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TAX INFORMATION Bulletin

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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.

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

Ref	Draft type/title	Description/background information	Comment deadline
ED0148	Draft general depreciation determination – Meal feeder, automated	The Commissioner proposes to set a general depreciation rate for "Meal feeders, automated" by adding a new asset class in the "Agriculture, Horticulture and Aquaculture" industry category. The Commissioner considers that the new asset class will have an estimated useful life of 20 years.	14 September 2012
ED0149	Draft determination – Depreciation rate for Mushroom Factory buildings	The Commissioner has reviewed the estimated useful life and depreciation rate applicable to specialised buildings used to grow mushrooms on a commercial basis. The Commissioner accepts that these specialised, mushroom-growing buildings are exposed to a harsh, corrosive environment due to the material that is used in growing mushrooms and the environment that mushrooms need to grow successfully. For these reasons it is proposed to add "Mushroom Factory (purpose built, predominantly in prefabricated stressed skin insulation panels)" to the "Building and Structures" industry category, with an estimated useful life of 33.3 years.	30 August 2012

IN SUMMARY

Interpretation guidelines

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Interpretation statements

IS 12/01: Income tax – timing of share transfers for the purposes of the continuity provisions 20

This interpretation statement sets out the Commissioner's view on who "holds" shares in a company and at what point during a sale of shares is there a change in who "holds" the shares. The Commissioner's view of these matters is in regard of s YC 2 and the "continuity provisions" of the Income Tax Act 2007. The continuity provisions provide the rules for the carrying forward and offsetting of losses, excess tax credits and credits in memoranda accounts based on shareholder decision-making rights carried by shares "held" by a person.

IS 12/02: Income tax – whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income 49

This interpretation statement sets out the Commissioner's view on whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income under section HC 6 of the Income Tax Act 2007. The Commissioner's view is that, in some circumstances, deemed income can give rise to beneficiary income under section HC 6.

IS 12/03: Income tax – deductibility of repairs and maintenance expenditure – general principles 68

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New legislation

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FIF deemed rate of return set for 2011–12

The deemed rate of return for taxing foreign investment fund interests is 7.58% for the 2011–12 income year, down from the previous year's rate of 8.52%.

Questions we've been asked

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INTERPRETATION GUIDELINES

This section of the *TIB* contains interpretation guidelines issued by the Commissioner of Inland Revenue.

Interpretation guidelines discuss the Commissioner's approach to the interpretation of a general area of law where there are also taxation implications. They are intended to clarify general points of interpretation that are causing, or may cause, difficulty for practitioners, taxpayers, and Inland Revenue. An interpretation guideline is Inland Revenue's opinion as to the better view of the law. That view is developed from an appreciation and assessment of the law on a particular topic, as gathered from leading cases.

IG 12/01: GOODS AND SERVICES TAX; INCOME TAX – "SHAM"

Introduction

1. Interpretation guidelines discuss the Commissioner's approach to the interpretation of a general area of law where there are also taxation implications. They are intended to clarify general points of interpretation that may cause difficulty for practitioners, taxpayers and Inland Revenue.
2. This interpretation guideline reviews the New Zealand, Australian and English case law on sham. In doing so, it clarifies the Commissioner's understanding of:
   - the meaning of sham;
   - when sham can be alleged;
   - how the courts determine whether there is a sham; and
   - the consequences of a finding of sham.

   To illustrate the practical application of the sham doctrine, the guideline summarises two significant sham cases and discusses two factual examples.
3. The conclusions reached in this interpretation guideline are set out in paragraphs 5–13 below. The main conclusions can be summarised as follows:
   - An allegation of sham is serious—it is akin to an allegation of fraud. The courts have stated that an allegation of sham should not be made lightly, and that a high standard of evidence is required to prove it.
   - A sham exists where the parties to the transaction documents did not intend to create the legal rights and obligations created by those documents, and intended to mislead third parties into considering they had created those legal rights and obligations. The parties intended either to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.
   - In considering whether the transaction documents are shams, the courts are concerned with the parties' subjective intentions, and not with the economic substance or commercial reality of the transaction.
   - A sham can exist at the time the documents are created. Documents that were bona fide when created can later become shams. This will occur when the parties agree to change the terms of their transaction, but leave the original documents standing so as to give the impression that those documents continue to accurately record the terms of their transaction.
   - If the court is satisfied that the allegation of sham is proven, the documents are disregarded to the extent they are shams. A document may be a sham in part and, in such cases, only that part of the document will be disregarded. The true arrangement between the parties (ie, the legal rights and obligations (if any) they created) is then given effect and the parties taxed accordingly. By contrast, if the court is satisfied that the documents are not shams, the parties are taxed in accordance with the legal rights and obligations created in those documents (except where s BG 1 or another anti-avoidance provision applies).
4. This interpretation guideline replaces the earlier interpretation guideline "Sham – meaning of the term", *Tax Information Bulletin*, Vol 9, No 11 (November 1997). This guideline does not signal a change of approach by the Commissioner towards sham. The main differences between this guideline and the earlier guideline can be summarised as follows:
   - The earlier guideline has been reorganised and revised so as to improve its readability.
   - The earlier guideline's analysis has been updated to take account of subsequent court decisions, in particular the Supreme Court's decision in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289.
   - New discussion has been inserted on the onus and standard of proof where sham is alleged in the tax law context.

ANALYSIS

Summary

5. As a general rule, the tax treatment of transactions between taxpayers depends on the legal rights and obligations created by the transaction documents. However, if satisfied that the documents are "shams", the courts disregard them to the extent they are shams. The court then gives effect to the true legal arrangement between the parties and the parties are taxed accordingly.
6. The essential characteristic of a sham is pretence. A sham exists where the parties intend the transaction documents to mislead third parties as to the true nature of the relationship between the parties. The parties intend either to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.
7. The leading New Zealand authority on sham is *Ben Nevis*. In this decision, the Supreme Court reiterated the requirements for sham as set out in Diplock LJ's judgment in *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 (CA). It also described the effect of a sham in the tax law context (at [33]):

   > A sham in the taxation context is designed to lead the taxation authorities to view the documentation as representing what the parties have agreed when it does not record their true agreement. The purpose is to obtain a more favourable taxation outcome than that which would have eventuated if documents reflecting the true nature of the parties' transaction had been submitted to the Revenue authorities.

8. To establish sham, it must be shown that the parties did not intend to create the legal rights and obligations recorded in the transaction documents; and that they intended that third parties would be misled by those documents into considering that the parties had created those legal rights and obligations. In considering whether there is a sham, the courts are concerned with the parties' subjective intentions and not with the economic substance and commercial reality of the transaction.
9. A sham can exist from the time when a document is created. A document that was bona fide when created can later become a sham. This will happen where the parties agree to change the terms of their transaction, but leave the original transaction documents standing so as to give the impression that those documents continue to accurately record the terms of their transaction.
10. The courts' approach to determining whether there is a sham can be outlined in three stages.
11. First, the courts determine the legal rights and obligations recorded in the documents. The courts interpret the documents objectively to arrive at the meaning a reasonable person would give them. They may consider evidence of surrounding circumstances at the time the documents were created to ascertain the meaning of the words used, but this evidence cannot be used to contradict or vary the terms of the documents. Evidence of the parties' subjective intentions is not considered at this stage.
12. Second, the courts then consider whether there is evidence that the documents are shams. The courts are concerned with the parties' subjective intentions at this stage. To show there is a sham, the courts must be satisfied on the balance of probabilities that:
    - the parties did not intend to create the legal rights or obligations recorded in the documents, and
    - it was intended that third parties would be misled by those documents into thinking the parties had created those rights and obligations.

    An allegation of sham is serious—it is akin to an allegation of fraud. Consequently, the courts have made clear that an allegation of sham is not to be made lightly and that a high standard of evidence is required to prove it.
13. Third, if the court is satisfied the documents are shams, the documents are disregarded to the extent they are shams. A document may be a sham in part and, in such cases, only that part of the document will be disregarded. The true arrangement between the parties (ie, the legal rights and obligations (if any) they created) is then given effect and the parties taxed accordingly. By contrast, if the court is satisfied that the documents are not shams, the parties are taxed in accordance with the legal rights and obligations created in those documents (except where s BG 1 or another anti-avoidance provision applies).

Meaning of sham

14. The doctrine of sham is a long-standing doctrine developed by the courts. In his article "Sham, trusts and mutual intention" [2008] NZLJ 227, Matthew Conaglen observes:

    > For well over two hundred years, the courts have refused to permit sham transactions – transactions which were created as "a mere cloak or screen for another transaction" (*Yorkshire Railway Wagon Co v Maclure* (1882) 21 ChD 309 at 318) – to conceal the truth. They have asserted a jurisdiction to "see through" (ibid) such transactions to get at "the real truth of the matter" (*Re Watson* (1890) 25 QBD 27 at 33).
    >
    > …

> The jurisdiction to ignore sham transactions is a jurisdiction of general application.

English case law

15. The classic definition of sham is contained in *Snook v London and West Riding Investments Ltd*. In this English Court of Appeal decision, Diplock LJ stated (at 802):

> I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the Court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities … that for acts or documents to be a 'sham,' with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating.

16. Diplock LJ's definition was discussed in *Hitch v Stone* [2001] EWCA Civ 63, [2001] BTC 78. In this English Court of Appeal decision, Arden LJ stated (at [63], [66] and [69]):

> 63. The particular type of sham transaction with which we are concerned is that described by Diplock LJ in *Snook*, above. It is of the essence of this type of sham transaction that the parties to a transaction intend to create one set of rights and obligations but do acts or enter into documents which they intend should give third parties, in this case the Revenue, or the court, the appearance of creating different rights and obligations. The passage from Diplock LJ's judgment set out above has been applied in many subsequent decisions and treated as encapsulating the legal concept of this type of sham.
>
> …
>
> 66. Second, as the passage from *Snook* makes clear, the test of intention is subjective. The parties must have intended to create different rights and obligations from those appearing from (say) the relevant document, and in addition they must have intended to give a false impression of those rights and obligations to third parties.
>
> …
>
> 69. Fifth, the intention must be a common intention: see *Snook*'s case, above.

17. Diplock LJ's judgment in *Snook* is authority for the proposition that a sham will exist where:

   - the parties intended that the transaction documents (or the acts they have done) would not create the legal rights or obligations they appear to create; and
   - it was intended that the documents (or acts) would mislead a third party into believing the parties had created those rights and obligations.

New Zealand case law

18. New Zealand courts have defined sham consistently with Diplock LJ's judgment in *Snook*. As defined by the New Zealand courts, a sham exists where the parties execute documents, or do acts, so as to mislead third parties as to the true nature of the legal arrangement between the parties. The parties either intended to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

19. For example, in *Bateman Television Ltd v Coleridge Finance Co Ltd* [1969] NZLR 794 (CA), Turner J held (at 813):

> I think that the occasions on which Courts have set aside the form of a transaction as a "sham" are confined to cases in which, really doing one thing, the parties have resorted to a form which does not fit the facts in order to deceive some third person, often the revenue authorities, into the belief that they were doing something else. Thus where in a lease both parties prescribe a rent in excess of what is really to be paid, so as to deceive those who collect taxes as to the quantum of a deduction to be allowed, this is a sham … .

To similar effect, in the same decision McCarthy J reiterated Diplock LJ's judgment in *Snook* by stating (at 821):

> … whatever else is accepted as being involved in the concept of a sham, one thing is clear in legal principle, morality and authority, namely that for acts or documents to be a sham all the parties thereto must have a common intention that the acts or documents are not to create legal rights and obligations which they give the appearance of creating.

20. By contrast, there is no sham if the parties intended the document to be legally effective. In *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164 (CA), Turner J held (at 175):

> The word "sham" is well on the way to becoming a legal shibboleth; on its mere utterance it seems to be expected that contracts will wither like one who encounters the gaze of a basilisk. But by a "sham" is meant, in my opinion, no more and no less than an appearance lent by documents or other evidentiary material, concealing the true nature of a transaction, and making it seem something other than what it really is. The word "sham" has no applicability to transactions which are intended to take effect, and do take effect, between the parties thereto according to their tenor … .

21. In *Marac Finance Ltd v Virtue* [1981] 1 NZLR 586 (CA), Richardson J stated (at 588) that a sham could exist at the outset when the documents are created. Alternatively, the documents might be bona fide when created but could later become shams. This would happen when the parties agree to change the terms and conditions of their transaction, but decide to leave the original documents unchanged so as to mislead third parties:

    > Where the essential genuineness of the documentation is challenged a document may be brushed aside if and to the extent that it is a sham. There are two such situations: (1) where the document does not reflect the true agreement between the parties in which case the cloak is removed and recognition given to their common intentions; and (2) where the document was bona fide in inception but the parties have departed from their initial agreement and yet have allowed its shadow to mask their new arrangement.

    See similar statements in *Mills v Dowdall* [1983] NZLR 154 (CA), at 160.

22. In the trust law context, the Court of Appeal in *Official Assignee v Wilson* [2007] NZCA 122, [2008] 3 NZLR 45 clarified that whether there is a sham depends on the **subjective** intention of the parties. Robertson and O'Regan JJ held (at [50]):

    > An important prior question is whether common intention must be ascertained objectively, as is usual in the construction of commercial documents, or subjectively, in the departure from orthodox norms of construction. Where a sham is alleged, should a Court look behind the objective trust appearance of an alleged sham so as to ascertain the true nature of the transaction? The answer must be "Yes". Otherwise, the most insidious kinds of shams are those most able to work their mischief. To answer "No" would be to give exaggerated weight to the objective appearance of a transaction. While the objective appearance is the default determinant of a transaction's effect and substance, sham transactions are by definition transactional aberrations, and therefore require departure from the default principles of analysis.

    Glazebrook J concurred with Robertson and O'Regan JJ (at [108]):

    > In my view, where a sham is alleged, the search is for subjective intent that the transaction is a sham. After all, the whole point of a sham is that it is intended to have an effect other than the effect it would have if looked at objectively. See Conaglen at p 186, *Hitch v Stone* [2001] STC 214 at para [56] per Arden LJ (for the Court) and *Sharrment v Official Trustee* (1988) 18 FCR 449 at p 456, where Lockhart J said:
    >
    > It is not clear from Diplock LJ's formulation [in *Snook*] whether it is the subjective intention of the parties that is determinative, although logically this seems to be the correct result. In *Coppleston's* case Hunt J (at 98; 4022) took the view that the authorities established that it is the intention of the parties to the transaction which determines the question whether the act or document was never intended to be operative according to its tenor at all but rather was meant to cloak another and different transaction.

23. In *Official Assignee v Wilson* the Court of Appeal accepted that the sham doctrine can apply to express trusts. Some overseas courts have also accepted that express trusts can be shams: *Midland Bank Plc v Wyatt* [1995] 1 FLR 697 (Ch); *Shalson v Russo* [2003] EWHC 1637 (Ch), [2005] Ch 281; *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 18 FCR 449 (FCAFC). The law is not entirely settled as there are some issues concerning how the sham doctrine applies to trusts, for example, as to whether a validly created trust can subsequently become a sham trust and vice-versa.

24. The New Zealand and English case law on sham was summarised by the Supreme Court in *Ben Nevis*. This decision is the latest and leading authority on sham in New Zealand. In *Ben Nevis* the Supreme Court stated (at [33], footnote omitted):

    > There is no need for us to engage in any extended discussion of what constitutes a sham for present purposes. In essence, a sham is a pretence. It is possible to derive the following propositions from the leading authorities. A document will be a sham when it does not evidence the true common intention of the parties. They either intend to create different rights and obligations from those evidenced by the document or they do not intend to create any rights or obligations, whether of the kind evidenced by the document or at all. A document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement.

    The "leading authorities" referred to by the Supreme Court were (at footnote 34) *Snook v London & West Riding Investments Ltd*; *Paintin and Nottingham Ltd v Miller Gale and Winter*; and *NZI Bank Ltd v Euro-National Corporation Ltd* [1992] 3 NZLR 528 (CA).

25. The English and New Zealand decisions refer to the need to show the parties to the alleged sham had a "common intention". The courts have not provided much guidance on this common intention requirement. It is clear it must be shown that the parties did not intend to create the legal rights and obligations recorded in the transaction documents.

It is also clear it must be shown that it was intended that the documents would mislead third parties into thinking that those legal rights and obligations had been created. What is less clear is whether both parties must share in this intention to mislead.

26. Some United Kingdom decisions have suggested that a sham may exist where only one party intends to deceive, and the other party "merely went along with the 'shammer' not either knowing or caring about what he or she was signing": *Midland Bank Plc v Wyatt* [1995] 1 FLR 697, at 699–700; *Minwalla v Minwalla* [2004] EWHC 2823 (Fam), [2005] 1 FLR 771. Other United Kingdom decisions have rejected this approach: *Shalson v Russo*; *Al-Sabah & Abacus Ltd v Grupo Torras SA* [2004] WTLR 1 (Royal Court (Jersey)).

27. It is unclear which approach will be taken in New Zealand. In *Official Assignee v Wilson*, Robertson and O'Regan JJ noted (at [36]–[39]) that *Wyatt* could be seen to support the proposition that it is sufficient that one party intends to mislead, while the other party is "reckless or ignorant" about what he or she was signing and goes along with the "shammer". However, their Honours stopped short of endorsing this approach, and instead noted that an "alternative view" was that *Wyatt* did not support this proposition. In her separate concurring judgment, Glazebrook J noted (at [114]) that the "weight of overseas authority suggests … complicity or at least … ignorance and recklessness" by one party might be sufficient. Her Honour also stopped short of endorsing this approach.

