign company is required using a *Controlled foreign companies disclosure (IR 458)* form. This form, which involves uploading a prescribed spreadsheet, can cater for up to 500 individual disclosures.

The IR 458 form must be completed online at **www.ird.govt.nz** (keyword: ir458). Please note that electronic filing is a mandatory requirement for CFC disclosure.

Overlap of interests

It is possible that a resident may be required to disclose an interest in a foreign company which also constitutes an attributing interest in a FIF. For example, a person with an income interest of 10% or greater in a foreign company which is not a CFC is strictly required to disclose both an interest held in a foreign company and an attributing interest in a FIF.

To meet disclosure requirements, only one form of disclosure is required for each interest. If the interest is an attributing interest in a FIF, then the appropriate disclosure for the calculation method, as discussed previously, must be made.

In all other cases, where the interest in a foreign company is not an attributing interest in a FIF, the IR 458 for controlled foreign companies must be filed.

Interests held by non-residents and transitional residents

Interests held by non-residents and transitional residents in foreign companies and FIFs do not need to be disclosed.

This would apply for example to an overseas company operating in New Zealand (through a branch) in respect of its interests in foreign companies and FIFs; or to a transitional resident with interests in a foreign company or an attributing interest in a FIF.

Under the international tax rules, non-residents and transitional residents are not required to calculate or attribute income under either the CFC or FIF rules. Therefore disclosure of non-residents' or transitional residents' holdings in foreign companies or FIFs is not necessary for the administration of the international tax rules and so an exemption is made for this group.

PERSONS NOT REQUIRED TO COMPLY WITH SECTION 61 OF THE TAX ADMINISTRATION ACT 1994

This exemption may be cited as "International Tax Disclosure Exemption ITR21".

1. Reference

This exemption is made under section 61(2) of the Tax Administration Act 1994. It details interests in foreign companies and attributing interests in FIFs in relation to which any person is not required to comply with the requirements in section 61 of the Tax Administration Act 1994 to make disclosure of their interests, for the income year ending 31 March 2011.

2. Interpretation

For the purpose of this disclosure exemption to determine an income interest of 10% or more, sections EX 14 to EX 17 of the Income Tax Act 2007 apply for interests in controlled foreign companies. In the case of attributing interests in FIFs, those sections are to be applied as if the FIF were a CFC.

The relevant definition of "associated persons" is contained in the parts of subpart YB of the Income Tax Act 2007.

Otherwise, unless the context requires, expressions used have the same meaning as in section YA 1 of the Income Tax Act 2007.

3. Exemption

i) Any person who holds an income interest of less than 10% in a foreign company, including interests held by associated persons, that is not an attributing interest in a FIF, or that is an attributing interest in a FIF in respect of which no FIF income or loss arises under either section CQ 5(1)(d) or section DN 6(1)(d) of the Income Tax Act 2007, is not required to comply with section 61(1) of the Tax Administration Act 1994 for that interest and that income year.

ii) Any person who is a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct interest of 10% or more in a foreign company that is not a foreign investment vehicle, and uses the fair dividend rate or comparative value calculation method for that interest, is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year, if the person discloses the end-of-year New Zealand dollar market value of

investments, in an electronic format prescribed by the Commissioner, split by the jurisdiction in which the attributing interest in a FIF is held or listed.

iii) Any person who is not a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct income interest of 10% or more, and uses the fair dividend rate or comparative value calculation method is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year, to the extent that the FIF is incorporated or tax resident in a country with which New Zealand has a double tax agreement in force at 31 March 2011.

iv) Any non-resident person or transitional resident who has an income interest or a control interest in a foreign company or an attributing interest in a FIF in the income year corresponding to the tax year ending 31 March 2011, is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year if either or both of the following apply:

- no attributed CFC income or loss arises in respect of that interest in that foreign company under sections CQ 2(1)(d) or DN 2(1)(d) of the Income Tax Act 2007; and/or
- no FIF income or loss arises in respect of that interest in that FIF under sections CQ 5(1)(f) or DN 6(1)(f) of the Income Tax Act 2007.

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

This exemption is signed on 24th of March 2011.

John Nash
Chief Advisor (International Audit)

DETERMINATION CFC 2011/01: NON-ATTRIBUTING ACTIVE INSURANCE CFC STATUS (TOWER INSURANCE LIMITED)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

Under sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007, subject to sections CQ 2(2B) and DN 2(2), no attributed CFC income or loss arises from a CFC that is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC that is an insurer meeting the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 is a non-attributing active CFC. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because insurance income is otherwise treated as passive income and an attributable CFC amount by section EX 20B(3) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of the members of a group of CFCs, if the members satisfy subsection (3). TOWER Insurance Limited has made application in respect of the members of the group of CFCs set out below.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the members of the group of CFCs satisfy the requirements set out in section 91AAQ(3) of the Tax Administration Act 1994 and are accordingly non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of determination

The CFCs to which this determination applies are:

Name	Jurisdiction
National Insurance Company (Holdings) Limited	Fiji
TOWER Insurance (Fiji) Limited	Fiji
Southern Pacific Insurance Company (Fiji) Limited	Fiji

Interpretation

In this document, unless the context otherwise requires:

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a CFC as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994 I hereby determine that the above CFCs are non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2009–10 and 2010–11 income years.

This determination is signed by me this 14th day of March 2011.