Australian case law

28. Australian courts have defined sham consistently with *Snook* and the New Zealand case law: *Cranstoun v FCT* 84 ATC 4,876 (QSC); *Faucilles Pty Ltd v FCT* 90 ATC 4,003 (FCAFC); *Case W48* 89 ATC 460; and *Sonenco (No. 87) Pty Ltd v Commissioner of Taxation* (1992) 111 ALR 131 (FCAFC).

29. For example, in *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* [2004] HCA 55, 211 ALR 101, the High Court of Australia held (at [46]):

> "Sham" is an expression which has a well-understood legal meaning. It refers to steps which take the form of a legally effective transaction but which the parties intend should not have the apparent, or any, legal consequences.

The High Court of Australia cited the Full Federal Court of Australia's decision in *Sharrment v Official Trustee*. In this decision, the Full Federal Court cited Diplock LJ's judgment in *Snook* and held (at 454):

> A "sham" is therefore, for the purposes of Australia law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive.

30. Again, in the Full Federal Court of Australia decision in *Richard Walter Pty Ltd v FCT* 96 ATC 4,550, Hill J defined (at 4,562):

> … a transaction as being a sham transaction where it involves:
>
>> A common intention between the parties to the apparent transaction that it be a disguise for some other and real transaction or for no transaction at all.
>
> In so doing I give effect to the words emphasised in the passage from Diplock LJ [in *Snook*].
>
> For example, parties might bring into existence a document described as a mortgage which records an advance by a lender to a borrower of a sum of money and the obligation of the borrower to repay it. The document may be a disguise in the sense that while on its face it appears to be a mortgage securing an obligation to repay, there is no real transaction at all behind it for which the document will be a disguise. Such would commonly be the case where the so called mortgage is brought into existence as part of a "money-laundering" exercise to enable a fraudulent explanation to be given as to how certain funds came into the hands of the person described as the mortgagor.
>
> However, in a case such as the present where there have been real payments made by bills of exchange in the form of cheques cleared through the banking accounts of the parties and recorded as loans in relevant books of account, the transactions involving the bills of exchange can clearly not be a disguise for something which is not a transaction at all. Rather, for there to be a sham there will need, in such a case, to be a common intention of both the apparent lender and the apparent borrower, that the transaction which they have purported to have entered into disguises some real transaction.

In his separate concurring judgment, Lockhart J also defined (at 4,552) sham consistently with *Snook*.

31. These Australian cases may therefore assist in understanding and applying the sham doctrine in New Zealand. However, the High Court of Australia's decision in *Raftland Pty Ltd v FCT* 2008 ATC ¶20-029 (HCA) suggests a broader approach to sham might be taken by the Australian courts in the future.

32. In *Raftland*, the majority of the High Court (Gleeson CJ, and Gummow and Crennan JJ) suggested transaction documents can be shams even if there was no evidence that the parties intended to mislead third

parties. Their Honours stated (at [35]–[36]) that the term "sham" could be used in a "less pejorative" sense to cover cases where there is an "apparent discrepancy between the entitlements appearing on the face of the documents and the way in which the funds were applied … [that could give] rise to a question whether the documents were to be taken at face value".

33. In their separate judgments, Kirby J (at [145]–[146]) and Heydon J (at [173]) defined sham consistently with Diplock LJ's judgment in *Snook*. Kirby J stated that traditionally Australian courts had adopted this narrow approach to sham. His Honour outlined the requirements of sham as follows (at [145]–[146] and [148], footnotes omitted):

> [145] The key to a finding of sham is the demonstration, by evidence or available inference, of a disparity between the transaction evidenced in the documentation (and related conduct of the parties) and the reality disclosed elsewhere in the evidence. Where, for example, the evidence shows a discordance between the parties' legal rights or obligations as described in the documents and the actual intentions which those parties are shown to have had as to their legal rights and obligations, a conclusion of sham will be warranted.
>
> [146] The test as to the parties' intentions is subjective. In essence, the parties must have intended to create rights and obligations different from those described in their documents. Such documents must have been intended to mislead third parties in respect of such rights and obligations.
>
> …
>
> [148] To justify a conclusion that documents constitute a sham, the requisite intention to mislead must be a common intention of the parties. An exception may exist where the acts and documents reflect a transaction divisible into separate parts, such that a transaction is a sham as to part only of the transaction.

34. However, Kirby J left open the possibility that Australian courts might adopt a broader approach to sham (at [159]):

> There is an orthodox approach to sham, accepted and expressed in Australian legal doctrine, as in the law of other, similar jurisdictions. There have also been suggestions of the emergence of a broader approach to the notion of sham, particularly in revenue cases. I accept that the "narrower" approach to sham, explained by this Court in *Equuscorp*, is applicable to this case. It was correctly applied by the primary judge. However, in my view, the idea of sham could be broadened somewhat. Doing so would not cut across the language and purpose of the explicit tax avoidance provisions enacted as Pt IVA of the Act. On the contrary, such an approach would be compatible with that contained in Pt IVA and the purposes that led to the enactment of that Part. It would demonstrate, once again, that in the present age, the doctrines of the common law evolve in the orbit of statute.

35. The majority of the High Court, and Kirby J, did not discuss the boundaries of any broader conception of sham. Kirby J reviewed (at [105]–[136]) Commonwealth case law, and noted that in Canadian and some English cases "the judges have indicated some degree of willingness to consider the development of a broader and more robust approach to the identification of a sham" (at [113]). In doing so, the Canadian and English courts had sought to "ameliorate the strictness" of Diplock LJ's definition of sham in *Snook* by considering the economic substance and commercial reality of the transactions concerned.

36. In *Raftland*, Kirby J observed that in New Zealand, by contrast, the courts had adhered to a "narrow operation of the sham doctrine" that is consistent with *Snook* (at [128]). This is the Commissioner's view as well. New Zealand case law is clear that, when considering allegations of sham, the courts are concerned only with the parties' common intention (ie, whether the parties intended to mislead third parties as to the true nature of their relationship). The courts are not concerned with the economic substance or commercial reality of the transaction. In *Ben Nevis*, the Supreme Court reiterated (at [33]) that a sham will exist when the transaction documentation "does not evidence the true common intention of the parties". It also stated (at [39]):

> Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve.

37. In *R v Connolly* (2004) 21 NZTC 18,884 (HC), the High Court rejected a broader approach to sham. In this decision, the Crown submitted that the term "sham" should be given a broader meaning "when examining schemes pursuing tax advantage". Under this broader meaning, circular transactions involving no real money were shams as they were "fictional" (at [72] and [74]). Fogarty J rejected this submission. His Honour held (at [99]–[100]) that the New Zealand courts had adhered to the "classic definition of sham in *Snook*". Consequently, there was no authority for "a broader meaning of sham, broader than the narrow definition in *Snook*".

Summary

38. A sham exists where the transaction documents created by the parties are intended to mislead third

parties. The parties intend either to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

39. To establish sham it must be shown that the parties did not intend to create the legal rights and obligations recorded in the documents; and that they intended that third parties would be misled by the documents into considering that the parties had created those legal rights and obligations. In considering whether transaction documents are shams, the courts are concerned with the parties' subjective intentions and not with the economic substance and commercial reality of the transaction.

40. A sham can exist at the time the documents are created. A document that was bona fide when created can later become a sham. This will happen where the parties agree to change the terms of their transaction, but leave the original documents standing so as to give the impression that those documents continue to accurately record the terms of their transaction.

When sham can be alleged

Sham cannot be alleged by a party to the transaction

41. Parties are bound by the legal documents they execute. They cannot argue that they are not bound by them (except where they were induced to execute the documents by fraud, mistake or misrepresentation). Consequently, the parties to a transaction cannot allege that the documents they have executed are shams. In *Official Assignee v Wilson*, Glazebrook J stated (at [109]):

> This does not mean that a settlor is entitled to give later oral evidence of his or her subjective intentions, particularly where this is with a view of depriving the beneficiaries of their rights under the trust or … defrauding a third party … . [I]n *Snook*, Diplock LJ made it clear at p 802 … that no unexpressed intentions of a "shammer" should affect the rights of a party whom he or she deceived.

No halfway house between sham and a genuine arrangement

42. The courts have stated that there is no "halfway house" between a sham and a legally effective transaction. In *Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 (CA), Richardson J said (at 706):

> … 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.

His Honour explained this position more fully in *Mills v Dowdall*, at 159:

> The only exceptions to the principle that the legal consequences of a transaction turn on the terms of the legal arrangements actually entered into and carried out are (i) where the essential genuineness of the transaction is challenged and sham is established; and (ii) where there is a statutory provision, such as s 99 of the Income Tax Act 1976, mandating a broader or different approach which applies in the circumstances of the particular case. A document may be brushed aside if and to the extent that it is a sham in two situations: (a) where the document does not reflect the true agreement between the parties, in which case the cloak is removed and recognition given to their common intentions …; and (b) where the document was bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.

43. No legal principle allows the courts to disregard documents that correctly record the parties' intentions on the basis that the substance of the transaction could be interpreted in such a way that it would produce some different legal result. Consequently, the courts cannot disregard the legal arrangements that are in place and consider the economic substance when determining the tax treatment of an transaction: *Re Securitibank Ltd* (No 2) [1978] 2 NZLR 136 (CA), at 168; *NZI Bank Ltd v Euro-National Corporation Ltd*, at 539; *Australia and New Zealand Savings Bank Ltd v FCT* [1993] 25 ATR 369 (FCAFC).

Onus and standard of proof

44. This section discusses the onus and standard of proof where sham is alleged in the tax law context.

45. When the Commissioner considers that the transaction documents are shams, the Commissioner will disregard the documents (to the extent they are shams) for the purposes of calculating the taxpayer's tax liability. The Commissioner may then assess or reassess the taxpayer according to what the Commissioner considers is the true legal arrangement between the parties disguised by the documents. [The consequences of a finding of a sham are discussed further in paragraphs 76–81 below.]

46. For the Commissioner's assessment to be valid, it cannot be made "arbitrarily in disregard of the law or facts as known to him" the Commissioner or be based on "an arbitrary conjecture or [be] demonstrably unfair": *Lowe v CIR* (1981) 5 NZTC 61,006 (CA), at 61,015 and 61,026. The Commissioner must make an honest judgement as to the tax liability on the information in the Commissioner's possession: *CIR v Canterbury Frozen Meat Company Ltd* (1994) 16 NZTC 11,150 (CA), at 11,160. This obligation cannot be

elevated into a requirement that the Commissioner not assess unless and until fully informed of the taxpayer's affairs: *CIR v NZ Wool Board* (1999) 19 NZTC 15,476 (CA), at 15,489. Nor is it a requirement for a valid assessment that the Commissioner must believe the assessment "will ultimately prove to be correct": *Canterbury Frozen Meat*, at 11,160. The courts have noted that the taxpayer is likely to be in the best position to provide the evidence required to determine the allegation: *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA), at 61,283; *Case N39* (1991) 13 NZTC 3,333.

47. Therefore, the Commissioner when making an assessment must act in good faith. The assessment must be based on the available facts and so represent the Commissioner's honest opinion. This means that, before disregarding a document on the basis of sham, the Commissioner must honestly consider that the available information supports the document being a sham. The Commissioner is not required to be completely confident that a court would uphold the sham allegation.

48. However, the Commissioner must give due regard to the fact that an allegation of sham is akin to an allegation of fraud. As the Supreme Court in *Ben Nevis* stated (at [39]):

> An allegation of sham, being akin to an allegation of fraud, should not be lightly made. Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve.

Similarly, in *Case U6* (1999) 19 NZTC 9,038 the Taxation Review Authority stated that the allegation of sham is "a very serious allegation" and that (at [86]):

> The facts must be measured against the gravity of the allegation and such a serious charge must always be responsibly made.

49. If the taxpayer disagrees with the Commissioner's view that the document is a sham, the taxpayer may challenge the assessment through the disputes process. If this occurs, the Commissioner has the "evidentiary onus" of pointing to evidence supporting the sham allegation. The standard of proof on the Commissioner is commensurate with the gravity of the allegation of sham: *Case X10* (2005) 22 NZTC 12,155, at [121].

50. Under s 149A(2) of the Tax Administration Act 1994, the onus of proof is on the taxpayer to show why the assessment is wrong and by how far it is wrong: *Buckley & Young*; *Beckham v CIR* (2008) 23 NZTC 22,066 (CA). The standard of proof required is the balance of probabilities: *Yew v CIR* (1984) 6 NZTC 61,710 (CA). This means that the taxpayer must establish on the balance of probabilities that the evidence or inferences pointed to by the Commissioner do not support the allegation of sham: *Case X10*, at [123].

Courts' approach to determining sham

51. This section discusses the New Zealand courts' approach to determining whether there is a sham.

Courts' general approach to analysing transaction documents

52. Before considering whether there is evidence supporting an allegation of sham, the courts determine what legal rights and obligations are created by the transaction documents.

53. The following principles were set out by Richardson J in *Re Securitibank (No. 2)* and *Marac Finance Ltd v Virtue*:

- The true nature of the transaction must first be determined in a careful, systematic and objective way.
- The legal character of the transaction is decisive of its true nature and not the overall economic consequences to the party.
- The legal character of the transaction cannot be determined conclusively by the nomenclature or labelling that is used by the parties. It is the inevitable effect of the terms of the contract that matters, not simply the form or language in which the parties chose to express it.
- In order to determine the true nature of the legal relationship the whole of the contract must be considered.
- Where the transaction is embodied in several interrelated documents, all the documents must be considered together and one may be read to explain the others.
- The documents are interpreted objectively so as to arrive at the meaning they would reasonably convey to a reasonable person.
- When interpreting the transaction documents, the courts are not concerned with ascertaining the parties' subjective intentions. The courts may consider the circumstances surrounding the entering into the transaction, and oral evidence may be admitted for the purposes of ascertaining the surrounding circumstances. Such evidence allows the courts to understand the setting in which the documents were executed. It cannot be given for the purposes of varying or contradicting the documents.

54. More recently, the Supreme Court in *Ben Nevis v CIR* at [48] emphasised that the character of the transaction is determined by the "true meaning of all provisions" of the documents, not the labels adopted in those documents:

> ... it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it. The label "licence premium" is accordingly not what is important in the present case, but rather the true contractual nature of the legal rights for which payment is to be made and the effect of applying the tax legislation to a payment of that character.

55. For further discussion on the interpretation of contractual documents, see: *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, [2010] 2 NZLR 444,; *Yoshimoto v Canterbury Golf International Ltd* [2001] 1 NZLR 523 (CA); *Boat Park Ltd v Hutchinson* [1999] 2 NZLR 74 (CA).

Matters the courts examine when determining if there is a sham

56. After ascertaining the legal rights and obligations recorded in the transaction documents, the courts consider whether any evidence shows that:
    - the parties intended to create different legal rights and obligations to those created by the transaction documents; and
    - it was intended that third parties would be misled by the documents into considering that they had created the legal rights and obligations created by the documents.

57. When considering an allegation of sham, the courts are concerned to ascertain the parties' subjective intentions: *Official Assignee v Wilson*, at [50] and [108]. As a result, the courts consider evidence that would normally be excluded when determining the objective meaning of the documents: *Buckley & Young*, at 61,277. In *Hitch v Stone*, the English Court of Appeal stated (at [65]):

> First, in the case of a document, the court is not restricted to examining the four corners of the document. It may examine external evidence. This will include the parties' explanations and circumstantial evidence, such as evidence of the subsequent conduct of the parties.

In *Raftland* Kirby J stated (at [147] footnote excluded):

> Where a court is considering a suggestion of sham that has a reasonably arguable evidential foundation, the court will not be confined to examining the propounded documentation alone. It may examine (and draw inferences from) other evidence, including the parties' explanations (if any) as to their dealings, and evidence describing their subsequent conduct.

58. The courts are reluctant to find sham and require clear evidence to justifying doing so. Mere circumstances of suspicion do not by themselves establish a transaction as a sham; it must be shown that the outward and visible form does not coincide with the inward and substantial truth: *Miles v Bull* [1969] 1 QB 258, at 264. An allegation of sham may be proven even in the absence of direct evidence, and on the basis of inferences drawn from the surrounding circumstances: *Sharrment v Official Trustee*, at 539. However, where there is no direct evidence, the courts require "compelling material". A finding of sham cannot be made if another inference is at least equally open on the facts: *Official Assignee v Wilson*, at [93]; *Sharrment v Official Trustee*, at 544.

59. The courts' reluctance to find sham is attributable to them recognising the need for "commercial certainty". In *Official Assignee v Wilson*, the Court of Appeal stated (at [52] and [111]):

> [52] ... that courts will not wantonly interfere in ostensibly valid commercial transactions. ... A Court will only look behind a transaction's ostensible validity if there is good reason to do so, and "good reason" is a high threshold, since a premium is placed on commercial certainty.
>
> ...
>
> [111] ... The party asserting the existence of the sham bears the onus of proving this on the balance of probabilities. Further, the ordinary approach to proof in civil cases should apply, where the more serious the allegation, the less likely it is that the event occurred and, therefore the stronger the evidence must be before the allegation will be established on the balance of probabilities ... .

In *Raftland* Kirby J stated to similar effect (at [144]):

> Although, therefore, courts will ordinarily give legal effect to documents according to their language, sham analysis is an exception to that conventional approach. That is why it requires exceptional circumstances to enliven a conclusion that documents and acts amount to a sham, with the legal results that such a conclusion justifies.