Jessica Griffin
Acting Investigations Manager

DETERMINATION CFC 2011/02: NON-ATTRIBUTING ACTIVE INSURANCE CFC STATUS (TOWER INSURANCE LIMITED)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

Under sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007, subject to sections CQ 2(2B) and DN 2(2), no attributed CFC income or loss arises from a CFC that is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC that is an insurer meeting the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 is a non-attributing active CFC. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because insurance income is otherwise treated as passive income and an attributable CFC amount by section EX 20B(3) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of the members of a group of CFCs, if the members satisfy subsection (3). TOWER Insurance Limited has made application in respect of the members of the group of CFCs set out below.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the members of the group of CFCs satisfy the requirements set out in section 91AAQ(3) of the Tax Administration Act 1994 and are accordingly non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of determination

The CFCs to which this determination applies are:

Name	Jurisdiction
Southern Cross Marine Limited	Papua New Guinea
TOWER Insurance (PNG) Limited	Papua New Guinea

Interpretation

In this document, unless the context otherwise requires:

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a CFC as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994 I hereby determine that the above CFCs are non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2009–10 and 2010–11 income years.

This determination is signed by me this 14th day of March 2011.

Jessica Griffin

Acting Investigations Manager

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.

FURTHER AND BETTER DISCOVERY

Case	Beacham Holdings Ltd v Commissioner of Inland Revenue
Decision date	4 February 2011
Act(s)	High Court Rules
Keywords	Further and better discovery

Summary

The Court upheld the Commissioner's complaint that the plaintiff, in its discovery affidavit, had failed to provide sufficient particulars of the steps taken in relation to obtaining potentially relevant documents. As well, the Court ordered the plaintiff to list individually the documents for which it claimed privilege.

Impact of decision

The decision reaffirms the fact that the Courts will ensure that litigants comply with their discovery obligations

Facts

The Commissioner applied for further and better discovery by the plaintiff.

The issue in the substantive matter is whether the plaintiff and an associated company had, in the relevant years, the necessary commonality of shareholding for the plaintiff to be able to offset losses from its associated company.

The Commissioner alleged that the affidavit of the plaintiff failed to provide sufficient particulars of the steps taken in relation to obtaining potentially relevant documents from its accountants and lawyers.

Similarly, the Commissioner alleged that the plaintiff had failed to state the steps it took to obtain documents relevant to its claim against its accountants alleging breach of duty in respect of the failure to arrange a transfer of shares.

Lastly, as the plaintiff had failed to list documents individually for which it claimed privilege, the Commissioner applied for an order that the documents be properly listed by the plaintiff.

Decision

The Court agreed with the Commissioner's arguments and ordered further and better discovery.

DEDUCTIBILITY OF SHARE LOSSES

Case	TRA 37/08
Decision date	25 January 2011
Act(s)	Income Tax Act 1994
Keywords	Share speculation, partnership loss, deductible, valid or real shares, loan by family trust

Summary

The partnership invested in shares overseas and eventually lost all that was invested. The partnership claimed the loss and the partners to the partnership each claimed the deduction. The Commissioner denied the claim. The Taxation Review Authority ("TRA") found the expenditure was on revenue account and deductible.

Impact of decision

The TRA has taken a broad view on what constitutes a business. The TRA has also taken the view that the disputant using funds from the Family Trust without authority did not mean there was no loan. This case also follows the reasoning in *Inglis* and *Stockwell* whereby, if shares are purchased with the intention of selling to make a profit, any loss will be deductible.

Facts

The taxpayer is a husband and wife partnership. The husband received a "cold call" from overseas brokers

offering the opportunity to invest in shares. The brokers were extremely convincing, persuasive and persistent. The modus operandi of the brokers was to purchase undervalued shares in companies in the United States and then persuade overseas persons to buy those shares at a highly inflated price. The brokers promised the buyers that they would be able to sell the shares at a profit after the shares became publicly listed on the American Stock Exchange.

Over a period of about three years from 1999 to 2002, the disputant purchased shares in five USA companies at a total cost of about $1.1 million.

While the shares were purchased in the name of the partnership, the funds used to pay for the shares came from the Family Trust.

Eventually, after ongoing difficulty in obtaining share certificates and responses to his request for information, the partners realised that the money spent had been lost.

The partnership claimed the loss in its 2003 income year and each partner claimed $627,564 as their half share of the partnership loss. The Commissioner denied the deductions and imposed a shortfall penalty on both the husband and the wife for having taken an unacceptable tax position.

Decision

It was put to the TRA by the Commissioner that the disputant could not demonstrate that it acquired any such shares or incurred any such loss. The Commissioner claimed that the shares did not exist and it was the Family Trust that paid for the shares, not the disputant. Also, that there was no agreement between the disputant and the Trust for the lending of the money.

However, the TRA found that the disputant did incur a loss and that real shares were purchased by the disputant, which became worthless by late 2003.

Judge Barber concluded that the partnership borrowed the money from the Trust:

> … Much was made in submissions as to whether the Trust could have been the shares purchaser in reality, or as a result of a resulting Trust or an agency or something like that; but with a complete absence of records as to any funding contract from the Trust to the partnership, I consider that the partnership simply borrowed money from the Trust, possibly, on an unauthorised basis without clear terms and without any arrangements for payment of interest by the disputant partnership to the Trust [10].
>
> It seems to me that the disputant partnership acquired funds (mainly by borrowing from the Family Trust) and, at all material times, owned the funds which it applied to the share purchases listed above … [42].

Judge Barber found that real shares were acquired by the disputant:

> I understand that, until the hearing before me, the defendant Commissioner had not been prepared to accept that […] Groups sold real shares to the disputant, and considered that the so-called brokers had simply misappropriated the disputant's funds. However, the hearing before me showed that the disputant did receive real shares and these were known as Regulation S shares … [60].

The relevant sections in regards to whether losses are deductible are sections BD 2 and CD 4 of the Income Tax Act 1994. The leading authorities on the deductibility of losses incurred in respect of shares to which section CD 4 applies are *CIR v Inglis* [1993] 2 NZLR 29 (CA) and *CIR v Stockwell* [1993] 2 NZLR 40 (CA).

Judge Barber considered whether the disputant was operating a business of trading in shares. His Honour considered that it seemed that there was sufficient activity on the part of the disputant regarding those speculative investments for the activity to amount to a business, when coupled with the intention of seeking fairly quick profit, and that those investments were real. While the husband admitted to the Inland Revenue investigator that he was not carrying on a business of share dealing, Judge Barber said that that was an issue for the Court to decide.

However, Judge Barber said that the point was peripheral in this case because he considered that the partnership had the dominant intention of purchasing the shares for a fairly speedy resale at a profit. Judge Barber concluded:

> The evidence is clear that the speculative share purchase transactions were entered into by the disputant with a view to profit for the partners … [11].
>
> The evidence is that the partners purchased the shares with the intention of soon selling them at a profit, as promised by the high powered broker vendors [13].
>
> I find from the evidence adduced to me that the husband purchased the shares listed above for the disputant with the intention of the disputant very soon selling the shares at a profit after they became publicly listed on the American Stock Exchange [47].

Therefore, the TRA found expenditure was on revenue account and deductible.

A FURTHER TRINITY ARGUMENT ESTOPPED

Case	XX v CIR
Decision date	1 February 2011
Act(s)	Income Tax Act 1994
Keywords	Trinity, tax avoidance, res judicata, abuse of process, issue estoppel

Summary

It was held the assessments made were not prohibited due to the effect of section 114 of the Tax Administration Act 1994 ("TAA"). Furthermore, the assessments were valid due to the presumption of validity and even if there was a technical error, the Taxation Review Authority ("TRA") had jurisdiction to consider the challenge to the assessments.

The Supreme Court judgment is binding on the disputant for the purposes of issue estoppel and could not be re-litigated. Despite the technical black-letter argument, the Trinity Scheme had been found to be tax avoidance. The challenge proceedings were therefore struck out.

Impact of decision

This judgment provides further confirmation that the Supreme Court's judgment in the Trinity test case litigation is the final word on the tax consequences of taxpayers' participation in the "Trinity Scheme".

The judgment also confirmed that the Commissioner's assessments are to be treated as valid until a Court rules otherwise and re-affirmed the TRA power under section 138P of the TAA to confirm, cancel or vary assessments as it sees fit.

Facts

In his tax returns for the 1997 to 2006 income years, the disputant claimed attributed loss attributing qualifying company (LAQC) losses and losses brought forward based on his shareholding in an LAQC that was a member of a joint venture participating in the "Trinity Scheme".

The Commissioner of Inland Revenue ("the Commissioner") assessed the disputant disallowing losses brought forward claimed in the 2004 income year and assessed the disputant with 100% shortfall penalties for adopting an abusive tax position in the 1997 to 2003 income years. The Commissioner is yet to reassess the disputant in the 2005 and 2006 income years. That said, the appropriate notices of proposed adjustment and notices of responses have been exchanged.

By way of a background, in the Trinity test case litigation, the High Court, Court of Appeal and Supreme Court upheld assessments made by the Commissioner disallowing deductions on the basis that the Trinity Scheme was a tax avoidance arrangement and imposing 100% shortfall penalties for an abusive tax position (see *Accent Management Ltd v CIR* 22 NZTC 19,027 (HC), *Accent Management Ltd v CIR* [2007] NZCA 231; (2007) 23 NZTC 21,366 (CA) and *Ben Nevis Forestry Ventures Ltd v CIR* [2009] 2 NZLR 289; (2009) 24 NZTC 23,188 (SC)).

In these proceedings the disputant sought, amongst other things, a declaration that the Commissioner's assessments were unlawful or should be replaced by assessments allowing the deductions sought under sub-part EH of the Income Tax Act 1994 ("the ITA94") (financial arrangements) or, if those rules did not apply, deductions on a straight-line basis. The disputant additionally contended, on the basis that the Commissioner's assessments were prohibited, that the TRA had no jurisdiction to hear his challenges.

The disputant's submissions

The disputant submitted that the Commissioner's assessments were prohibited because they were calculated under sub-part EG of the ITA94 (depreciation) and it should have been sub-part EH of the ITA94 that was applied.

The disputant said that, in circumstances where sub-part EH applies, its application is mandatory and that it is unlawful to fail to apply it. The disputant claimed that subpart EH is a special regime standing apart from, having superior operation to, and overriding the rest of the ITA94. The disputant additionally contended that, because sub-part EG had no effect in the circumstances, it could not support the Commissioner's assessments which must be quashed accordingly.

The Commissioner's submissions

For the Commissioner it was submitted that the disputant's claim about sub-part EH of the ITA94 was identical, in all material respects, to the taxpayers claim in *Ben Nevis* so that the relief sought should not be available.

Further it was submitted that the disputant was prevented from running his sub-part EH argument under the doctrines of issue estoppel/res judicata and that it was an abuse of process for him to now seek to do this.

The Commissioner generally supported his relevant assessments and indicated that the only issues were whether there was a tax avoidance arrangement allowing the Commissioner to remove the losses claimed by the disputant and whether the disputant had adopted an abusive tax position and could be penalised accordingly.

Decision

Issue 1

Judge Barber held that the Commissioner's assessments were not prohibited and that the TRA did have jurisdiction to hear the disputant's challenges.

At paragraph [23] Judge Barber commented that:

> It seems to me to be elementary that the assessments against the disputant now in issue cannot be regarded as void *ab initio*, as the disputant is suggesting, due to the effect of section 114 of the Tax Administration Act 1994 … Accordingly, since at least, *prima facie*, there are assessments in existence as pleaded, and because the jurisdiction of the Taxation Review Authority is to decide whether assessments are correct, it seems quite untenable to me for the disputant to submit that I do not now have jurisdiction to deal with his challenges.