Tax avoidance

60. Sham is not the same as tax avoidance. In *Ben Nevis* the Supreme Court emphasised (at [34]) that sham and tax avoidance are different:

> It is important to keep firmly in mind the difference between sham and avoidance. A sham exists when documents do not reflect the true nature of what the parties have agreed. Avoidance occurs, even though the documents may accurately reflect the transaction which the parties intend to implement, when, for reasons to be discussed more fully below,

> the arrangement entered into gives a tax advantage which Parliament regards as unacceptable.

The Supreme Court held (at [38]) that the fact the transactions concerned involved or facilitated tax avoidance did not mean they were shams. Similarly in *Accent Management Ltd v CIR* [2007] NZCA 230, (2007) 23 NZTC 21,323, the Court of Appeal held (at [59]) that the concepts of sham and tax avoidance are not correlatives.

61. Consequently, a transaction can be a "tax avoidance arrangement" under s BG 1 without being a sham. Similarly, a transaction can be a sham without being a "tax avoidance arrangement". If a transaction involves tax avoidance, but the documents reflect the true nature of what the parties have agreed, the Commissioner can only challenge it under s BG 1 (or any other anti-avoidance provision).

62. That sham and tax avoidance are different does not preclude the Commissioner from alleging that a transaction is a sham and, in the alternative, a tax avoidance arrangement.

Legally discouraged or prohibited arrangements

63. A transaction is not a sham only because it is discouraged or prohibited by legislation: *Sharrment Pty Ltd v Official Trustee*, at 455. Transaction documents that take effect between the parties as they are intended cannot be shams even if, for example, they are deliberately planned so as to fraudulently prefer one creditor over others. Other statutes and rules of law may "thwart the intentions" of those who enter into particular transactions, but the fact that the law does so does not mean such transactions are shams: *Paintin and Nottingham Ltd v Miller Gale and Winter*, at 175.

Ulterior purpose or motive

64. A transaction is not a sham merely because the parties entered it with an ulterior purpose or motive. "If what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it": *Miles v Bull* (No 1), at 264. For example, in *Official Assignee v Wilson*, at [123] the settlor created a trust for the ostensible purpose of providing for his children. The evidence showed that the settlor had set up the trust for the ulterior purpose of keeping his assets secure from creditors. The Court of Appeal held that this evidence did not show that the trust was a sham. However, this does not mean that evidence of an ulterior purpose is irrelevant. The existence of an ulterior purpose by one or both parties, together with other factors, may be considered relevant evidence of the parties' real intentions: *Re La Rosa; Ex p Norgard v Rocom Pty Ltd* (1990) 93 ALR 571 (FCA), at 581.

Parties' subsequent conduct

65. When considering allegations of sham, the courts are not restricted to considering the parties' conduct before or at the time the transaction documents were created. The courts are entitled to consider the parties' subsequent conduct: *AG Securities Ltd v Vaughan* [1990] 1 AC 417 (HL), at 475.

66. The case law shows that the courts have been frequently asked to find sham on the basis of that the parties acted inconsistently with the terms of the transaction documents. The courts have held that such evidence does not necessarily show the parties did not intend the documents to be effective and binding. In *Hitch v Stone* the English Court of Appeal stated (at [68]):

> … the fact that parties subsequently depart from an agreement does not necessarily mean that they never intended the agreement to be effective and binding. The proper conclusion to draw may be that they agreed to vary their agreement and that they have become bound by the agreement as varied … .

Similarly, in *Sonenco (No 87) Pty Ltd*, the Full Federal Court of Australia stated (at [82]):

> As was pointed out in *Snook* … one must first determine what were the genuine common intentions of the parties. If the acts and documents in question reflect those intentions, there will be no "sham". Haphazard conduct or departures from the provisions of the documentation may, or may not, indicate that the documents do not truly reflect what was intended. What is crucial … is the ascertainment of the parties' real intentions.

For similar comments, see *Australian Guarantee Corporation (NZ Ltd) v Broadlands Finance Ltd*; *General Motors Acceptance Corporation (NZ) Ltd v Australian Guarantee Corporation (NZ) Ltd and Broadlands Finance Ltd* (HC Auckland, A 256/80, 11 October 1983), at 22.

67. It is noted that part performance of the terms of the document does not preclude a finding of sham. In *Hitch v Stone* the English Court of Appeal stated (at [76]):

> However I would not agree with the judge that performance of the 1984 agreement in part was sufficient to remove the possibility of its being a sham. Part performance of the 1984 agreement does not in my judgment mean that it cannot be a sham. The terms actually performed may be terms of the true arrangement between the parties and they may accordingly have somewhat different consequences from the same terms appearing in the sham transaction. The correspondence of the terms in this respect is then coincidental and partial.

Mislabelled or carelessly prepared documents

68. On occasions, parties may use incorrect terms in their transaction documents. For example, the parties may use the term "lease" in the documents when the legal effect of the documents is that they have created a licence; or one party may be described as an "independent contractor" when the legal effect of the documents is that this party is an "employee". Mislabelling does not, by itself, mean the documents are shams. In *Accent Management Ltd*, the Court of Appeal stated (at [54]):

> At trial the argument against the taxpayers other than those associated with Dr Muir and Mr Bradbury was that the arrangements were shams because they were not true insurance arrangements. The conclusion does not follow logically from the asserted premise. A contract can be mislabelled without being ineffective. If the relevant arrangements were mislabelled as "insurance" but were nonetheless intended to create real legal obligations which were to be honoured, they would necessarily not be shams.

As the Court of Appeal held, a mislabelled transaction document cannot be disregarded if the parties intended the legal rights and obligations created by the document to be legally effective.

69. Similarly, carelessness, or haste, in the preparation of the documents does not, by itself, provide evidence of sham: *Bateman Television v Coleridge Finance Co Ltd*; *Coppleson v Commissioner of Taxation* (1981) 52 FLR 95 NSWSC), at 104.

Lack of commerciality or artificiality

70. "Artificiality and lack of a commercial point … are not indicia of sham": *Accent Management Ltd v CIR* (CA), at [59]. An artificial arrangement is not a sham if the transaction document "had the effect that it purported to have", and did not purport "to do something different from what the parties had agreed to do": *IRC v Littlewoods Mail Order Stores Ltd* [1963] AC 135 (HL), at 155; *Sharrment Pty Ltd v Official Trustee*, at 454–455; *Sonenco (No 87) Pty Ltd v Commissioner of Taxation*, at [82]–[84]. In *Hitch v Stone*, the English Court of Appeal stated (at [67]):

> … the fact that the act or document is uncommercial, or even artificial, does not mean that it is a sham. A distinction is to be drawn between the situation where parties make an agreement which is unfavourable to one of them, or artificial, and a situation where they intend some other arrangement to bind them. In the former situation, they intend the agreement to take effect according to its tenor. In the latter situation, the agreement is not to bind their relationship.

71. That the transaction between the parties is circular will not, by itself, show it is a sham. In *Re Barnett (Deceased) Perpetual Trustee Co Ltd v Barnett* (1969) 2 NSWR 720 (NSWSC), at 730–731, the Supreme Court of New South Wales held that a transaction was not a sham only because it involved a "round robin of cheques" (ie, the cheques exchanged by the parties were not cashed and instead cancelled each other out). Similarly, in *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd*, the High Court of Australia rejected (at [46]–[48]) the submission that the transactions were shams as no "real money" was lent or brought into the venture. The evidence showed that the parties intended the transactions to be legally effective—debts were created and satisfied by the debiting and crediting of the parties' accounts.

72. This does not mean that artificiality or lack of commerciality is irrelevant when deciding whether there is a sham: *Case X10*, at [116]. The courts have taken into account (along with other factors) elements of artificiality and lack of commerciality when deciding whether the documents reflect the legal rights and obligations the parties intended to create: *Erris Promotions Ltd v CIR* (2003) 21 NZTC 18,330 (HC), at [106]; *Raftland Pty Ltd*, at [149]; *Hitch v Stone*, at [75]–[80]. In *National Westminster Bank Plc v Jones* [2001] 1 BCLC 98 (Ch), the English High Court (Chancery Division) stated (at 109):

> Accordingly, while the palpable, and freely admitted artificiality of the agreements in the present case cannot be doubted, it certainly does not follow that, as a result, the agreements must be shams. However, in my judgment, the fact that a particular transaction is palpably artificial is a factor which can properly be taken into account when deciding whether it is a sham. Indeed, it would seem to me to require very unusual circumstances before the court held that a transaction which was not artificial was in fact a sham.

73. The courts have emphasised that the complexity of a transaction does not, by itself, establish that the arrangement is a sham: *Sharrment Pty Ltd v Official Trustee*, at 455. In *Coppleson v Commissioner of Taxation* the Supreme Court of New South Wales stated (at 100):

> The fact that, in order to obtain those advantages, the transaction became complex and elaborate rather than simple and straightforward does not seem to me to affect its true nature if in legal form it is a gift and if the parties thereto intended it to be operative according to its tenor … .

Parties adopt one legal form over another

74. A transaction is not a sham just because the parties could have structured it in another way. In *Bateman Television v Coleridge Finance Co Ltd*, the appellants entered into arrangements for the hire-purchase of television sets. The respondent submitted that the arrangements were "shams" in that the "reality" was that the arrangements were "moneylending transactions requiring the formalities prescribed by the Moneylenders Act [1908]". Under the Moneylenders Act, moneylending arrangements were illegal and void if they did not conform to the formalities prescribed in the legislation. The Court of Appeal rejected this submission. Turner J stated (at 813):

> I think that the occasions on which Courts have set aside the form of a transaction as a "sham" are confined to cases in which, really doing one thing, the parties have resorted to a form which does not fit the facts in order to deceive some third person, … into the belief that they were doing something else … but I cannot agree that the term is applicable to the form of a transaction into which the parties are legally at liberty to enter, and into which they do in fact enter, if what they do is simply to prefer this form of transaction to some other into which they might have entered, but did not.

Part shams

75. In some cases the parties intended to create some, but not all, the legal rights and obligations recorded in the transaction documents. For example the parties may genuinely intend to create a sale and purchase agreement, yet also intend to deceive third parties by falsifying the pricing or payment terms in the agreement. In *Hitch v Stone* the English Court of Appeal held that a finding of sham is not excluded by the fact that parts of the document are genuine. Arden LJ stated (at [85]):

> … the effect of Mr Price's submission is that the court will be precluded from finding that a document is a sham because it includes an additional provision which is intended to be effective. This might deprive the doctrine of sham of any operation in a situation which is logically indistinguishable from the situation where the doctrine of sham already applies. **In my judgment, the law does not require that in every situation every party to the act or document should be a party to the sham.** I accordingly reject Mr Price's submission save that I accept that the case where a document is properly held to be only in part a sham will be the exception rather than the rule, and will occur only where the document reflects a transaction divisible into separate parts.
>
> [Emphasis added]

Similarly in *Raftland* (at [148]) Kirby J stated:

> [148] To justify a conclusion that documents constitute a sham, the requisite intention to mislead must be a common intention of the parties. An exception may exist where the acts and documents reflect a transaction divisible into separate parts, such that a transaction is a sham as to part only of the transaction.

Consequences of a finding of sham

Transaction documents void and unenforceable "to the extent" that they are shams

76. When the courts find that the transaction documents are shams, the documents are disregarded "to the extent" they are shams: *Buckley & Young*, at 61,276. In *Henwood v CIR* (1995) 17 NZTC 12,271 (CA), Richardson J stated (at 12,276) that "[d]ocuments and clauses in documents may be brushed aside if they are sham." Where the **entire** document is a sham, the document is "void and unenforceable" and "wholly invalid and of no effect": *Midland Bank plc v Wyatt*; *Minwalla v Minwalla*. By contrast where **part** of the document is a sham and this part is severable, the document is void and unenforceable only in respect of that part: *Raftland*, at [148]; *Case W48* 89 ATC 460, at [26].

77. It is noted that an innocent third party might be able to enforce rights arising under a sham arrangement: *Hitch v Stone*, at [87]; *Official Assignee v Wilson*, at [120]–[122], per Glazebrook J.

78. By contrast, if the court is satisfied that the documents are not shams, the documents contain the legal rights and obligations the parties intended to create. The Commissioner therefore cannot disregard the documents (unless there is statutory authorisation to do so, for example, under ss BG 1 and GA 1). Consequently, the parties are taxed in accordance with the legal rights and obligations created by the documents (except where s BG 1 or another anti-avoidance provision applies).

True legal arrangement given effect

79. When the courts brush aside a sham document, they then ascertain the true legal arrangement between the parties. This does not involve considering the economic substance of the arrangement. Instead the courts determine the legal rights and obligations (if any) that the parties intended to create. In *Buckley & Young* Richardson J stated (at 495):

> As a cloak or façade to conceal the true nature of the payment, the qualifying reference to the $6,000 per year must be brushed aside as not reflecting the true intentions of the parties. That step does not leave a vacuum. It becomes necessary to determine for what

> the payments were to be made. Just as oral evidence is always admissible in support of an argument that a transaction is in whole or in part a sham, so, too, that evidence may at the same time assist in determining what was the positive common intention of the parties in that regard.

80. In the tax context, this means that the parties to the sham are taxed on the basis of the true legal arrangement between them. As already discussed (see paragraphs 44–48 above), when the Commissioner considers the transaction document is a sham, the Commissioner will disregard that document (to the extent it is a sham) for the purposes of calculating the taxpayer's tax liability. The Commissioner may then amend the taxpayers' assessments to reflect the true legal arrangement between the parties.

81. The current approach of ascertaining the true arrangement between the parties can be contrasted with the approach taken in some earlier decisions concerning transactions involving the refinancing of existing liabilities. This earlier approach was explained in by Thorp J in *Australian Guarantee Corporation (NZ Ltd) v Broadlands Finance Ltd*, at 22–23:

> The significance of a finding of sham has changed. In the earlier cases, certainly when the transaction was in the nature of the refinancing of existing liability rather than the creation of a new obligation for the purpose of acquiring a new asset, a finding of sham almost inevitably led the court to infer that the true nature of the transaction was one of loan. That apparent dichotomy has been disavowed in a series of cases.

His Honour identified (inter alia) *Paintin* and *Re Securitibank Ltd (No 2)* as decisions where the courts had "disavowed" this earlier approach, and stated (at 24):

> From these decisions it now follows, as I read the authorities, that a mere finding of sham, that is to say that the documentation amounts to a facade, will not aid the party who proves that fact unless, in addition, he can point to positive evidence that the underlying intention was one of loan.

Case summaries

82. In New Zealand few reported tax cases have upheld a finding of sham. This is largely due to the courts' reluctance to entertain sham allegations. The following tax law cases on sham will now be summarised:

- *Erris Promotions Ltd v CIR* – where the High Court held that three software purchases were shams.
- *Accent Management Ltd* and *Ben Nevis* – where the Court of Appeal and the Supreme Court held that an insurance arrangement was not a sham.

When reading these summaries, and also other decisions considering sham, it is important to keep in mind that a finding of sham in a particular case is inherently fact-dependent.

Erris Promotions Ltd

83. In *Erris Promotions Ltd*, the High Court considered whether three software purchases were shams. Ronald Young J cited Diplock LJ's definition of sham in *Snook* as "conveniently set[ting] out what constitutes a sham" (at [91]). Applying Lord Diplock LJ's definition, his Honour held that the three software purchases were shams.

84. With respect to the first software purchase, the parties had purported to buy and sell software. However, the facts showed that nothing was transferred "other than [an] idea which is in itself not depreciable". There were no specifications, no source code and no software. Ronald Young J inferred from the lack of due diligence that the parties knew there was no software being bought and sold (at [106]):

> Any credible sale of software for $144m would require as a minimum extensive due diligence involving technical analysis of the software and what it could do, an in-depth analysis of the market, due diligence of legal issues which would include ensuring that the vendor owned the software. Enquiries would be made as to the cost of replicating this software and whether there were any other similar products available overseas. There was none of this because both parties knew the purchase was a sham. … I find the agreement … was a sham and that both parties knew there was nothing beyond an idea unable to be protected in a property sense, bought or sold.

85. Ronald Young J held that these facts showed the first purchase was a sham. His Honour did not consider it relevant that the $144 million price was "self-evidently an absurd purchase price" but observed, as an aside, that "[t]he purchase of an idea, not especially original, for $144m says it all" (at [106]).

86. With respect to the second software purchase, Ronald Young J held that the purported purchase was a sham because the vendor did not own the software. His Honour was satisfied that both parties knew the vendor did not own what he purported to sell (at [119]). The third software purchase was also a sham because the vendor did not own the software he purported to sell and, in addition, part of that software did not exist at the time of sale. Ronald Young J was satisfied that both parties knew that the vendor did not own the software and that it was not fully developed (at [128]).

Accent Management Ltd and Ben Nevis

87. In *Accent Management Ltd* and *Ben Nevis* the Court of Appeal and Supreme Court considered whether insurance arrangements were shams. Under the insurance arrangements, the insured parties were insured for a "loss of surplus" expected to be derived from a forestry venture. In return, the insured parties were required to pay an initial premium of $1,307 per hectare each and, on or before 31 December 2047, another premium of $32,791 per hectare (with respect to one party) and $410,104 per hectare (with respect to the other party). The documentation provided that the last figure was to be adjusted so that the total amount required to be paid would not exceed the amount of the cover the insurer was obliged to provide.