In respect of the Commissioner's assessments specifically, His Honour commented:

a) with reference to section 114 of the TAA, that "… even if there were some technical error in the assessments, that would not make them invalid" [49];

b) that even if the Commissioner had somehow failed to comply with section EH8 of the ITA94 in carrying out the assessments, these assessments would not be invalidated but instead would merely be incorrect [50];

c) that there is a presumption of validity and that an assessment will be treated as valid until a Court rules otherwise [51];

d) that his analysis was supported by the High Court's decisions in *Redcliffe Forestry Venture Ltd v CIR* (HC Auckland CIV 2009-404-005991, 26 February 2010 Venning J and *Accent Management Ltd v CIR* (HC Auckland CIV 2008-404-8649, 12 March 2010 Keane J [81]; and

e) that he must regard the assessments as correct [92].

In respect of the TRA's jurisdiction the Judge specifically commented that:

f) the disputant's current argument was contrary to the analysis of the Supreme Court which had been rigorously fought previously in the High Court and Court of Appeal [36];

g) the TRA's power under section 138P of the TAA is "… never simply to confirm, but to 'confirm or cancel or vary' as it sees fit …" [76];

h) the High Court decisions of *Redcliffe* and *Accent Management* confirmed that the TRA had jurisdiction to consider these challenges ([59], [76] and [91]).

Judge Barber held that if the TRA were to dismiss the disputant's challenges for want of jurisdiction, the Commissioner's assessments would stand and accordingly there would be no benefit to the disputant in persisting with his objection to jurisdiction [82].

His Honour additionally rejected the disputant's arguments based on *BASF NZ Ltd v CIR* [1995] 17 NZTC 12,136 (HC) ([51]–[55]) and commented that the presumption of validity precluded the disputant's assertion that the TRA had any extra-statutory power to "declare" assessments invalid before the challenge process had run its course [81].

Issue 2

Judge Barber also held that the disputant was prevented from running his sub-part EH of the ITA94 argument under the doctrines of issue estoppel/res judicata and for him to now seek to run this argument amounted to an abuse of process.

In respect of the issue estoppel/res judicata matter, Judge Barber specifically found that:

i) with reference to the findings of the High Court, Court of Appeal and the Supreme Court in particular, the disputant "… cannot tenably suggest that he could ever have been entitled to the deduction which he now seeks …" and that he "… must be *estopped* by the findings of those Courts from even making the arguments he has so elaborately set out before me" [28];

j) there had been a final decision as to the appropriate legal analysis of the Trinity Scheme—the Supreme Court having determined that the appropriate analysis was under sub-part EG not sub-part EH of the ITA94 [38];

k) "… [the] Supreme Court judgment finally determined all matters between the defendant and the plaintiffs in the Trinity litigation including their privies of which the disputant is one. There is a sufficient mutuality of interest to find that the disputant and the plaintiffs in *Accent Management/Ben Nevis* are privies … Accordingly, for the purposes of *issue estoppel*, that Supreme Court judgment is binding on him as if he were a named party to it" [39].

In respect of the abuse of process matter, His Honour held (at [41]) that:

> … Broadly, I agree that if the disputant were permitted to proceed with his new argument based on sub-part EH of the Act, that would be manifestly unfair to the defendant Commissioner who, at significant expense, has succeeded in Ben Nevis after extensive litigation on the issue. To relitigate matters would bring the administration of justice into disrepute among right thinking people. In the public interest, public money should be carefully spent.

At [56] Judge Barber indicated that while the disputant was entitled to argue that the assessments were incorrect, he could not relitigate issues which have already been dealt with by the Supreme Court in the Trinity litigation. If the disputant wished to challenge the correctness of the assessments he needed to set out why he considered his case was distinct from those dealt with by the Supreme Court (see also [91]).

The Judge commented that the disputant's arguments were moot in any event because, even if the Commissioner, the High Court, Court of Appeal and Supreme Court were wrong in their analysis as to the applicability of sub-parts EH or EG of the ITA94, both sub-parts were subject to the general anti-avoidance provision (section BG1 of the ITA94) and the Trinity Scheme had been found to be a tax avoidance arrangement ([11], [22], [38] and [45]).

Other

With reference to his previous findings, at [92] Judge Barber ordered that the disputant's challenge proceedings be struck out.

QUESTIONS WE'VE BEEN ASKED

QB 11/01: RESIDENTIAL INVESTMENT PROPERTY OR PROPERTIES IN AUSTRALIA OWNED BY NEW ZEALAND RESIDENT – NRWT TREATMENT OF INTEREST PAID TO AUSTRALIAN FINANCIAL INSTITUTION

Income Tax Act 2007, section YD 4(11)(b)(i) – Interest deemed to be derived from New Zealand

Double Taxation Relief (Australia) Order 2010, Schedule, Article 11 – Taxation of interest

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

The Commissioner has been asked to clarify Inland Revenue's position on whether New Zealand residents who borrow money from Australian financial institutions to purchase residential investment properties in Australia are liable for non-resident withholding tax (NRWT) on the interest payable. Articles have appeared in the media regarding this issue over recent years, and there has been uncertainty as to how the domestic legislation and the double tax agreement ("DTA") with Australia apply.

This item considers the same issues as QB 09/05, which is on the same topic. QB 09/05 is based on Double Taxation Relief (Australia) Order 1995. A new DTA between New Zealand and Australia came into force on 19 March 2010 and commenced in New Zealand from 1 May 2010 for withholding taxes. This "Question we've been asked" is substantially the same as QB 09/05 but has been updated for the new DTA and related domestic legislative amendments.