88. The evidence showed the insurer was not expected to accumulate the premium income and had not entered into any reinsurance arrangements. On the structure of the insurance arrangements, there was no need for accumulations of premiums or reinsurance. This was because the net effect of the arrangements was that either one of the insured parties would default in its obligations (thereby releasing the insurer from its liability to make payment), or the 2047–2048 wash-up would occur in a way that was self-funding for the insurer. In addition, the parent company of the insured parties gave the insurer a letter of comfort, and this created an additional element of circularity to the insurance arrangements. Under the letter of comfort, the parent company undertook to provide funds to the insurer to meet any claim under the policy, provided the insurer had exhausted its resources and its ability to call on "contributors and/or insurers or reinsurers" in meeting claims.

89. The Court of Appeal examined the correspondence between the parties concerning the setting up of the insurance arrangements. One letter showed the parties considered that there was "no real risk in the whole thing". Another letter showed the parties considered that the entering of the insurance arrangement was a necessary condition to obtain tax relief, and that the actual outcome of the arrangement in 2047–2048 was "not considered material".

90. The Court of Appeal examined how the initial premium of $1,307 per plantable hectare paid to the insurer was used. The initial premium was first applied to cover the costs of establishing the insurer and to provide a US $200,000 bond required by the inspector of insurance in the British Virgin Islands. A substantial part of the remainder of the premium was paid as a "finder's fee" to another entity, and was then made available to the family trusts of the arrangement's architects. The net result was that the insurer retained only $157 per plantable hectare for possible accumulation, and the family trusts of the architects of the arrangement had the benefit of the "vast bulk" of the initial premiums.

91. The Court of Appeal held that the insurance arrangements by a "narrow margin" were not shams.

92. With respect to the requirement to pay the initial premium, the Court of Appeal stated that the arrangements were clearly "highly artificial and indeed contrived" (at [58]). However, artificiality and lack of commercial point (other than tax avoidance) are not indicia of sham, and the concepts of sham and tax avoidance were not correlatives. While there were "elements of pretence (and certainly concealment)" associated with the insurer's arrangements with respect to the initial premiums it was paid, these were explicable on bases other than sham, in particular the possibility of disallowance by the Commissioner for tax avoidance (at [59]). Accordingly, the Court of Appeal declined to find that the insurance arrangement provisions as to the payment of the initial premiums were shams.

93. The Court of Appeal then considered whether the contractual provisions governing the 2047–2048 wash-up were shams. It held that the evidence showed that the parties did not have any settled intention that the 2047 premiums would be paid. At the time of entering the arrangements, the parties regarded what would happen in 2047 as immaterial and to be addressed at that time. Their state of mind was "perhaps best categorised as involving indifference" as to whether the wash-up transactions occurred. This was presumably because, given the circular nature of insurance arrangements, the parties thought they could avoid the possibility of suffering any appreciable adverse consequences associated with the 2047 obligations (at [62]).

94. However, these factors did not persuade the Court of Appeal that the provisions for the 2047 wash-up were shams. It held (at [63]):

> By a narrow margin, however, we have reached the view that we cannot classify the transactions as shams. An obligation can be genuinely entered into even though subject to legal or practical defeasance or entered into on the basis that it might be replaced by another amended obligation. In a strange way, the very circularity which is involved in the transactions might be thought to be consistent with a desire that they be at least capable of achievement (or

> legally agreed variation) during or prior to the wash up. Whether these transactions are shams depends primarily on the states of mind of Dr Muir and Mr Bradbury as to their genuineness. Given that it is not to their advantage that the transactions be shams, it might be thought a little perverse to attribute to them states of mind which are inconsistent with their best interests.

95. On appeal, the Court of Appeal's conclusion on sham was upheld in *Ben Nevis*. However, the Supreme Court appeared to more firmly hold that the insurance arrangements were not shams:

> [38] The Courts below correctly applied the law and arrived at concurrent findings with which we agree. In short, we consider it has not been shown that the parties to the relevant documents were intending to deceive the Commissioner as to the nature of their arrangement in respect of insurance or as to their intention to implement the insurance arrangements according to their tenor. The fact that the insurance arrangements were constructed in a way that, as will later be demonstrated, materially contributed to the whole Trinity scheme being characterised as a tax avoidance arrangement does not, according to proper principles of law, mean that the insurance aspect of the whole scheme was a sham. The fact that the insurance arrangements were put in place with the purpose or effect of obtaining a tax advantage does not mean they were a sham.
>
> [39] The shifting nature of the Commissioner's allegations of sham as this litigation proceeded, and the contradiction which derives from the Commissioner's acceptance that the initial premium was prima facie deductible, makes it difficult for the Commissioner to sustain the proposition that the insurance arrangement was a sham. An allegation of sham, being akin to an allegation of fraud, should not be lightly made. Those engaging in a sham are in reality seeking to deceive others as to the true nature of what they have agreed and are intending to achieve. That is not shown here.

96. The Court of Appeal and Supreme Court's decisions emphasise that an allegation of sham should not be lightly made as it is akin the fraud, and that clear evidence is required to support such an allegation. The decisions also emphasise that sham and tax avoidance are different. In this respect, it is observed that the Court of Appeal and the Supreme Court held that the arrangements were not shams, even though they also held that s BG 1 applied to the same arrangements.

Examples

97. These two examples illustrate how the sham doctrine might operate in practice.

Example 1

98. C owns a shop that sells building materials. D owns and operates a house building company that is registered for GST purposes. D is currently building his own house using labour and materials provided by himself (and not his company). D wants to purchase building materials from C in order to complete his house. D visits C's shop and purchases the materials using his own money. D informs C that he is purchasing the materials for his company, and asks C to prepare an agreement for sale and purchase of the materials that identifies D's company as the purchaser. C and D sign the sale and purchase agreement. D then uses the building materials in the construction of his house. D claims input tax deductions for the GST paid on the building materials and, in support of his claims, produces the agreement for sale and purchase.

99. On the facts of this example, the agreement for sale and purchase is not a sham. In order to establish that the agreement is a sham, **both** parties must be shown to have the common intention not to create the legal rights and obligations contained in the agreement, and that it was intended that a third party (ie, Inland Revenue) would be misled into believing they had created these rights and obligations.

100. The common intention requirement is not satisfied on the facts. D did not intend that his company would take ownership of the building materials. Instead, D intended that he himself would take ownership of the materials, thereby enabling him to use them for building his house. D also intended to mislead Inland Revenue into believing that his company had purchased the materials, as shown by him presenting the agreement in support of his input tax deduction claims. However, the evidence does not suggest that C shared D's intention. C was unaware of D's intention to use the materials personally and, from his perspective, considered that he was contracting to sell the building materials to D's company.

101. While the requirements of sham are not satisfied, it may be necessary to consider (as a separate matter) whether D's claims amount to evasion or avoidance.

Example 2

102. M works for P and is paid fortnightly wages that are subject to PAYE. M and P consider that they could both attain a tax advantage by opting out of their PAYE obligations, because P could stop deducting PAYE and M could take deductions not available to employees. Accordingly, M and P enter into a new contract that expressly states that the nature of the employment relationship is one "for service" rather than "of service". The contract states that M is a self-employed independent contractor of P. Under the contract's terms, P is not responsible for holiday pay or sick leave and M is responsible for supplying to P all the equipment, plant, and so on for the contract work.

103. After the new contract is signed, the only noticeable difference in the employment relationship is the contract. All other facets of the relationship between M and P remain the same. M and P do not implement the terms of the new contract and have no intention of doing so. The "employment relationship" maintains the same entitlements and obligations as before. Although the new contract stipulates that M is not entitled to holiday pay or sick leave, M continues to take paid holidays and sick leave. P continues to provide all the assets and make all the decisions regarding how the business and M's services are to be managed. In reality, M and P are continuing to operate in a "master–servant" relationship. However, for tax purposes, P ceases to deduct PAYE from M's fortnightly "contractual payments". When queried about this lack of deduction, P produces the new contract for services as evidence of the new relationship.

104. The new employment relationship is clearly a sham. M and P intend to deceive the Commissioner by holding out that an independent contractual arrangement exists when clearly there is no change in the employment relationship. Once a sham is established, the new arrangement is ignored and legal effect is given to the real employment status. Also, it is likely that M's failure to deduct PAYE from the "wages" mean M is subject to shortfall penalties. However, if M and P genuinely began to operate in accordance with the express terms in the new agreement for services then no sham would exist. Alternatively, if M and P entered into the new contract, did not implement its terms in practice, but continued to meet their legal and taxation obligations on the basis that an employment relationship still existed, there would not be a sham. For a sham to exist, the parties' common intention must be to mislead someone else (such as the Commissioner) in respect of the true legal or factual position.

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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 12/01: INCOME TAX – TIMING OF SHARE TRANSFERS FOR THE PURPOSES OF THE CONTINUITY PROVISIONS

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the appendix to this commentary.

Scope of this statement

1. This Interpretation Statement considers:
   - who **holds** shares issued by a company;
   - **when**, during a sale or transfer of shares, there is a change in who holds those shares.

   The Commissioner is aware that people have had difficulty in determining the latter point in particular.

2. The person who holds shares issued by a company will have a "voting interest" in the company. The amount of the person's voting interest in the company must be calculated when applying the "continuity provisions" of the Act. The continuity provisions govern the ability of companies to:
   - carry forward losses;
   - offset losses with other companies;
   - carry forward credits in any memoranda accounts (eg, imputation credit accounts);
   - carry forward excess tax credits.

3. The continuity provisions are set out in ss GB 3, GB 4, IA 3 to IA 5, IC 1, LP 3(4), OB 41, OC 24, OE 10 and OK 15.[1] Generally, these provisions require that over a period a group of persons' combined voting interests in a company or companies exceed certain minimum levels.

4. Under s YC 2 the amount of a person's voting interest in a company is a product of two factors. One factor is the number of shares the person holds. The other factor is the "shareholder decision-making rights" carried by those shares. This Interpretation Statement considers the first factor only.

5. This Interpretation Statement also does not apply to:
   - market value interests under s YC 3 that arise where there is a "market value circumstance" as defined in s YA 1;
   - rectification (where there is a mistake in a company's share register);
   - options over shares.

6. In respect of the last item above, in certain circumstances (involving "shareholder decision-making rights" as defined in s YA 1) the calculation of voting interests under s YC 2 and market value interests under s YC 3 include options where an "option" includes an "agreement for sale at a time when beneficial ownership of the property sold has not completely passed to the purchaser". In addition, a "market value circumstance" can include an occasion or a situation in which an option exists. Accordingly, in addition to the matters concerning agreements for the sale and purchase of shares discussed in this Interpretation Statement, continuity implications may arise from some uncompleted agreements in terms of options and market value circumstances. In particular, this may be the case if an agreement provides for an alteration of any of the vendor's shareholder decision-making rights.

7. This Interpretation Statement applies to "shares" issued by a company registered under the Companies Act 1993 where those shares are an "interest in the capital of a company" (as per para (a) of the definition of "share" in s YA 1). The definition of "share" includes other items such as certain debentures, stapled debt securities and units in a unit trust. None of these additional items falling under the definition is dealt with in this Interpretation Statement.

Summary

8. As a rule, shares issued by a company will be held by the registered holder of those shares. The registered

[1] Section OE 10 has been repealed, effective from 1 July 2012: see the Appendix.

holder of shares is the person whose name appears on the share register of the company.

9. There are two exceptions to this rule.

10. The first exception is if those shares are held by the registered holder as "nominee" for another person. If so, under s YB 21, the registered holder is "looked through" and the other person will hold the shares for the purposes of the Act, unless the second exception applies.

11. The second exception is if any of ss YC 8 to YC 19 and s FB 10 apply. These provisions apply in specific circumstances (eg, where a person has a voting interest of less than 10% in a company). If any of these provisions apply, someone other than the registered holder of the shares may be considered to hold the shares. This Interpretation Statement does not consider these provisions in depth.

12. Where shares are transferred from one person to another, a change in who holds the shares occurs at the earlier of when:
    - the purchaser of the shares becomes the registered holder of the shares (ie, when the purchaser's name is entered onto the company's share register in accordance with the agreement); or
    - under s YB 21, the vendor holds the shares as "nominee" for the purchaser.

13. The vendor will hold the shares as "nominee" for the purchaser when one of the following occurs:
    - The vendor and the purchaser enter into an agreement, either as part of the transfer agreement or separately, that explicitly or implicitly creates a "nominee" relationship in relation to the shares.
    - The vendor is the bare trustee for the purchaser of shares under an agreement that has been settled, but the purchaser is not the registered holder of the shares. In such a case, the purchaser may go on to be registered or may never be registered (eg, where it is agreed the vendor will hold the shares as bare trustee for the purchaser indefinitely).

14. In the nominee situation, exceptions to when the purchaser is then the holder of the shares could arise if:
    - the purchaser is themselves a "nominee" for someone else (in which case s YB 21 will deem the shares to be "held" by that other person); or
    - any of the provisions of ss YC 8 to YC 19 or s FB 10 apply so that someone other than the purchaser is the holder of the shares.

15. Where the vendor is the purchaser's nominee, entering the purchaser's name onto the share register of the company later does not affect who holds the shares. In that situation, the purchaser is already considered the holder of the shares.

16. A flowchart showing when during a transfer of shares there is a change in who "holds" shares is in paragraph 155. Examples follow the flowchart. In all cases and for the avoidance of doubt, the outcomes in terms of the application of the continuity provisions suggested by the flowchart and in the examples may not apply where s BG 1 applies.

ANALYSIS

17. The issues to consider are:
    - who shares are "held" by; and
    - when under a share transfer agreement there is a change in who holds those shares.

18. These issues are important for applying the continuity provisions. Therefore, it is useful to first review those provisions.

What are the continuity provisions?

19. The continuity provisions relate to whether a company may:
    - carry forward losses;
    - offset losses with other companies;
    - carry forward credits in its memorandum accounts (eg, imputation credit account);
    - carry forward excess tax credits.

20. As will be seen in the following paragraphs, pivotal to the continuity rules is the measurement of voting interests under s YC 2.

Carry forward of losses

21. The continuity provision relating to the carrying forward of company losses is s IA 5. Section IA 5 provides that a company's tax loss is carried forward only if a group of persons holds for the relevant period a minimum voting interest in the company that adds up to at least 49%.

22. A "minimum voting interest" for a person is defined by s IA 5(6) as the lowest "voting interest" the person has in the company during the relevant period. "Voting interest" is defined in s YA 1 as the percentage voting interest that a person is treated as holding in the company under ss YC 2 to YC 20.

Offset of losses with other companies

23. The continuity provision relating to the offset of losses between companies is s IC 1. Section IC 1 provides that if a company has a tax loss for an income year and is a member of a group of companies, the company

may make its tax loss available to another company in the group. Section IC 1 requires s IC 2 to be satisfied.

24. Section IC 2 sets out requirements for the continuity of ownership of the loss company itself and for the commonality of ownership of the two companies seeking to offset losses.

25. The continuity of ownership of the loss company referred to in s IC 2 is set by reference to s IA 5. Section IA 5 is mentioned under "Carry forward of losses" in paragraphs 21 to 22.

26. The commonality of ownership of the two companies seeking to offset losses referred to in s IC 2 is set by s IC 3.

27. Section IC 3 refers to two or more companies in relation to which a group of persons hold common voting interests that add up to at least 66%. Section IC 3(3) provides that the common voting interests of the group are found from the percentage of each individual's voting interests in each of the companies at the time, as decided by reference to s YC 2.

28. Accordingly, the offset of losses between companies can occur only when there is both continuity of ownership of the loss company and commonality of ownership between the companies concerned. Both requirements are decided with reference to voting interests under s YC 2.

Carry forward of credits in memorandum accounts

29. Section OA 8 in certain circumstances prevents a company from maintaining credits in its memorandum accounts. Section OA 8 provides that a credit in a memorandum account may be carried forward only if a group of persons continues to hold aggregate minimum voting interests in the company of at least 66%. Where continuity is breached, s OA 8 refers to a debit arising under the specific continuity provision that relates to each type of memorandum account. For instance, the continuity provision relating to imputation credit accounts is s OB 41.

30. Accordingly, the ability of a company to carry forward credits in its memorandum accounts depends on whether a group of persons holds a certain level of minimum "voting interests" that is decided by reference to s YC 2.

Carry forward of excess tax credits

31. The continuity provision relating to the carrying forward of excess tax credits is s LP 3(4). Section LP 3(4) provides that if a company has an amount of tax credit remaining for the tax year the amount must be carried forward. Where this occurs, s LP 4 provides the continuity rules that then apply. Section LP 4 requires that a group of persons, for the relevant period, must have minimum voting interests in the company that add up to 49%. Section LP 4(3) defines "minimum voting interests" as the lowest voting interest that a person has in the company for the relevant period.

32. Thus, similar to other continuity provisions, whether a company can carry forward excess tax credits is decided by reference to s YC 2.

Who holds shares?

Section YC 2

33. Section YC 2 provides:

> *Percentage of shareholder decision-making rights*
>
> (1) A person's voting interest in a company equals the percentage of the total shareholder decision-making rights for the company **carried by shares** or options **held by the person**.
>
> *When decision-making rights vary*
>
> (2) Despite subsection (1), if the percentage of **shareholder decision-making rights for a company carried by shares** or options **held by any person** differs as between the types of decision-making listed in the definition of shareholder decision-making right, the person's voting interest in the company equals the average of those differing percentages.
>
> [Emphasis added]

34. On an ordinary reading, s YC 2 is referring to two concepts:
    - shareholder decision-making rights for the company carried by shares;
    - "shares … held" by the person.

35. That is, the section is concerned with shareholder decision-making rights held by a person via the means of that person holding shares. This interpretation is supported by the word "held" appearing immediately after the phrase "shares or options". This suggests the verb "held" relates to the holding of shares or options and not to the holding of shareholder decision-making rights.