Question

1. If you own one or more residential investment properties in Australia and you have borrowed money from an Australian financial institution to purchase the property or properties, do you have to pay NRWT on the interest paid to the Australian financial institution?
2. Different fact situations could arise in respect of this question. This item considers the two most common situations, where:
   a) you manage the property or properties yourself (situation A); and
   b) a property manager in Australia manages the property or properties for you (situation B).

Answer

Australian financial institution has a fixed establishment in New Zealand

3. In every case, you will need to consider your own particular fact situation. However, in general terms the following applies.
   1) If the Australian financial institution to which you pay interest has a branch in New Zealand, in both situations A and B the NRWT rules **will not** apply to the interest because the financial institution has a fixed establishment in New Zealand.

      It is important to note that some Australian financial institutions that operate in New Zealand do so through subsidiaries rather than through branches. The NRWT rules **will apply** if the Australian financial institution from which you borrowed money in Australia operates in New Zealand only through a subsidiary, ie, it does not also have a branch in New Zealand. If you borrow from a New Zealand subsidiary of an Australian financial institution no NRWT issues will arise, however, because the interest is not paid to a non-resident. If you wish to check which financial institutions operate as branches in New Zealand go to the Reserve Bank website (**www.rbnz.govt.nz/nzbanks**).
   2) If the Australian financial institution to which you pay interest does not have a branch in New Zealand, the outcomes between situations A and B may differ.

Australian financial institution does not have a fixed establishment in New Zealand

Situation A

4. Under situation A, if you manage the property or properties in Australia from New Zealand, you will not have a fixed establishment or a permanent establishment in Australia. You **will** have to pay NRWT on the interest whether or not you are in the business of leasing.

Situation B

5. Under situation B, if you have more than one residential investment property in Australia, you may have a fixed establishment in Australia. If you do have a fixed establishment in Australia, then you **will not** have to pay NRWT on the interest.

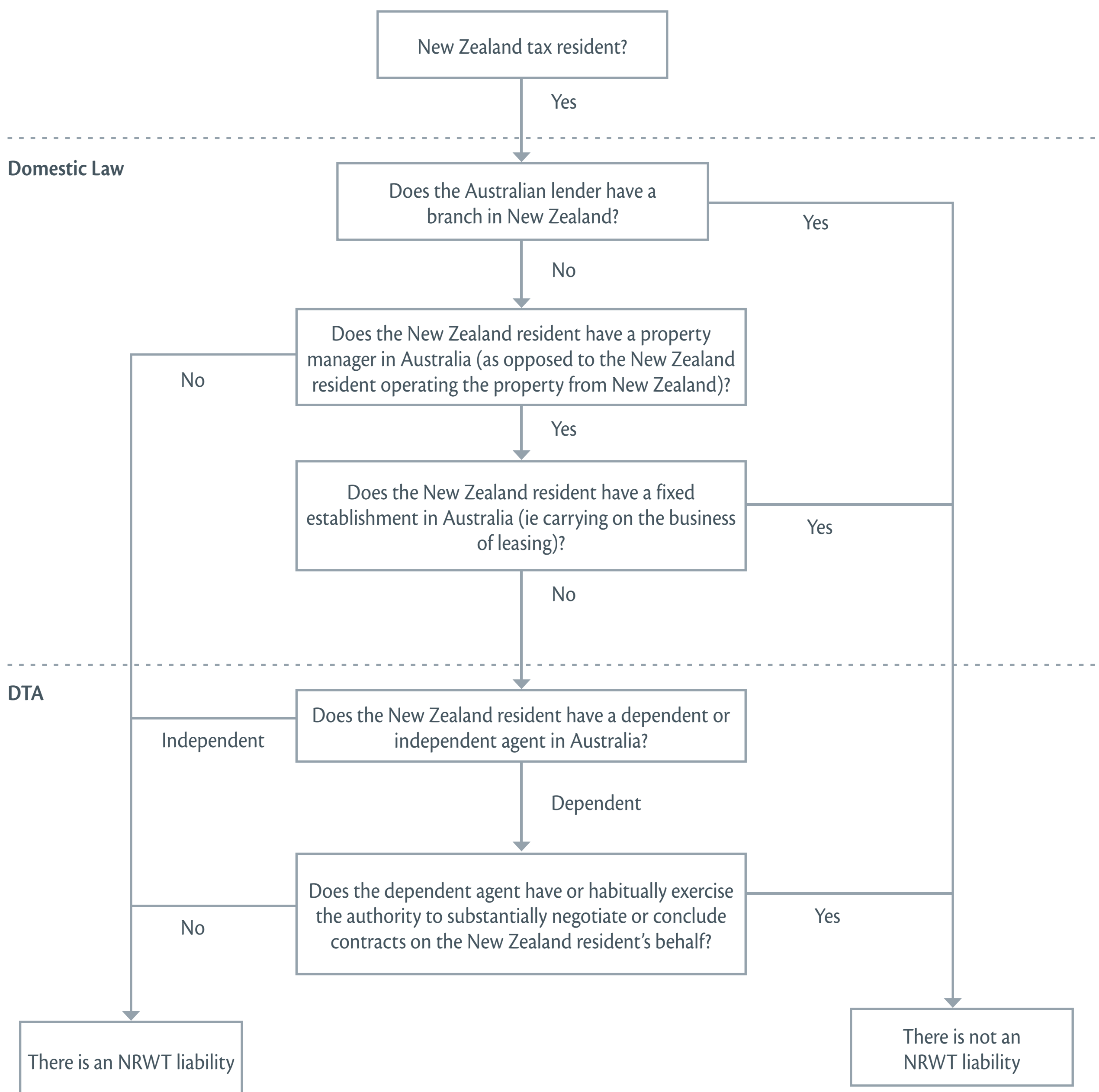
6. If you do not have a fixed establishment in Australia and you employ a property manager who:
   - works as a property manager only for you; and
   - has and habitually exercises the authority to substantially negotiate or conclude contracts on your behalf

   then under the DTA you will not have to pay NRWT on the interest because the property manager will be a dependent agent and you will be deemed to have a permanent establishment in Australia. As you borrowed the funds to purchase the property or properties, there is sufficient connection between the permanent establishment and the indebtedness and the DTA will apply.