36. Accordingly, the person's voting interest in a company is calculated firstly, by determining the total number of shares the person "holds", and secondly, by determining the "shareholder decision-making rights" carried by those shares. Consideration of this latter point is not included in this Interpretation Statement.

37. In relation to what determines the meaning of "shares … held" as used in s YC 2 and, as a result, what determines who holds shares, the following matters are considered important:
    - the meaning of "shares";
    - the ordinary meaning of "shares … held";

- the courts' view on the meaning of "shares … held";
- the context of s YC 2.

Ordinary meaning of "shares"

38. The Companies Act 1993 (CA 1993) provides that every company must have one or more shares, and that, after registration, shares must be issued to the people named in the company's application for registration. Thereafter, the board of a registered company may issue further shares subject to the CA 1993 and the constitution of the company. Under s 51 of the CA 1993 a share is issued by a registered company when the name of the holder is entered on the share register of the company.

39. For tax purposes, the term "share" is broadly defined in s YA 1. It includes, in para (a) of the definition, "any interest in the capital of a company".

40. The expression "interest in" can be given a wide meaning. *Black's Law Dictionary* (9th ed, West, St Paul, 2009) defines "interest" as:

> **2.** A legal share in something; all or part of a legal or equitable claim to or right in property.

41. The English Court of Appeal in *IRC v R Woolf (Rubber) Ltd* [1962] 1 Ch 35 considered the meaning of s 255(2) of the Income Tax Act 1952 (UK). This section defined a "member" in relation to a company as including "any person having a share or interest in the capital or profits or income of the company". Donovan LJ stated at 45–46:

> It is in this context, and against this background, that the word "interest" must, in my view, be construed; and, so construed, I think it connotes an interest which gives the possessor a right or expectation to share in a company's profits even though they might come to him via liquidation.

42. And at 46, Upjohn LJ stated:

> The share or interest of a member in the capital of a company has no precise legal signification. In the context it may refer to the share or interest of the member in the issued share capital, or it may refer to his ultimate right to receive a dividend in liquidation after all creditors have been discharged …

43. The meaning of capital and share capital in particular is discussed in *NZ Company Law and Practice Commentary* (online ed, CCH, accessed 12 June 2012, at [15-005]):

> The term capital loosely describes the funds to which a company has access for the purpose of its business and development.
>
> …
>
> *Share capital* represents the funds of the company contributed by the issue of shares to shareholders.
>
> The concept of share capital is of much less significance under the [Companies Act 1993] than formerly: see ¶15-125. In fact, the term capital appears only once in the Act, in s 37(2)(b). The provisions of the *Companies Act* 1955 relating to share capital were based upon the existence of an identifiable capital fund (albeit represented by assets) which was required to be maintained intact for the benefit of creditors and, to a lesser extent, shareholders. …
>
> The terms *authorised*, *issued* and *nominal* share capital are now obsolete. The term share capital is now a misnomer if it implies the existence of a capital fund. **The share structure of the company under the Companies Act 1993 is significant for the rights of the shareholders against the company and between themselves**; it has no significance for the protection of creditors.
>
> A share has been described as a fractional part of the capital: *Bradbury v English Sewing Cotton Co Ltd* [1923] AC 744 at p 767. This concept was easily understood in the case of a company having an issued share capital, say, of $100,000 comprising 100,000 shares of a nominal value of $1 each. But, as noted above, the legal concept of *capital* has all but disappeared under the 1993 Act. **A share now represents not so much a fraction of the capital, but an entitlement to benefits, such as dividends and voting rights.**
>
> [Emphasis added]

44. The House of Lords discussed the nature of a share in *IRC v Laird Group plc* [2003] BTC 385. The issue was whether a payment of a dividend was "a transaction relating to" shares. Lord Millett said at [35]:

> The juridical nature of a share is not easy to describe. It is not a share in the company's undertaking, for the company owns its property beneficially and not in trust for its members: "shareholders are not, in the eye of the law, part owners of the undertaking" (see *Short v Treasury Commissioners* [1948] 1 KB 116 at p122 (CA)). It is classified as a chose in action, but this merely tells us that it is a species of intangible personal property. **It is customary to describe it as "a bundle of rights and liabilities", and this is probably the nearest that one can get to its character**, provided that it is appreciated that it is more than a bundle of contractual rights. The most widely quoted definition of a share is that of *Farwell J* in *Borland's Trustee v Steel* [1901] 1 Ch 279 at p288 which was approved by your Lordships' House in *IR Commrs v Crossman* [1937] AC 26. It was usefully and in my respectful opinion accurately summarised by Lord Russell of Killowen in his speech (dissenting on the facts) in that case, at p66:
>
> "It is the interest of a person in the company, that interest being composed of rights and obligations which are defined by the Companies Act and by

> the memorandum and articles of association of the company."
>
> These rights, however, are not purely personal rights. They confer proprietary rights in the company though not in its property. The company is at one and the same time a juridical person with rights and duties of its own, and a res owned by its shareholders: see *Gower's Principles of Modern Company Law* (6th ed, 1997 p301).
>
> [Emphasis added]

45. The standard bundle of rights that attaches to a share is set by s 89(2) of the CA 1993. Section 89(2) provides that:

> (2) A company may treat the registered holder of a share as the only person entitled to—
>
> (a) Exercise the right to vote attaching to the share; and
>
> (b) Receive notices; and
>
> (c) Receive a distribution in respect of the share; and
>
> (d) Exercise the other rights and powers attaching to the share.

46. Section 89(2) of the CA 1993 is clear that the registered holder of shares issued by a company in terms of s 51 of the CA 1993 would be entitled to, among other things, vote and receive distributions in relation to those shares. These shares would give the holder an interest in the capital or profits or income of the company. Therefore, they would constitute an "interest in the capital" of the company. Accordingly, a share issued under s 51 of the CA 1993 would be a "share" as defined in the Income Tax Act 2007.

Ordinary meaning of "shares … held"

47. The Act does not define "held", "hold" or "shares held". However, s YA 1 defines "shareholder" as:

> (a) includes—
>
> (i) a **holder** of a share; and
>
> (ii) a member of a company, whether the company's capital is divided into shares or not …
>
> [Emphasis added]

48. Therefore, the reference in s YC 2 to shares "held" would cover those instances where, in terms of the definition of "shareholder", someone "holds" those shares. However, this does not clarify what decides **who** it is that holds the shares.

49. The *Shorter Oxford English Dictionary* (6th ed, Oxford University Press, New York, 2007) describes "held" as the past tense and past participle of hold. "Hold" is defined as:

> **5** Have or keep as one's own: possess, be the owner …

50. In this context, "held" seems to be about ownership. This definition suggests that determining who shares are "held" by requires a decision about who is the legal owner of the shares.

51. Section 89(1) of the CA 1993 states:

> (1) Subject to section 91 of this Act, the entry of the name of a person in the share register as holder of a share is prima facie evidence that **legal title to the share vests in that person**.
>
> [Emphasis added]

52. Similarly, s 84 of the CA 1993 states:

> (1) Subject to the constitution of the company, shares in a company may be transferred by entry of the name of the transferee on the share register …

53. Furthermore, s 96(a) of the CA 1993 defines "shareholder" as:

> (a) a person whose name is entered in the share register as the holder for the time being of 1 or more shares in the company …

Therefore, the legal title or ownership of shares issued by a company in terms of s 51 of the CA 1993 would be determined by who is the registered holder of those shares. The ordinary dictionary definition of "hold" suggests that the legal owner of shares would "hold" those shares. Therefore, the dictionary definition of "hold" provides some support for the view that the reference to "shares … held" in s YC 2 should be read as referring to the registered holder of those shares.

54. However, this interpretation of "shares … held" needs to be consistent with the interpretation the courts have adopted.

Courts' view of meaning of "shares … held"

55. Several cases have looked at the meaning of "held" or "hold" in relation to shares issued by a company. A leading case in this area is the High Court of Australia case *Dalgety Downs Pastoral Company Pty Ltd v FCT* (1952) 86 CLR 335.

56. The court in *Dalgety* looked at s 80(5) of the Australian legislation that governed the carrying forward of company losses. The section required that shares carrying at least 25% of the voting power in the company be "beneficially held" by the same persons during the relevant period. The issue was whether continuity of shareholding had been maintained when a shareholder transferred his shares as security for a loan. The court concluded the shares were held by the person whose name appeared in the company's share register. The court stated at 341–342:

> we are of opinion that the construction of s 80(5) upon which the deputy commissioner acted is correct. Dixon J so held in *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353, basing his conclusion upon the view that **in the terminology of company law shares are said to be "held" by the person who is registered as a shareholder** in respect thereof, and that s 80(5), being concerned with voting power, should be treated as using that terminology. We share this view. Indeed **it is not too much to say that the verb "hold" and its variants, when used in relation to shares in companies, normally refers to the legal ownership of the shares according to the register of members**. The Companies Acts of the United Kingdom and of several States of the Commonwealth have uniformly used the word in this sense, and common usage has followed their example. **Before a different meaning is accepted, some justification must be found in the context, or the subject-matter**. No such justification is provided by the fact that "held" is modified by the adverb "beneficially". This word serves more naturally the purpose of excluding the case of a holding for the benefit of others than the purpose of so broadening the meaning of the word "held" beyond the particular significance which it normally has in relation to shares as to make it equivalent to "owned" in the most general sense of that word.
>
> [Emphasis added]

57. Therefore, the court in *Dalgety* held that the verb "hold" and its variants (eg, "held"), when used in relation to shares in a company, normally refer to the legal ownership of the company's shares. Shares that have been issued by a company are, as noted above, legally owned by the person who is listed on the company's share register as being the legal holder of those shares. Therefore, this suggests that shares issued by a company are "held" in terms of s YC 2 by the registered shareholder.

58. Similarly, in *Patrick Corporation Ltd v FCT* (1974) 74 ATC 4,149 at 4,164 Mason J held:

> For the appellants it was submitted that the word "shareholder" should be read as signifying not only a person who is entitled as against the company to be entered as a member in the register but also a purchaser of shares who is beneficially entitled to them as against the person registered as the holder of them. Reliance was placed upon the principle that a contract for the sale of shares in a company whose shares are not available for sale on the market is capable of specific performance and that the vendor of such shares holds them as trustee for the purchaser on completion of the contract. To my mind, this argument does not assist in resolving the problem, which is essentially a question of elucidating the meaning of the word in the light of the extended definition contained in sec. 6(1). It is not enough that the word includes a member. **A person who is a beneficial holder of shares in a company (save, perhaps, a subscriber to the memorandum) but who is not, and has not, been entered in the register as the holder of those shares cannot accurately be described as a "shareholder" or a "member" of the company within the meaning of the Act** (see *Norman v. F. C. of T.* (1963), 109 C.L.R. 9, at p. 16).
>
> [Emphasis added]

59. *Patrick* was appealed to the High Court of Australia as *Patcorp Investments Ltd v FCT* (1976) 76 ATC 4,225, where the majority dismissed the appeal. However, the whole court agreed on the issue of whether Patcorp was a "shareholder". After considering various decisions on the meaning of "shareholder", Gibbs J stated at 4,234:

> that entry on the register is necessary to constitute membership of a company, and clearly establish that **beneficial ownership of shares, without registration, does not make a person a shareholder**.
>
> [Emphasis added]

60. A similar approach was taken by the court in *Spencer v Kennedy* [1926] Ch 125. The court in *Spencer* considered whether someone who was absolutely entitled to be registered as a shareholder of a company, but who had not yet been entered onto the share register, could be said to "hold a share" in the company. The court held at 132:

> Now under Table A, art 70, the qualification of a director is "the holding of at least one share". But, **a man does not "hold a share" until he is registered**.
>
> [Emphasis added]

61. The court in *Spencer* considered whether the claimant could be said to "hold a share" in the company. The court held that no one "holds a share" in a company until their name has been entered onto the company's share register as the registered holder of that share. See also the English Court of Appeal decision in *Bainbridge v Smith* (1889) LR 41 Ch D 462 at 470 where the same conclusion is reached.

62. This interpretation of the circumstances when shares will be "held" has also been adopted in a New Zealand context. *BHL v CIR* (2011) 25 NZTC 20-088 concerned whether the taxpayer company (BHL) could offset its profits against the losses of another company. Who "held" the shares in each company and, in particular, whether one individual (Mrs B) "held" certain shares in BHL, was relevant to determining this issue. The High Court concluded that Mrs B did not "hold" the

shares in question at the relevant time because her name was not entered in the share register of BHL as the shareholder of those shares. Courtney J stated at [14]–[16]:

> However, none of these provisions [of the Income Tax Act 2004] assist in deciding what constitute shares "held by the person". **Mr Dempster, for the Commissioner, argued that, although "held" is not defined in any of the ITAs [Income Tax Acts], the concept of "holding" a share is well known in company law to mean having one's name entered in the share register as a shareholder**. Section 96 of the Companies Act 1993 defines a shareholder as:
>
> > … a person whose name is entered in the register as the holder for the time being of 1 or more shares in the company.
>
> **There is very strong support for this argument** in *Avon Downs Pty Ltd v Federal Commissioner of Taxation* and *Dalgety Downs Pastoral Pty Ltd v Federal Commissioner of Taxation*. Both concerned the deduction of losses for tax purposes under the relevant Australian legislation. In *Dalgety Downs* the High Court of Australia held that shares "beneficially held" for the purposes of determining who held the voting power in a company at the relevant time (in the context of income in one year against losses from prior years) required that the name of the shareholder be entered in the register of members:
>
> …
>
> **I accept that, for the purposes of the group company offset provisions of the ITA, Mrs B had to be recorded in the share register of the company as being a shareholder at least to the extent of 50% of the company's shares**. It is common ground that she was not and that alone should be sufficient to determine the issues raised by BHL.
>
> [Emphasis added]

63. Another New Zealand case is the Taxation Review Authority (TRA) decision *Case D27* (1980) 4 NZTC 60,621. That case concerned the carrying forward of losses by the company. The bulk of the shares in the company had been transferred by the original shareholders (the M Family) to another party (WF) with a nominal single share held by the company's secretary (TP). This transfer occurred before the losses at issue were incurred. The purchase money for the shares had been advanced under debenture by the former shareholders. WF eventually defaulted on the debenture. Arising from this default, WF transferred his shares back to the original shareholders. The company argued that the re-transfer of the shares back to the original shareholders plus the stringent conditions attached to the debentures gave practical control of the company and a practical continuation of the shareholding rights of the original shareholders throughout the relevant period. The TRA looked at the meaning of the words "held" and "on behalf of" in relation to shares. At 60,628 the TRA cited *Dalgety* and *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353, before concluding that there had been a change in who "held" the shares concerned:

> From the evidence it is clear that WF was shown as the holder of 1,999 shares, TP holding the remaining one share in the Objector. There was no evidence that WF held his share in trust for any member of the M family in any way. Had there not been losses incurred which it was desired to write off, there would have been no argument that WF held such shares by and on behalf of himself only.

64. Therefore, the TRA, like the High Court in *BHL*, concluded that shares will be "held" by the person who is entered onto the share register as being the holder of those shares (ie, the legal holder of the shares). See also *Case N26* (1991) 13 NZTC 3,219 at 3,228.

65. These cases are clear that beneficial or equitable ownership of shares without registration does not make a person a "holder" of a share that has been issued by a company. A person does not "hold" shares that have been issued by a company until their name is entered onto the company's share register as being the holder of those shares. When the name of the person is inserted onto the share register that person obtains the legal title to the shares. This legal title makes that person the "holder" of the shares. This is consistent with the dictionary definition of "hold" and the CA 1993. Therefore, this suggests that shares issued by a company will be "held" in terms of s YC 2 by the registered holder of those shares. This is subject to consideration of whether the context of s YC 2 requires some other conclusion.

Context of section YC 2

66. The court in *Dalgety* considered that if some justification could be found in the relevant context, a reference to "shares … held" in an enactment might not refer to the legal ownership of shares (see the quotation from that case in paragraph 56).

67. It is necessary then to consider whether the relevant context provides any assistance in clarifying what the reference to "shares … held" in s YC 2 means. This involves considering the legislative scheme and intent underpinning s YC 2.

Legislative intent of section YC 2

68. To consider the legislative intention underpinning s YC 2 it is useful to outline the history of the section.

69. Section YC 2 can be traced back to s 188 of the Income Tax Act 1976 (the 1976 Act). Section 188 dealt with the ability of a company to carry forward accumulated losses. This depended on whether there was sufficient continuity of who shares in the company were "held" by.

70. The Income Tax Amendment Act (No 2) 1992 introduced ss 8A to 8F to the 1976 Act. This amendment Act introduced new ownership tests of "voting interest" and "market value interest" to provide a measure of a person's interest in a company. These interest tests were relevant in several regimes such as the continuity provisions, tax recovery provisions and qualifying company regime.

71. Section 8C of the 1976 Act provided the "voting interest" measure of a person's interest in a company. This measure changed the legislative focus from who shares were "held" by to a broader consideration of whether there was sufficient continuity of who had a "voting interest" in the company over a continuity period.

72. Section 8C of the 1976 Act was essentially replicated in s OD 3 of the Income Tax Act 1994 and s OD 3 of the Income Tax Act 2004. It is now set out in s YC 2 of the Income Tax Act 2007. Section 8C referred to "shareholder decision-making rights". "Shareholder decision-making rights" were defined in s 8B of the 1976 Act. Section 8B was replicated in the definitions in s OB 1 of the Income Tax Act 1994 and s OB 1of the Income Tax Act 2004 and now appears in the definitions in s YA 1 of the Income Tax Act 2007.