7. If the property manager acts for you in the ordinary course of their business and is able to act independently of you, it is likely the property manager will be an independent agent and you will have to pay NRWT on the interest because you will not have a permanent establishment in Australia.

8. The following flowchart sets out the questions that need to be answered to determine NRWT liability.

9. For further information on the payment of NRWT, see the two Inland Revenue guides *NRWT – payer's guide (IR 291)* and *NRWT reconciliation statement guide (IR 67SG)*.



Transitional residents

10. If you have become a New Zealand resident since 1 April 2006 and were non-resident here for a continuous period of at least ten years prior to becoming resident, you may qualify as a "transitional resident" under s HR 8.
11. If you qualify as a transitional resident and you pay interest in relation to money borrowed when you were not a New Zealand resident, the amount of NRWT you need to withhold is zero.
12. If you meet the requirements, you become a transitional resident at the same time as you become, or are treated as becoming, tax resident in New Zealand. You will become resident in New Zealand if you have a permanent place of abode in New Zealand or when you are personally present in New Zealand for more than 183 days in total in a 12-month period (you will be treated as resident in New Zealand from the first day of the 183 days). Generally speaking, the period of transitional residence lasts for four years from the end of the month when the requirements for being a resident are first met (being the earlier of the date from which you first have a permanent place of abode, or the date when you were personally present in New Zealand for more than 183 days). After that four-year period, you must withhold NRWT at the generally applicable rate (currently 10%).
13. You may make an irrevocable election not to be a transitional resident (see s HR 8(4)).

Penalties and interest

14. As the person who pays the interest to the Australian financial institution, you are required to withhold the NRWT and pay it to the Commissioner of Inland Revenue. If you fail to do so, use of money interest, late payment penalties and/or shortfall penalties ranging from 20% to 150% could be imposed on you.
15. For more information on these penalties, see the Inland Revenue guides *Late payment and late filing penalties (IR 741)* and *Taxpayer obligations, interest and penalties (IR 240)*.

Approved issuer levy

16. If you are liable to pay NRWT, for the future you could request approval from Inland Revenue to become an approved issuer and have the loan treated as a registered security. You then pay the approved issuer levy of 2% instead of withholding NRWT at 10%.
17. You will be eligible to elect to pay AIL if you borrow, have borrowed, or will borrow money in relation to a security. You must notify the Commissioner if you wish to have approved issuer status. Approved issuer status cannot be backdated. You must then register all the securities to which AIL is to apply. The Commissioner may revoke your approved issuer status if you have been responsible for serious default or neglect in complying with your obligations under the Inland Revenue Acts in the two year period leading up to the revocation of approved issuer status.
18. For further information, see the Inland Revenue guide *Approved issuer levy: A guide for payers (IR 395)*.

Analysis

19. The NRWT rules apply to gross income deemed to be derived from New Zealand that consists of interest (see s RF 2(1)).
20. Section YD 4(11)(b)(i) provides that interest derived from money lent outside New Zealand to a New Zealand resident is derived from New Zealand unless the resident borrows the money for a business carried on through a fixed establishment outside New Zealand.
21. However, in three instances NRWT will not be payable. The first two are provided by the domestic legislation. Section RF 2(1) provides that if the Australian financial institution to which the interest is paid operates through a fixed establishment (ie, a branch) in New Zealand, the NRWT rules do not apply. Section YD 4(11)(b)(i) provides a further exception that applies if the resident borrows the money for a business carried on through a fixed establishment outside New Zealand. The third instance where NRWT will not be payable is if relief is provided by the DTA. The DTA provides that no NRWT will be payable if the New Zealand resident carries on a business through a permanent establishment in Australia and the debt is effectively connected to that permanent establishment.
22. Section YD 4(11)(b)(i) applies to you even if you were not a New Zealand resident when you borrowed the money in respect of which you now pay interest from New Zealand. There is an exception to this general rule though, which is that if you borrowed the money for a business carried on through a fixed establishment outside New Zealand, then the interest is not considered to be sourced in New Zealand. In those circumstances, there is an economic link with the other country through the use of the money in the business carried on there. This is consistent with international treaty practice and is reflected in the DTA provisions discussed in this item.
23. The transitional residents provisions (referred to above) mitigate the effect of the requirement for new

New Zealand residents to withhold NRWT in relation to interest paid on money borrowed prior to gaining residency. The provisions were one of the legislative amendments that resulted from the Government discussion document *Reducing Tax Barriers to International Recruitment to New Zealand* published in November 2003.

Terminology

24. The term "fixed establishment" is used in New Zealand's domestic legislation and is defined in s YA 1.
25. The term "permanent establishment" is defined in art 5 of the DTA.
26. The two terms are used to describe types of business arrangements and can affect a person's tax position, including whether or not the interest paid to an Australian financial institution is subject to the NRWT rules in New Zealand.
27. A fixed establishment and a permanent establishment have similar features but a fixed establishment requires a substantial business to be carried on.

Australian financial institution has a branch in New Zealand – situations A and B

28. If the Australian financial institution to which the interest is paid operates through a fixed establishment (ie, a branch) in New Zealand, the NRWT rules will not apply to the interest (see s RF 2(1)).

Australian financial institution has no branch in New Zealand – situation A

29. In terms of the definitions of "fixed establishment" and "permanent establishment", a property or properties managed by a New Zealand resident ("the New Zealand owner") from New Zealand cannot constitute a "fixed place of business". The property (ie, an apartment or house) is a fixed place but the business of leasing is not carried on through or in that place. All the management of the business takes place in New Zealand. The property itself is not where the business is carried on, rather it is the subject of the business.
30. If the lessee carries on a business from the rental property, then the property is the lessee's fixed place of business, not the lessor's. The property is not available to the lessor (the New Zealand owner) throughout the period of the lease, so cannot constitute a fixed establishment or a permanent establishment of the New Zealand owner. The business of leasing is carried on elsewhere; that is, on the facts described above, in New Zealand. This means the exception to NRWT provided by the domestic legislation does not apply.
31. If the New Zealand owner makes regular trips to Australia to carry out management activities in respect of the residential investment property but carries out those activities from a motel or hotel, there is no fixed place of business—a rented room in such circumstances lacks the required permanence to be a "fixed" place of business. In addition, the business of leasing is not limited to the period when the New Zealand owner is operating in Australia, the New Zealand owner is still required to deal with management issues from New Zealand from time to time.

Australian financial institution has no branch in New Zealand – situation B

Fixed establishment

32. If a fixed establishment exists, s YD 4(11)(b)(i) will not apply and the interest will not be deemed to be derived from New Zealand. Therefore, the New Zealand owner **will not** be liable for NRWT on interest paid.
33. Unlike the permanent establishment definition in the DTA (discussed below), the definition of "fixed establishment" does not include any provisions relating to the use of dependent or independent agents. However, general principles of agency can still be applied. A fixed establishment will be found to exist only if there is a fixed place of business in Australia through which a substantial business is carried on. The residential property is not itself a fixed place in which the business is carried on; rather it is the *subject* of the business.
34. If the property manager is working for the New Zealand owner as their agent and has a fixed place in Australia from where that activity takes place, it could be considered that the business of leasing is carried on through that place and that the New Zealand owner has a fixed establishment in Australia.
35. However, if the New Zealand owner owns only one property that a property manager manages in Australia, a fixed establishment will generally not exist, as the leasing of one property will generally not amount to a "substantial business". However, this will depend on the nature of the single property: for example, if the single property is an apartment block, the leasing of it may be a substantial business.
36. If the New Zealand owner owns more than one property, whether there is a substantial business (and therefore a fixed establishment) will depend on the particular facts. It is more likely that there will be

a substantial business of renting (and hence a fixed establishment) where several properties are rented out.

37. While the decided cases (such as *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue* [1978] 3 All ER 1185 (PC) and *L D Nathan Group Properties Ltd v CIR* (1980) 4 NZTC 61,602) do indicate that a business may be more readily found to exist where a rental property or properties is owned by a company (rather than an individual), this will still depend upon the particular circumstances of the case. In addition, for there to be a fixed establishment any such business must be a *substantial* business.

Permanent establishment

38. If the property manager is a "dependent agent" (see art 5(8) of the DTA), a permanent establishment will exist and NRWT **will not** be payable by the New Zealand owner provided the indebtedness is attributable to the permanent establishment and the interest is deductible in determining the profits of the permanent establishment (see art 11(7) of the DTA).

39. A dependent agent of the New Zealand owner is one who is acting solely for the New Zealand owner and who has and habitually exercises the authority to substantially negotiate or conclude contracts on the New Zealand owner's behalf. Such an agency makes it likely that the New Zealand owner will be deemed to have a permanent establishment under the DTA.

40. If a permanent establishment exists, the DTA requires that there be a connection between the permanent establishment and the indebtedness in respect of which the New Zealand owner pays interest. As the New Zealand owner borrowed the funds to purchase the property or properties, and the property manager works for the New Zealand owner in respect of that property, a sufficient connection exists between the permanent establishment and the indebtedness, so the DTA will apply.

41. However, if the property manager is acting in the ordinary course of their own business of managing properties and is independent of the New Zealand owner legally and economically, the New Zealand owner will likely not be deemed to have a permanent establishment. This is so because the property manager will be an independent agent and any interest **will** be subject to NRWT.

42. If the property manager acts solely for the New Zealand owner in respect of the rental property but also owns another business *unrelated* to the property management business, the manager could still be considered a dependent agent of the New Zealand owner. The DTA expressly excludes an agent who acts for the New Zealand owner in the *ordinary course* of the agent's own property management business from being a dependent agent. However, a person who operates a business of their own (which is not related to property management) and who acts for the New Zealand owner *outside* the ordinary course of that business is able to be considered a dependent agent of the New Zealand owner, if such person has and habitually exercises the authority to substantially negotiate or conclude contracts on behalf of the New Zealand owner.

43. Note also that the New Zealand owner is not deemed to have a permanent establishment in Australia under art 5(4)(c) of the DTA. A residential property does not constitute substantial equipment within the meaning of this provision.

Examples

Example 1

44. Mr Acorn, a New Zealand resident, purchases a residential property on the Gold Coast in Australia as an investment. To finance the purchase, Mr Acorn takes out a loan with the Commonwealth Bank of Australia that is secured by a mortgage over the residential property.

45. The Commonwealth Bank of Australia operates in New Zealand through a branch. Consequently, the bank is considered to have a fixed establishment in New Zealand and the NRWT rules will not apply to require Mr Acorn to deduct a withholding payment from the interest paid on the loan to the bank.

Example 2

46. Mr Smith, a New Zealand resident, purchases a residential property on the Gold Coast in Australia as an investment. To finance the purchase, Mr Smith takes out a loan with the National Australia Bank that is secured by a mortgage over the residential property.

47. Mr Smith manages the residential property from his home in New Zealand and organises for maintenance work to be carried out as necessary when advised by his tenants. He does not engage the services of any person to act on his behalf in Australia in relation to the property.