73. The policy intent underpinning (the equivalent of) s YC 2 is summarised in "Measurement of Voting and Market Value Interests" *Tax Information Bulletin* Vol 3, No 7 (April 1992): 18:

> Under the new provisions, shareholders' economic interests in a company will generally be measured by reference to their voting interests held in that company, both directly and indirectly through interposed companies.

74. The quotation above shows the intention for the "voting interest" test was to base the measurement of a shareholder's economic interest in a company on that shareholder's voting interests in the company. This "voting interest" was determined by the shareholder decision-making rights carried by shares "held" by a person.

75. Therefore, s YC 2 is intended to measure the economic interest a person has in a company based on that person's voting interests in the company. In turn, these voting interests in the company relate to the right of the person to vote on decisions affecting dividends, the constitution of the company, capital variations and the appointment of directors.

76. As noted at paragraphs 45 and 51, s 89 of the CA 1993 provides that a registered holder of a share has the ability to vote and share in the company's capital, income and profits. It is the share in the company that carries these rights. This means that a registered holder of a share will have an economic interest (reflected by these rights) in the company. Section YC 2 was intended to capture such economic interests. Therefore, the view that shares issued by a company will be "held" in terms of s YC 2 by the registered holder is arguably consistent with the legislative intention. Next, any other legislative context that clarifies this point is considered.

Legislative scheme re the meaning of "shares … held"

77. Several sections (namely, ss DC 13, DC 15, GB 5, HA 7 and YC 9) state that a trustee, rather than a beneficiary, "holds" shares. Similarly, as detailed in paragraph 86, s YB 21 assumes that trustees (including bare trustees) can "hold" things (including, for instance, shares). No section in the Act states that a beneficiary holds shares for tax purposes.

78. A trustee has the legal interest in trust property (including any shares that are trust property). Therefore, the holder of the shares, in terms of these sections, will be the legal, rather than the equitable or beneficial, owner of the share (ie, the trustee).

79. This suggests that Parliament intended that shares would generally be "held" by the legal owner of those shares. This owner would be the registered holder. This result makes sense; otherwise a trustee and a beneficiary could "hold" the same share at the same time. This would raise the issue of whether the legal holder or equitable holder would be assessable for tax on dividend income arising from the shares. It is reasonable to believe that Parliament would not have intended these compliance costs. There would also be the possibility that both holders would be assessable for dividend income, raising double taxation issues. This provides further support for the view that the reference to "shares … held" in s YC 2 should generally be read as referring to the registered holder.

80. Section YC 13(7) is also relevant. Section YC 13(7) relates to the over-riding of the look-through rules in the context of corporate spin-outs. The issue of corporate spin-outs is beyond the scope of this Interpretation Statement. However, s YC 13(7) provides useful contextual guidance about the intended scope of s YB 21. Section YC 13(7) states:

> For the purposes of measuring common interests, neither section YB 21 (Transparency of nominees) nor YC 4 apply to treat a nominee's or company's voting interest or market value interest in the original parent or the spun-out company to be held by another person, if the interest the other person would be treated as holding would be less than 10%.

81. Section YC 13(7) is based on the assumption that, but for s YB 21, a "nominee" shareholder would be a shareholder who has a "voting interest" in a company. As is explained in paragraphs 114 to 118, a nominee shareholder has the legal interest in a share. Therefore, s YC 13(7) provides further support for the view that the reference to shares "held" in s YC 2 should (subject to, for instance, s YB 21 applying) generally be read as covering the person who has the legal interest in the share.

82. Therefore, despite the comments of the court in *Dalgety* noted in paragraph 56, the relevant context of the scheme and intent of the legislation in relation to s YC 2 does not support departing from the view that legal ownership of shares is what determines who holds shares.

Conclusion about who holds shares

83. The Commissioner considers that, as a rule, shares issued by a registered company in accordance with s 51 of the CA 1993 will be "held" in terms of s YC 2 by the registered holder of those shares. The registered holder of shares is the person whose name has been entered onto the share register of the company as the holder of those shares. This is consistent with the plain and ordinary meaning of "shares … held", the approach that the courts have adopted in relation to this issue, and the relevant context of the Act.

84. However, there are exceptions to this rule. One exception applies if a "nominee" holds the shares in terms of s YB 21. Other exceptions are set out in ss YC 8 to YC 19 and FB 10.

85. These exceptions are looked at next.

What are the exceptions to the rule of who "holds" shares?

Nominees and section YB 21

86. Section YB 21 provides that:

> (1) In this Act, unless the context otherwise requires, **if a person holds something** or does something **as a nominee for another person, the other person holds** or does **that thing and the nominee is ignored**.
>
> (2) **A person holds** or does **something as a nominee for another person if the person acts on the other person's behalf. However, a trustee is a nominee only if the trustee is a bare trustee.**
>
> (3) A person making a nominal settlement at the request of another person is treated for the purposes of this Act as a nominee in relation to the settlement.
>
> [Emphasis added]

87. Section YB 21 has general application and operates as an exception to various provisions of the Act. Section YB 21(2) provides that a person is a nominee of another person, if the person "acts on the other person's behalf". Where s YB 21 applies, the result is that if someone acts as a nominee for another person, that other person is deemed to hold or do something and the nominee is ignored. This helps to determine where the real economic control resides. In this sense, s YB 21 has a similar legislative intent as s YC 2.

88. Accordingly, s YB 21 is relevant to the application of s YC 2 because s YB 21 can deem that a registered holder acts, and so holds their shares as nominee, on behalf of someone else. If so, that other person will be deemed to "hold" the shares in terms of s YC 2.

89. Section YB 21(2) refers to a person (the "nominee") who "acts on the other person's behalf", including where the nominee is a "bare trustee" for the other person. The meaning of these terms is looked at next. Following that, the application of s YB 21 in the context of shares is considered.

When the person "acts on the other person's behalf"

90. The Act does not define the meaning of "act" or "acts" for the purposes of s YB 21. Therefore, the reference to "acts" is to be read as having its ordinary meaning.

91. The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) defines "act" as:

> **act** • v. **1** take action; do something … **2** (act for/on behalf of) representing on a contractual or legal basis.

92. The Commissioner considers that a person will "act" in terms of s YB 21, if they take action or do something on that other person's behalf, including representing the other person on a legal basis. Although the holding of shares may appear to be passive and not requiring the holder to take action or do something, it does require the person to act as the legal holder of shares such as exercising voting rights as directed by the other person.

93. The Act also does not define "on the other person's behalf". Therefore, this phrase is also to be read as having its ordinary meaning. The courts have considered the ordinary meaning of "on behalf of" many times. This is a slightly different phrase from

that set out in s YB 21(2). However, given the similarity between the phrase "on the other person's behalf" and the phrase "on behalf of", cases considering the latter are relevant.

94. Latham CJ discussed the general view of the phrase "on behalf of" in the Australian case *R v Portus, ex p Federated Clerk's Union of Australia* (1949) 79 CLR 428. Latham CJ stated at 435,:

> The phrase **on behalf of is not an expression which has a strict legal meaning**, it bears no single and constant significance. Instead it may be used in conjunction with a wide range of relationships, **all however in some way [are] concerned with the standing of one person as auxiliary to or representative of another person or thing**.
>
> [Emphasis added]

95. As noted in *Portus* above, "on behalf of" can apply to a wide variety of relationships. For instance, in *Lewis v Nicholson* (1852) 18 QB 503 the court considered that an agreement entered into by one party "on behalf of" another party meant the relationship between the parties was one of agent and principal.

96. In *Case D27*, the TRA, in relation to the expression "on behalf of", stated at 60,628:

> In *Words and Phrases Legally Defined*, vol. 4, cases are cited under the words "ON BEHALF OF". Lord Hatherley in *Gillespie v City of Glasgow Bank* (1879) 4 App. Cas. 632 at p. 642 said:
>
> > **I cannot perceive a difference between the words "for behoof of" and "in trust for"**. I hold the expression "for behoof of" to mean exactly the same as if the words used had been "on behalf of" or "for the benefit of", **or any of those other words, of which many might be suggested**, which indicate that although to the bank you are the absolute owner of the shares, yet as regards a third person, with whom you have entered into an arrangement you are not that owner.
>
> [Emphasis added]

97. This passage indicates that "on behalf of" and similar terms mean "in trust for" another person. The TRA does not analyse the term further. It is apparent, however, from the TRA's direct application of the law to the facts that to prove that one person was holding shares on behalf of another evidence of a trust or another similar arrangement or agreement is required.

98. Although the concept of a "nominee" is discussed later in this Interpretation Statement (at paragraphs 114 to 118), the term is used sometimes to signify an agent or a trustee in the sense of someone acting for another in representation of another. For instance, in *Schuh Trading Co v Comm'r* 95 F 2d 404 (7th Cir 1938) a case concerning the transfer of company assets to a nominee, the judge said at 411:

> The word nominee ordinarily indicates **one designated to act for another** as his [or her] representative in a rather limited sense. **It is used sometimes to signify an agent or trustee. It has no connotation, however, other than that of acting for another,** in representation of another, or as the grantee of another.
>
> [Emphasis added]

99. Similarly, in *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis, Wellington, 2005), the term "nominee" is defined to mean an agent acting on behalf of a principal:

> **nominee** An agent **acting on behalf** of a principal, often employed in the buying and selling of securities.
>
> [Emphasis added]

100. This extract means, consistent with the court's approach in *Schuh*, "on behalf of" covers a nominee or an agent who is acting on behalf of a principal.

101. It can be concluded that the expression "on behalf of":

- is not an expression that has a strict legal meaning; instead, it takes its meaning from the context in which it is used (*Portus*);
- it may be used in conjunction with a wide variety of relationships (*Portus*);
- is concerned with the standing of one person as auxiliary to or representative of another person or thing (*Portus*);
- may be satisfied by a trust, a nominee or an agency arrangement with another person (*Case D27, Lewis, Schuh* and *Butterworths New Zealand Law Dictionary*).

102. Therefore, the reference to "on the other person's behalf" in s YB 21(2) covers those instances where something is held or done (the acting) "on trust" for someone else. The inclusion of acting "on trust" is supported by what is effectively a proviso in s YB 21(2) that excludes all but "bare trustees" from being nominees under the section.

103. Of all the relationships that may be encompassed by the phrase "acts on the other person's behalf", of most relevance in the present context is that of a "bare trustee". This relationship is considered next.

When a person acts as "bare trustee"

104. The Act does not define "bare trustee". Therefore, this phrase is to be read as having its ordinary meaning. The meaning of "bare trustee" has been stated in *Halsbury's Laws of England* (Trusts, vol 48 (2007 Reissue) at [755]) as:

> A bare trustee has been defined as a person who holds property in trust for the absolute benefit and at the absolute disposal of other persons who are of full age and sui juris in respect of it, and who has himself no present beneficial interest in it and no duties to perform in respect of it except to convey or transfer it to persons entitled to hold it, and he is bound to convey or transfer the property accordingly when required to do so.

105. *Lewin on Trusts* (16th ed, Sweet and Maxwell, London, 1964) provides a useful definition of a "bare trust", as compared with a "special trust". It also refers to a "bare trustee" in the context of someone who holds shares in a company. *Lewin on Trusts* states at 6:

> The simple or bare trust is where property is vested in one person upon trust for another, and the nature of the trust, not being prescribed by the settlor, is left to the construction of law. In this case the beneficiary has...the right to be put into actual possession of the property, and … the right to call upon the trustee to execute conveyances of the legal estate as the beneficiary directs.
>
> **A bare or simple trustee, especially of shares in a limited company, is often called a nominee.**[2] He is a mere name or "dummy" for the true owner …
>
> The special trust is where the machinery of a trustee is introduced for the execution of the purpose particularly pointed out, and the trustee is not, as before, a mere passive depositary of the estate, but is called upon to exert himself actively in the execution of the settlor's intention, as in the ordinary case of a trustee holding property on the express trusts of a settlement or of a will, or where a conveyance is made to trustees upon trust to sell for payment of debts.
>
> [Emphasis added]

106. In *Herdegen v FCT* (1988) 20 ATR 24, the frequently cited decision on the meaning of a bare trust, Gummow J said at 32–33:

> Today the usually **accepted meaning of "bare" trust is a trust under which the trustee or trustees hold property without any interest therein, other than that existing by reason of the office and the legal title as trustee**, and without any duty or further duty to perform, except to convey it upon demand to the beneficiary or beneficiaries or as directed by them, for example on sale to a third party. The term is usually used in relation to trusts created by express declaration. But it has been said that the assignor under an Agreement for Value for Assignment of so-called "future" property becomes, on acquisition of the title to the property, trustee of that property for the assignee.
>
> [Emphasis added]

107. A later edition of *Lewin on Trusts* (18th ed, Sweet and Maxwell, London, 2008) provides at 15:

> A distinction has traditionally been drawn between "bare" trusts, or "simple" or "naked" trusts, and "special" trusts. According to that distinction, **a bare trustee holds property in trust for a single beneficiary absolutely and indefeasibly, and is a mere passive repository for the beneficial owner, having no duties other than a duty to transfer the property to the beneficial owner or as he directs**. By contrast a trustee holding property on special trusts has active duties to perform, for example in executing the trusts of a will or settlement, with administrative (and perhaps, also dispositive) powers accompanying his active duties. It is still possible to distinguish between an absolute trust for a single beneficiary, which might still be called a bare or simple trust, and other types of trust.
>
> [Emphasis added]

108. These descriptions of a "bare trustee" refer to the trustee's duty to transfer the property held to the beneficial owner on demand. *Halsbury's Laws of England* adds further that the beneficial owner or person for whose benefit the trust was created needs to be "of full age and *sui juris*" in respect of the property. *Sui juris* is a legal phrase used to describe people who are under no disability affecting their legal capacity to deal with their property, to bind themselves by contracts, and to sue and be sued. People who do not have full legal capacity, so are not *sui juris*, can include minors and people who are mentally incapable.

109. A "bare trustee" is often referred to as being a "nominee" in the context of shares. This seems to be consistent with the definition of "nominee" in s YB 21 specifically including bare trustees.

110. Furthermore, before a bare trust can be found to exist, there must be a valid trust. This is because a bare trust is a type of trust. The trust must possess the "three certainties":
- certainty of intention (ie, evidence of an intention to create a trust);
- certainty of subject matter (ie, the property that is subject to the trust relationship must be clearly identifiable); and
- certainty of objects (ie, ascertainable beneficiaries who have the power to enforce the trust: see *Knight v Knight* (1840) 3 Beav 148).

111. These elements have been firmly accepted in New Zealand law. See, for example, the Court of Appeal's judgments in *Royal Forest and Bird Protection*

[2] Subsequent editions of this publication omit the reference to nominee.

Society of NZ Inc v Nelson City Council [1984] 2 NZLR 480 at 486 and *Foreman v Hazard* [1984] 1 NZLR 586 at 594.

112. Three principles can be distilled from these authorities:

- A "bare trustee" is a person who holds property on trust for the absolute benefit and at the absolute disposal of other persons, and has no beneficial interest in the property.
- A "bare trustee" does not have any duties to perform in regard to the property, except to convey or transfer it to a person entitled to hold it when required to do so.
- For a bare trust relationship to exist, the three certainties of a trust must be satisfied.

113. Furthermore, the courts have also deemed a bare trust relationship (in relation to property) to exist in certain other circumstances: see *Musselwhite v CH Musselwhite & Son Ltd* [1962] Ch 964. The court in *Musselwhite* noted that a vendor of a share under an agreement is deemed to hold that share on bare trust for the purchaser at the point of settlement and before the purchaser's name has been entered onto the company's share register. This case is discussed from paragraph 133 in relation to when a change in "shares … held" occurs.

When a person acts as "nominee"

114. Finally, s YB 21 uses the term "nominee". The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) defines "nominee" as:

> **2** a person or company, not the owner, in whose name a company, stock, etc. is registered.

115. As noted at paragraph 99, in *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis, Wellington, 2005), the term "nominee" is defined to mean an agent acting on behalf of a principal:

> **nominee** An agent acting on behalf of a principal, often employed in the buying and selling of securities.

116. Furthermore, as noted at paragraph 105, in *Lewin on Trusts* (16th ed, Sweet and Maxwell, London, 1964) a bare or simple trustee, especially of shares in a limited company, is often called a nominee.

117. Therefore, a nominee would include a person who, for instance, is employed in the buying and selling of shares as agent for a principal. This means the meanings of "nominee" and "agent" overlap.

118. A nominee would also include a person who is, for instance, the registered holder of shares, albeit that someone else beneficially "owns" the shares. As noted above, the same test applies to determine whether shares are held on "bare trust". This means there is also an overlap between the meanings of "nominee" and "bare trustee", particularly in the context of shares.

Application of section YB 21

119. Having considered the terms used in s YB 21, it is necessary to consider how the section might apply in the context of shares. The circumstances when a registered holder will hold shares as bare trustee or nominee for someone else depends on whether the:

- shares are held by the registered holder for that other person on a bare trust that satisfies the three certainties of a trust or on a bare trust that is deemed to exist by operation of the law (see the discussion from paragraph 131); or
- registered holder merely holds the shares as nominee for someone else (who holds all of the beneficial interest in the shares).

120. Section YB 21(1) deems that, in such instances, the thing will be "held" by that other person and not by the bare trustee or nominee. This is directly relevant to the main interpretive issue of who shares are "held" by in a company in terms of s YC 2. This is because if the registered holder of a share holds a share as bare trustee or nominee for someone else, this means that they "act" for that other person in terms of s YB 21(2). Therefore, unless varied by any other provision in the Act, that share will be deemed by s YB 21(1) to be held by that other person and not to be held by the registered holder in terms of s YC 2.

121. This view is also consistent with the conclusion reached in the Question We've Been Asked "QB 10/06: Elections for Qualifying Company Status" *Tax Information Bulletin* Vol 23, No 1 (February 2011). QB 10/06 states at 114:

> **A nominee shareholder**
>
> Where a person uses a nominee to hold shares in a company, the nominee is the shareholder on the company's share register. However, the nominee holds the shares for the other person (the beneficial owner of the shares).

122. Accordingly, s YB 21 operates as an exception to the rule that shares issued by a company are "held" by the registered holder in terms of s YC 2.

123. As mentioned in paragraph 84, in addition to s YB 21 there are other exceptions to the rule that shares are "held" in terms of s YC 2 by the registered holder of those shares. These other exceptions are in ss YC 8 to YC 19 and FB 10.

Sections YC 8 to YC 19 and FB 10

124. Sections YC 8 to YC 19 and FB 10 deal with:
    - the death of the share or option holder (s YC 8);
    - shares or options held by trustees (s YC 9);
    - shareholders holding less than 10% direct interests (s YC 10);
    - the no look-through rule for companies in certain cases (s YC 11);
    - public unit trusts (s YC 12);
    - corporate spin-outs (s YC 13);
    - disregarding concessionary rules (s YC 14);
    - directors' knowledge of failure to meet requirements of continuity provision (s YC 15);
    - disregarding market value changes (s YC 16);
    - the demutualisation of insurers (s YC 17);
    - reverse takeovers (s YC 18);
    - corporate reorganisations not affecting economic ownership (s YC 18B);
    - the legislative conversion of foreign company of proprietors (s YC 19); and
    - continuity provisions: shares and options (s FB 10; settlements of relationship property).

125. It is beyond the scope of this Interpretation Statement to discuss these provisions in any depth but they generally apply when certain events occur (eg, the death of a shareholder).

126. These sections (in particular, ss YC 9 to YC 11) will sometimes be relevant to agreements for the sale and purchase of shares. For instance, if the purchaser is a trustee (s YC 9), holds direct interests of less than 10% in the target company (s YC 10) or is a company (s YC 11), these provisions could deem the shares to be "held" by someone other than the registered holder.

127. Accordingly, these provisions can operate as exceptions to the rule that shares will be "held" by the registered holder. Therefore, they must always be considered when the continuity provisions are applied.

When will there be a change in who holds shares?

128. Considered next is at what point in terms of s YC 2 there is a change in who shares are "held" by (ie, during a sale or transfer of shares).

129. It is helpful to first outline the stages of the share transfer process under which a purchaser becomes a registered holder of a company in terms of the CA 1993. The main stages in this process are listed below. These stages are not necessarily in sequential order. The precise order will always be a question of fact:
    - An agreement for the sale and purchase of the shares is entered into. This agreement could be an oral agreement or in writing.
    - A share transfer form, share certificate (if applicable) and other relevant documentation (if applicable) is completed and delivered to the company pursuant to the share transfer process set out in the Securities Transfer Act 1991.
    - The purchaser pays for the shares (settlement).
    - The company decides, in accordance with its constitution and any relevant provision of the CA 1993, whether to accept the transfer of the shares.
    - If the company decides to accept the transfer, the purchaser is entitled to have their name entered into the company's share register as being the holder of the shares.
    - The company enters the purchaser's name onto the company's share register in accordance with s 89 of the CA 1993.

130. However, the circumstances of a transfer of shares under the CA 1993 are not always the same as when there is a change in who "holds" shares in terms of s YC 2. This is because, as mentioned in paragraph 84, the Act includes exceptions so that it does not always treat the registered holder of the shares as the holder of the shares. At least one of those occasions (the look-though of nominees under s YB 21) can occur during a transfer of shares.

When the vendor holds the shares as "nominee" for the purchaser

131. The vendor of shares "holds" shares as "nominee" for the purchaser in the following circumstances:
    - *An agreement creates a "nominee" relationship* – the vendor and the purchaser enter into an agreement, either as part of the transfer agreement or separately, that explicitly or implicitly creates a "nominee" relationship in relation to the shares.
    - *The share transfer agreement has been settled* – the vendor is the bare trustee for the purchaser of shares under an agreement that has been settled but the purchaser is not the registered holder of the shares. In such a case the purchaser may go on to be registered, or may never be registered (eg, where it is agreed the vendor will hold the shares as bare trustee for the purchaser indefinitely).

When the share transfer agreement has been settled

132. Unless the parties otherwise agree, when an agreement for the sale and purchase of shares has been entered into, the vendor will continue to hold those shares in

terms of s YC 2 until the agreement has been settled. In such a case, provided the purchaser is *sui juris* and of full age, once the agreement has been settled the shares will be deemed to be held by the vendor as "bare trustee" for the purchaser. Therefore, the vendor will hold the shares as "nominee" in terms of s YB 21. This means that, unless varied by any of the statutory exceptions, the shares will be deemed (by s YB 21) to be "held" by the purchaser and not to be "held" by the vendor in terms of s YC 2. This is also assuming the purchaser's name has not already been entered in the register of the company as the new holder of the shares before settlement in circumstances where the parties' intention is that the change in ownership occurs before settlement. If this occurs, the purchaser will hold the shares from the date of their registration, consistent with the parties' intention and s YB 21 will not apply.

133. The leading case in this area is *Musselwhite*. The court in that case considered whether an unpaid vendor of shares had voting rights in relation to those shares. The court decided that the purchaser merely had an equitable interest in those shares. Therefore, in the absence of a contrary provision in the contract, the vendor retained the prima facie right to vote in relation to those shares. The court referred, at 986, with approval to the comments of Jessel MR in *Lysaght v Edwards* (1876) 2 Ch D 505 at 505–506:

> The matter was put thus by Jessel M.R. in *Lysaght v. Edwards*:
>
> …
>
> **In other words, the position of the vendor is something between what has been called a naked or bare trustee, or a mere trustee (that is, a person without beneficial interest), and a mortgagee who is not, in equity (any more than a vendor), the owner of the estate, but is, in certain events, entitled to what the unpaid vendor is**, viz., possession of the estate and a charge upon the estate for his purchase-money … In my judgment an unpaid vendor of shares remaining on the register after the contract for sale retains vis-a-vis the purchaser the prima facie right to vote in respect of those shares.
>
> [Emphasis added]

134. Therefore, the decision in *Musselwhite* shows that when an agreement for the sale and purchase of shares is entered into the shares will (before settlement) be held by the vendor with the purchaser having an equitable interest in those shares (see also *Hardoon v Belilios* [1901] AC 118 and *Loring v Davis* (1886) 32 Ch D 625). The vendor remaining on the share register would **not**, unless the parties had entered into an agreement creating a bare trustee relationship, hold the shares on bare trust for the purchaser at that point. Therefore, before settlement the shares would still be "held" by the vendor in terms of s YC 2.

135. The decision in *Musselwhite* was also cited with approval by the High Court in *Gillespie v Kinloch Golf Resort Ltd* (2008) 10 NZCLC 264,393 at 264,402. The court in *Gillespie* held:

> An unpaid vendor of shares remaining on the register after the contract for sale retains vis-à-vis the purchaser the prima facie right to vote in respect of those shares: *Musselwhite v C. H. Musselwhite & Son Ltd* [1962] 1 All ER 201 at 208 … in the absence of any contractual restriction in the agreement to the contrary, the Gillespies were entitled to exercise their voting rights as they saw fit.

136. Furthermore, the TRA in Case N26 held at 3,228 that:

> *Musselwhite's* case … sets forth the position with regard to such matters as voting rights. In that case an unpaid vendor of shares remained on the company's register of registered members or shareholders after the contract for the sale of those shares was made. It was decided in that case that the unpaid vendor, retained the rights to vote in respect of those shares, vis-a-vis the purchaser, unless the sale agreement restricted such a right.

137. The relationship between a vendor and purchaser of shares was also considered by the UK Court of Appeal in *Michaels v Harley House (Marylebone) Ltd* [1999] 1 All ER 356. The court held at 367, consistent with the court's approach in *Musselwhite*, that:

> the vendor under an uncompleted contract for the sale and purchase of shares is prima facie entitled to exercise the voting rights … A registered shareholder who is absolute beneficial owner can vote as he pleases … **A registered shareholder who is a nominee must vote in accordance with the directions of the absolute beneficial owner, to whom his voting rights are attributed. A registered shareholder who is a vendor under an uncompleted contract is in an intermediate position, a fiduciary but not a nominee**.
>
> [Emphasis added]

138. These cases followed the approach adopted by the court in *Musselwhite*. They are clear that, when an agreement has been entered into for the sale and purchase of shares, the vendor retains a beneficial interest in those shares until settlement occurs. As noted at paragraph 112, a bare trustee in relation to an asset does **not** have **any** beneficial interest in that asset. Therefore, a vendor will not be a bare trustee before settlement. Therefore, s YB 21 would not apply.

139. However, the nature of this relationship between the vendor and purchaser (in relation to the shares) changes when the agreement for the sale and purchase

of shares is settled. This point is summarised in *Avon Downs* at 365:

> It seems to me that a transferor of a share who has been paid the consideration for the transfer, holds simply **as a passive trustee** until the registration of the transfer and entry of the transferee's name on the register.
>
> [Emphasis added]

140. In other words, the court considered that a transferor of shares holds those shares as passive or bare trustee for the purchaser when an agreement is settled.[3] The characteristics of a bare trust were discussed at paragraphs 104 to 113. In the case of a settled agreement for the sale and purchase of shares, the court will recognise the existence of a bare trust relationship between a vendor and purchaser, although the parties may have had no intention of creating a trust. The transferor would have no beneficial interest in those shares at that stage. Therefore, they would be obliged to vote in accordance with the purchaser's instructions. This is consistent with the distinction drawn by the court in *Michaels* between a transferor under an uncompleted contract for the sale of shares and a transferor under a completed contract for the sale of shares (who would hold those shares as bare trustee or nominee for the purchaser).

141. The court adopted a similar approach in *Stern v McArthur* (1988) 165 CLR 489, although the case related to an agreement for the sale of land. The purchaser had not yet paid the full purchase price for that land. The court considered the nature of the purchaser's interest in that land. In their judgment, Deane and Dawson JJ stated at 522:

> **It has been said in a variety of ways that a vendor under a valid contract for the sale of land holds the land as trustee for the purchaser. He is, however, a trustee only in a qualified sense** and the qualifications are such as to rob the proposition of much of its significance or, for some purposes, its validity ... **the vendor retains a substantial interest in the property until the whole of the purchase money is paid**. He is entitled, subject to the contract, to possession and to the rents and profits in addition to a lien on the land as security for any amount outstanding. Any right to equitable ownership on the part of the purchaser is contingent only ... it is not really possible with accuracy to go further than to say that the purchaser acquires an equitable interest in the land sold and to that extent the beneficial interest of the vendor in the land is diminished.
>
> [Emphasis added]

142. The court considered that, when an agreement for the sale and purchase of land has been entered into, the vendor would retain a beneficial interest in that land until settlement. Therefore, the court considered that such a vendor would **not** hold the land on bare trust or as a nominee (for the purchaser) **until** the agreement had been settled. This is the point (settlement of the agreement) when the entire vendor's beneficial ownership would have transferred to the purchaser. This is consistent with the approach adopted by the courts for the transfer of shares in *Musselwhite*, *Michaels* and *Avon Downs*. Despite this, it may be possible for the parties to specifically agree that at settlement beneficial ownership does not pass until some later time. In such a case a bare trustee relationship may not be created. They might, for instance, agree beneficial ownership passes at the point of registration of the purchaser to avoid the possibility of the purchaser being unable to obtain registration—the next issue discussed.

143. There may be occasions where the purchaser does not ultimately have their name entered onto the share register of the company as the registered holder of the shares. Such a situation is explained by A Beck, in *Guidebook to NZ Companies and Securities Law* (8th ed, CCH, Auckland, 2010, at [546]):

> On a sale of shares the transferor does not guarantee that the transferee will obtain registration. The transferor is bound only to do all that is necessary to put the transferee in a position to obtain registration, which is the responsibility of the latter (*Skinner v The City of London Marine Insurance Corp* (1885) 14 QBD 882 (CA)). The transferor is bound only to do no more than deliver to the transferee a completed transfer form and the relevant share certificate if one has been issued. If the company refuses to register the transfer, neither party may cancel the contract of sale and the purchaser is not entitled to recover the purchase price (*London Founders Assn Ltd & Palmer v Clarke* (1888) 20 QBD 576 (CA)).

In such cases a bare trustee relationship would persist. The registered shareholder (vendor) would continue to be looked through under s YB 21 with the purchaser considered to "hold" the shares for tax purposes. It may be that the purchaser has no desire to become registered, but if the vendor and purchaser wished to protect themselves from such an outcome they could make the sale conditional on registration of the transfer or, as mentioned at paragraph 142, provide for beneficial ownership to pass only with registration.

144. On the basis of the above cases, it is concluded that when an agreement has been entered into for the sale

[3] A "passive" trust is another way of referring to a "bare trust": see *Underhill and Hayton: Law Relating to Trusts and Trustees* (18th ed, LexisNexis Butterworths, London, 2010, at 87).

and purchase of shares the shares can be held by the vendor as "bare trustee" for the purchaser. This will be the case where, subject to any agreement to the contrary, all of the following circumstances arise:

- The agreement has been settled so that the vendor has the legal obligation to vote in accordance with the purchaser's instructions but has no ongoing active duties as trustee. Absent any specific rules or agreements otherwise, all dividends received by the vendor would also be owned beneficially by the purchaser. The vendor would have no beneficial interest in the shares at that stage.
- The purchaser's name has not been entered onto the company's share register as being the registered holder of those shares.
- The purchaser is of full age and *sui juris* (see the quotation from *Halsbury's Laws of England* at paragraph 104).

145. If the three circumstances listed above arise, the vendor would hold the shares as "nominee" for the purchaser at that stage in terms of s YB 21; that is, unless any of the specific statutory exceptions applied or the purchaser was acting as nominee for someone else. Otherwise, the shares will, because of s YB 21, be deemed to be "held" by the purchaser in terms of s YC 2 and deemed not "held" by the vendor at that stage.

146. This interpretation of s YB 21 is consistent with the legislative intent underpinning s YC 2. As noted at paragraph 75, s YC 2 was intended to provide a means of determining a shareholders' economic interest in the company in terms of their ability to control the company's affairs. When shares are held by a "nominee" the principal or beneficiary has voting power (as they may instruct the nominee how to vote) and, generally, the beneficial right to any dividends in relation to the shares. They would clearly have an economic interest in the company and, depending on the size of their holding, be able to control the company's affairs.

When an agreement creates a "nominee" relationship

147. Consistent with the comments made by the court in *Musselwhite* (see paragraph 133), a vendor of shares could enter into an agreement to become a "nominee" holder of shares for a purchaser (who is *sui juris* and of full age) under s YB 21. This could occur if the parties entered into an agreement having the effect of creating the situation where the vendor holds those shares either as nominee or bare trustee for the purchaser, although the purchaser's name has not been entered onto the company's share register as the holder of the shares. This could be achieved by, for instance, inserting the requisite clauses into the share transfer agreement creating such a relationship. Alternatively, the parties could enter into another contract setting out this relationship in relation to the shares in question. This will always be a question of fact and law and will be determined by the principles outlined in paragraphs 86 to 123. However, in terms of creating a nominee relationship the Commissioner considers that some situations where such a relationship would *not* necessarily arise before full settlement of an agreement include where:

- an agreement simply imposes a duty on the vendor not to act in a way detrimental to the purchaser's interest in the shares;
- the vendor must consult with the purchaser (but not necessarily follow the purchaser's instructions) in relation to certain matters.

148. If there is such an agreement creating a nominee or bare trust relationship, the vendor will, at the time the agreement is entered into, become a "nominee" holder of the shares in terms of s YB 21. Therefore, the shares will (unless varied by any of the statutory exceptions referred to above) be deemed to be "held" by the purchaser and deemed not to be "held" by the vendor in terms of s YC 2.

Conclusion

149. As a rule, shares issued by a company under s 51 of the CA 1993 will be "held" in terms of s YC 2 by the registered holder of those shares. The registered holder of shares is the person whose name appears on the share register of the company (see *Dalgety, Patrick, Patcorp, Spencer, Bainbridge, BHL; Case D27* and *Case N26*).

150. An exception to this rule is if those shares are "held" by the registered holder as "nominee" for someone else in terms of s YB 21. If so, that other person will, unless varied by any other provision in the Act, be deemed to hold those shares and the registered holder will be deemed not to hold those shares in terms of s YC 2.

151. Other provisions of the Act that can vary the above conclusions are set out in ss YC 8 to YC 19 and FB 10. If any of these exceptions apply, someone other than the registered holder may be deemed to hold those shares in terms of s YC 2 for the purposes of applying the continuity provisions.