48. National Australia Bank does not operate through a branch in New Zealand, so does not have a fixed establishment here. Mr Smith will have to deduct NRWT from the interest payments that he makes to the bank and pay them to Inland Revenue.

49. Mr Smith could request Inland Revenue's approval to become an approved issuer and have his mortgage accepted as a registered security. If accepted, Mr Smith would pay a 2% levy in place of NRWT at 10% from the date of acceptance.

Example 3

50. Ms Worth, a New Zealand resident, purchases 10 apartments in a high-rise apartment tower on the Gold Coast in Australia. She finances the purchases by borrowing funds from National Australia Bank. The loans are secured by mortgages over each of the properties.

51. Ms Worth does not have time to manage the properties herself from New Zealand, so she engages an acquaintance, Mr Donald, who lives on the Gold Coast, to manage them on her behalf. Mr Donald is retired and undertakes this management role only for Ms Worth. She authorises him to enter into contracts (ie, tenancy agreements and maintenance contracts) on her behalf, and he does so regularly.

52. National Australia Bank does not operate through a branch in New Zealand, so does not have a fixed establishment here. However, because Mr Donald has and habitually exercises the authority to substantially negotiate or conclude contracts on behalf of Ms Worth and works as a property manager only for her, Mr Donald will be considered a dependent agent. Therefore, Ms Worth will have a permanent establishment in Australia and will not have to deduct NRWT from the interest payments made to National Australia Bank.

Example 4

53. Mrs King, a New Zealand resident, purchases two apartments in a high-rise apartment tower on the Sunshine Coast in Australia. She finances the purchases by borrowing funds from National Australia Bank. The loans are secured by mortgages over each of the properties.

54. Mrs King does not have time to manage the properties herself from New Zealand so she engages a professional property manager, Mr James, to manage the properties on her behalf. Mr James runs his own property management business on the Sunshine Coast, catering to non-resident owners of property in his area. Mrs King authorises Mr James to enter into contracts (ie, tenancy agreements and maintenance contracts) on her behalf, and Mr James does so regularly.

55. National Australia Bank does not operate through a branch in New Zealand, so does not have a fixed establishment here. Mr James operates his own property management business and acts for Mrs King in the ordinary course of that business. Therefore, Mr James is an independent agent. Mrs King will not have a permanent establishment in Australia. Mrs King will not have a fixed establishment either, because, even if she could be considered to be in business through the activities of her agent, the leasing of two properties does not amount to a substantial business. Mrs King will have to deduct NRWT from the interest paid to the bank and pay the NRWT to Inland Revenue.

Other countries

56. This item, and the underlying analysis, may also apply to the NRWT liability of New Zealand residents who own investment properties in countries other than Australia, where the purchase of such properties has been financed by a loan from a financial institution in that country. The general principles relating to New Zealand's domestic legislation will apply. However, it is important to note that the outcome may differ because the relevant provisions of New Zealand's double tax agreement with that country may not be the same as those considered in this item.

QB 11/02: DEDUCTIBILITY OF EXPENDITURE INCURRED BY BLOODSTOCK BREEDERS IN RESPECT OF HORSES THAT THEY RACE

Section DW 2 of the Income Tax Act 2007

Question

We have been asked to clarify the deductibility of expenditure incurred by bloodstock breeders in respect of horses that they race, or prepare for racing, as part of their breeding business.

Answer

A person who is in the business of breeding bloodstock and races horses as part of that business (for example, to enhance the value of those horses, or the stud), can claim a deduction for non-race related ("holding") costs, but none of the costs more directly associated with racing these horses.

Analysis

Under section DW 2(1) of the Income Tax Act 2007 ("the Act") a person is denied a deduction for expenditure or loss they incur:

- on the racing of bloodstock; or
- in relation to the racing of bloodstock.

Viewed in isolation, the effect of this subsection would mean that any costs incurred in racing a horse would not be deductible. This would include not only those costs directly attributable to racing the horse, but also those costs that would be incurred irrespective of whether the horse was being raced.

A limited exception to this general rule is provided by section DW 2(2) of the Act. This applies when a horse is being prepared for both racing and sale; for instance, the horse is being prepared for a "ready to race" sale. In this circumstance, if a breeder incurs expenditure that is preparatory to the racing and sale of the horse, that expenditure will be deductible so long as the breeder does not actually go on to race the horse for stake money.

Further, where a person is in the business of breeding bloodstock, any expenditure incurred in carrying on that business will be deductible in terms of the general deductibility provisions of subpart DA of the Act. Where horses are raced by a breeder as part of the breeding business a deduction will be permitted in respect of those costs that would ordinarily be incurred by the breeder, irrespective of the fact that the horses are being raced. Examples of these "holding costs" are insurance, non-race feed and veterinary costs, and agistment. However, any costs more directly related to the racing of these horses will not be deductible by virtue of section DW 2(1) of the Act. Examples of these "direct" racing costs are the racing proportion of the trainer's account, track fees, nomination and acceptance fees, riding/driving fees, race day transportation, race feed and veterinary costs.

Invoices received from trainers may contain both "holding" and "direct racing costs". The proportion of the trainer's account that will be deductible in these circumstances will be dependant on the particular circumstances of the case and in particular, whether there is a factual basis for the apportionment of the expenses. Unless there is a factual basis for apportionment, no deduction will be able to be claimed by the breeder.

This item corrects *Public Information Bulletin* No. 162, Part III – Bloodstock, April 1987 ("the PIB"). To the extent that the PIB could imply that feeding, maintenance and agistment costs are deductible even when the horse is not being raced as part of the breeder's breeding business, but as part of the breeder's racing activities (as a hobby for instance), it is incorrect.

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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.

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