152. An agreement for the sale and purchase of shares (as issued under s 51 of the CA 1993) will result in a change in who "holds" shares in terms of s YC 2 **at the earlier of when the**:

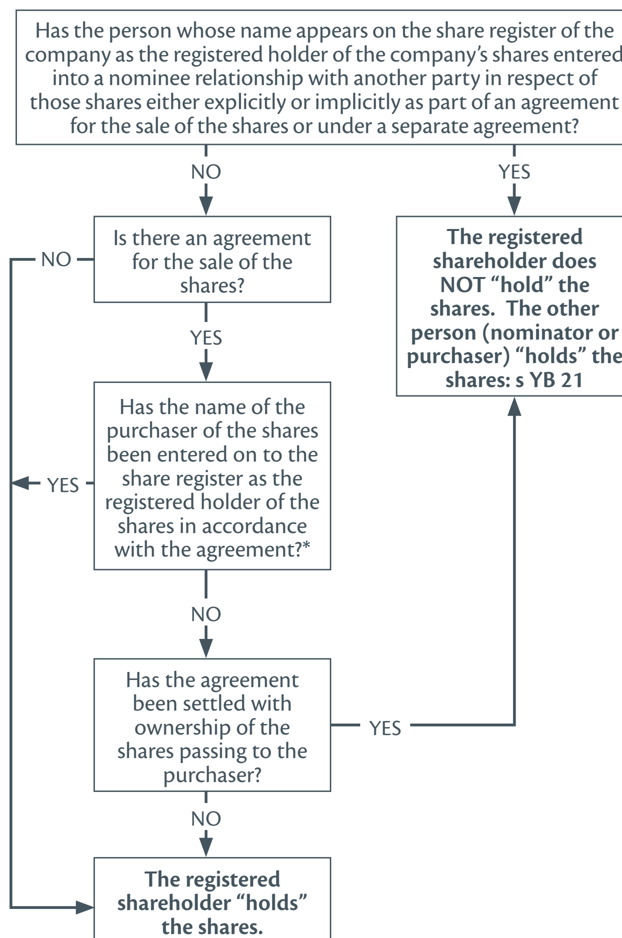
- purchaser's name is entered onto the share register as the holder of the shares in accordance with the agreement;
- vendor holds the shares as "nominee" for the purchaser (who is *sui juris* and of full age) in terms of s YB 21, which will occur if either the:
  - vendor and the purchaser enter into an agreement, either as part of the transfer agreement or separately, that explicitly or implicitly creates a nominee relationship in relation to the shares;
  - vendor is the bare trustee for the purchaser under an agreement that has been settled but the purchaser is not the registered holder of the shares; in such a case, the purchaser may go on to be registered or may never be registered (eg, where it is agreed the vendor will hold the shares as bare trustee for the purchaser indefinitely).

153. However, in the nominee situation, exceptions to when the purchaser is then the holder of the shares will arise if:

- the purchaser is themselves a "nominee" for someone else (in which case s YB 21 will deem the shares to be "held" by that other person);
- any of ss YC 8 to YC 19 or s FB 10 apply.

154. Where the vendor is the purchaser's nominee, the subsequent entering of the purchaser's name onto the share register of the company does not affect who holds the shares. In the nominee situation, the purchaser is already treated as holding those shares before that time.

155. These conclusions are illustrated in the following flowchart. It is assumed that any purchaser of shares is acting in their own right and not as a nominee or bare trustee for a third party.



* If, contrary to the agreement, the name of the purchaser was entered on to the share register by mistake, the purchaser would be considered the bare trustee of the vendor and the registration of the purchaser ignored under s YB 21. That is, until such time as the share register is either rectified or the agreement is settled and ownership of the shares passes to the purchaser in accordance with the agreement.

Examples

156. The following five examples help to explain the application of the law. They illustrate situations where who holds shares and when there is a change in who holds shares affect the calculation of voting interests and the application of the continuity provisions. To illustrate these points, the tax consequences mentioned have been limited to a single continuity provision. However, in practice the change in who holds shares shown in each example could affect several continuity provisions.

157. The examples are:

- Example 1: Change in who holds shares *after* end of continuity period for carrying forward income tax losses.
- Example 2: Change in who holds shares *before* end of continuity period for carrying forward of income tax losses.

- Example 3: Change in who holds shares before end of continuity period for carrying forward of imputation credits – purchaser registered as shareholder *before* full settlement.
- Example 4: Change in who holds shares before end of continuity period for carrying forward of imputation credits – purchaser registered as shareholder *after* full settlement by way of vendor finance.
- Example 5: Change in who holds shares before end of continuity period for carrying forward of imputation credits – purchaser registered as shareholder *after* full settlement by way of cash.

158. In these examples the following is assumed:
    - The company in each case has 100 shares and a standard 31 March balance date.
    - All the shares carry the same shareholder decision-making rights.
    - No transaction or arrangement has been entered into by the company that varies those shareholder decision-making rights.
    - No "options" carrying any shareholder decision-making rights have been issued or granted, either by the company or any shareholder, in relation to these shares in terms of s YC 2. In addition, it is assumed the agreement to transfer the shares does not give rise to an "option" (as defined).
    - There have not been any "market value circumstances". In particular, it is assumed the agreement to transfer the shares does not give rise to a "market value circumstance" (as defined).
    - Neither the existing shareholders nor any of the new holders of shares are nominees for other persons (except, where noted, a nominee relationship arises during the transfer of the shares).

159. In all cases and for the avoidance of doubt, the outcomes in terms of the application of the continuity provisions shown in these examples may not apply where s BG 1 applies.

Example 1: Change in who holds shares *after* end of continuity period for carrying forward income tax losses

160. Company A incurred a net loss of $100,000 for the year ended 31 March 2010. It has net income of $200,000 for the year ended 31 March 2011.

161. Company A's shareholding for the 2010 income year (ie, from 1 April 2009 to 31 March 2010) was:
    - Bill – 60% (60 shares)
    - Mary – 28% (28 shares)
    - Mike – 12% (12 shares).

162. The following events subsequently occur:
    - On 20 March 2011 Bill enters into an agreement to transfer all of his shares to Tom.
    - On 4 April 2011 the agreement is settled in full.
    - On 5 April 2011 Company A agrees to the transfer of the shares.
    - On 10 April 2011 Company A enters Tom's name onto the company's share register as being the registered holder of the 60 shares.

Is Company A able to carry forward its 2010 net loss of $100,000 and offset that loss against its 2011 net income of $200,000?

163. A change in who holds Bill's 60 shares occurs for tax purposes on 4 April 2011. This is because when settlement in full occurs on 4 April 2011, s YB 21 will deem the shares to be held by Bill as nominee (bare trustee) for Tom for the purposes of s YC 2. Tom is deemed to hold the shares and Bill is deemed not to hold the shares.

164. There is no further change in who holds the shares when Tom becomes the registered holder of the shares on 10 April 2011. This is because for tax purposes Tom is treated as holding those shares already.

165. Assuming that none of the other statutory exceptions applies, the minimum voting interest of the shareholders over the continuity period (1 April 2009 – 31 March 2011) is:
    - Bill – 60%
    - Mary – 28%
    - Mike – 12%.

166. The combined minimum voting interest of the shareholders over the continuity period is 100%. This is because the change in who holds Bill's shares occurred after the end of the continuity period.

167. Section IA 5 provides that a tax loss is carried forward if a group of persons holds for the continuity period minimum voting interests in the company that add up to at least 49%. Therefore, the minimum voting interest of the shareholders in Company A over the continuity period of 100% is more than that required by s IA 5.

168. Company A may carry forward and offset its net loss for the 2010 income year against its net income for the 2011 income year.

Example 2: Change in who holds shares *before* end of continuity period for carrying forward of income tax losses

169. Company B incurs a net loss of $100,000 for the year ended 31 March 2010. Of that loss $80,000 relates to the period from 1 April 2009 to 31 October 2009. The $20,000 balance relates to the period from 1 November 2009 to 31 March 2010. Company B has net income of $200,000 for the year ended 31 March 2011.

170. Company B's shareholding as at 1 April 2009 was:
    - Bill – 60% (60 shares)
    - Mary – 28% (28 shares)
    - Mike – 12% (12 shares).

171. The following events subsequently occur:
    - On 20 October 2009 Bill enters into an agreement to transfer all of his shares to Tom.
    - On 31 October 2009 the agreement is settled in full.
    - On 5 November 2009 Company B agrees to the transfer of the shares.
    - On 10 November 2009 Company B enters Tom's name onto the company's share register as being the registered holder of the 60 shares.

Is Company B able to carry forward its 2010 net loss of $100,000 and offset that loss against its 2011 net income of $200,000?

172. A change in who holds Bill's 60 shares occurs for tax purposes on 31 October 2009. This is because when settlement in full occurs on 31 October 2009 s YB 21 will deem the shares to be held by Bill as nominee (bare trustee) for Tom in terms of s YC 2. Tom is deemed to hold the shares and Bill is deemed not to hold the shares.

173. There is no further change in who holds the shares when Tom becomes the registered holder of the shares on 10 November 2009. This is because for tax purposes Tom is treated as holding those shares already.

174. Assuming that none of the other statutory exceptions applies, the minimum voting interest of the shareholders over the continuity period (1 April 2009 – 31 March 2011) is:
    - Bill – 0%
    - Mary – 28%
    - Mike – 12%
    - Tom – 0%.

175. The combined minimum voting interest of the shareholders over the continuity period is 40%. This is because the change in who holds Bill's shares occurred before the end of the continuity period. Therefore, Bill's shares are excluded from the calculation.

176. Section IA 5 provides that a tax loss is carried forward only if a group of persons holds for the continuity period minimum voting interests in the company that add up to at least 49%. Therefore, the minimum voting interest of the shareholders in Company B over the period is less than that required by s IA 5(2).

177. However, Company B may still be able to carry forward and offset part of its tax losses for the 2010 income year against its net income for the 2011 income year. This will depend on whether the requirements set out in s IP 3 are satisfied. In particular, s IP 3(4) provides that, despite a breach of the requirements of s IA 5, a loss from part of an earlier year may be carried forward to the extent that the requirements for continuity would be met if the continuity period included only part of that earlier year. The amount of loss carried forward must be calculated by preparing financial statements in accordance with s IP 6. No amount of loss can be carried forward from a year, if, over that entire year, the company had net income; nor can the amount of the loss carried forward be more than the total loss for that entire year.

178. If the requirements set out in s IP 3 are satisfied, the continuity period can be treated as covering the period since Tom became a shareholder: 1 November 2009 – 31 March 2011. In that period, there would be 100% continuity of who holds the shares in the company. Of Company B's loss for the 2010 year, $20,000 was incurred in this continuity period.

179. Company B could, provided these requirements are satisfied, carry forward and offset that $20,000 against its net income for the 2011 income year.

Example 3: Change in who holds shares before end of continuity period for carrying forward of imputation credits – purchaser registered as shareholder *before* full settlement

180. Company C has the following imputation credits in its imputation credit account (arising as a result of tax payments):
    - 28 August 2009 – $20,000

- 15 January 2010 – $30,000
- 7 May 2010 – $50,000.

181. There are no other entries in the company's imputation credit account.
182. On 1 April 2009 Company C's shareholding was:
    - Bill – 60% (60 shares)
    - Mary – 28% (28 shares)
    - Mike – 12% (12 shares).
183. The following events subsequently occur:
    - On 30 April 2010 Bill enters into an agreement to transfer all of his shares to Tom. The agreement provides for settlement to occur once there has been full payment for the shares. Full payment is to be made in two equal instalments. The first instalment is due on the date of the agreement and the second is due in six months' time. The agreement provides that ownership of the shares is to pass on the registration of Tom as the new shareholder following payment of the first instalment.
    - On 30 April 2010 Tom pays the first instalment and Bill delivers signed share transfer documents to Tom.
    - On 10 May 2010 Company C agrees to the transfer of the shares and enters Tom's name onto the company's share register as being the registered holder of the 60 shares.
    - On 12 May 2010 the board authorises and pays a dividend.
    - On 31 October 2010 Tom pays the second and final instalment for the shares.

Is Company C able to attach imputation credits when it pays the dividend?

184. A change in who holds Bill's 60 shares occurs for tax purposes on 10 May 2010. This is because Tom's name is entered onto Company C's share register as the holder of the shares on 10 May 2010 which is the date on which the agreement provides ownership is to pass.
185. There is no further change in who holds the shares when Tom pays in full for the shares on 31 October 2010. By that date Tom is already the registered holder of the shares. No bare trustee relationship arises between Bill and Tom and s YB 21 does not apply.
186. Assuming that none of the other statutory exceptions applies, the voting interest of the shareholders for the relevant period until the date the dividend is paid is:
    - Bill – 0%
    - Mary – 28%
    - Mike – 12%
    - Tom – 0%.
187. The combined minimum voting interest of the shareholders over the relevant period is 40%. This is because the change in who holds Bill's shares occurred before the date the imputation credits could be used by being attached to the dividend paid. Therefore, Bill's shares are excluded from the calculation.
188. For each imputation credit, shareholder continuity is measured from the time the credit arises until the time it is used or continuity is breached. A combined minimum voting interest of 40% does not satisfy the continuity requirement of 66% or more set out in s OA 8. Section OB 41(1) states that an imputation credit account company has an imputation debit for the amount equal to the imputation credit retained in the imputation credit account and unused before the date on which shareholder continuity is breached. Therefore, as of 10 May 2010 there is a debit of the entire amount in Company C's imputation credit account (being the $100,000 of tax that Company C paid up to that point).
189. This means Company C has no imputation credits in its imputation credit account that it can attach to the dividends that it authorised and paid on 12 May 2010.

Example 4: Change in who holds shares before end of continuity period for carrying forward of imputation credits – purchaser registered as shareholder *after* full settlement by way of vendor finance

190. The facts in this example are the same as the preceding example involving Company C with the following two differences in the terms of the agreement between Bill and Tom:
    - There is no provision in the agreement specifying when ownership of the shares is to pass.
    - The agreement provides for Bill to provide vendor finance. Settlement of the agreement occurs in full on the provision of acceptable debt arrangements and the payment by Tom of the first instalment.

Is Company C able to attach imputation credits when it pays the dividend?

191. A change in who holds the shares occurs on 30 April 2010. This is because with settlement in full occurring at that date, Bill would hold the shares as bare trustee for Tom until Tom's name was entered onto the company's share register on 10 May 2010. Under s YB 21 Tom would be deemed to hold the shares from 30 April 2010.

192. There is a debit to Company C's imputation credit account for $50,000 (being the amount of credits which arose before 30 April 2010). While the change in who holds the shares still occurs before the dividend is paid on 12 May 2010, the $50,000 credit to the company's imputation credit account for the tax paid on 7 May 2010 would be available to attach to the dividend. This is because there has been continuity of the new shareholding of Company C from the date the tax is paid on 7 May 2010 until the date the dividend is paid a few days later.

Example 5: Change in who holds shares before end of continuity period for carrying forward of imputation credits – purchaser registered as shareholder *after* full settlement by way of cash

193. Company D has the following imputation credits in its imputation credit account (arising as a result of tax payments):
   - 28 August 2009 – $20,000
   - 15 January 2010 – $30,000
   - 7 May 2010 – $50,000.

194. There are no other entries in the company's imputation credit account.

195. On 1 April 2009 Company D's shareholding was:
   - Bill – 60% (60 shares)
   - Mary – 28% (28 shares)
   - Mike – 12% (12 shares).

196. The following events subsequently occur:
   - On 30 April 2010 Bill enters into an agreement to transfer all of his shares to Tom.
   - On 8 May 2010 the agreement is settled in full in cash.
   - On 10 May 2010 Company D agrees to the transfer of the shares.
   - On 12 May 2010 Company D enters Tom's name onto the company's share register as being the registered holder of the 60 shares.
   - Also on 12 May 2010 the board authorises and pays a dividend.

Is Company D able to attach imputation credits when it pays the dividend?

197. A change in who holds Bill's 60 shares occurs for tax purposes on 8 May 2010. This is because when settlement in full occurs on 8 May 2010, s YB 21 will deem the shares to be held by Bill as nominee (bare trustee) for Tom in terms of s YC 2. Tom is deemed to hold the shares and Bill is deemed not to hold the shares.

198. There is no further change in who holds the shares when Tom becomes the registered holder of the shares on 12 May 2010. This is because for tax purposes Tom is treated as holding those shares already.

199. Assuming that none of the other statutory exceptions applies, the voting interest of the shareholders for the relevant period until the dividend is paid is:
   - Bill – 0%
   - Mary – 28%
   - Mike – 12%
   - Tom – 0%.

200. The combined minimum voting interest of the shareholders over the continuity period is 40%. This is because the change in who holds Bill's shares occurred before the date the dividend is paid. Therefore, Bill's shares are excluded from the calculation.

201. For each imputation credit, shareholder continuity is measured from the time the credit arises until the time it is used or continuity is breached. A combined minimum voting interest of 40% does not satisfy the continuity requirement of 66% or more set out in s OA 8. Section OB 41(1) states that an imputation credit account company has an imputation debit for the amount equal to the imputation credit retained in the imputation credit account and unused before the date on which shareholder continuity is breached. Therefore, as of 8 May 2010 there is a debit of the entire amount in Company D's imputation credit account (being the $100,000 of tax that Company D paid up to that point).

202. This means Company D has no imputation credits in its imputation credit account that it can attach to the dividends that it authorised and paid on 12 May 2010.

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APPENDIX: LEGISLATION

Income Tax Act 2007

A1. The following are the sections of the Income Tax Act 2007 relevant to this Interpretation Statement.

Definitions

A2. Section YA 1 defines "share" as:

> (a) includes any interest in the capital of a company:
>
> (b) includes a debenture to which section FA 2 (Recharacterisation of certain debentures) applies:
>
> (bb) includes a stapled debt security to which section FA 2B(2) (Stapled debt securities) applies:
>
> (c) includes a unit in a unit trust:
>
> (d) includes an investor's interest in a group investment fund if—
>
> (i) the fund is not a designated group investment fund; and
>
> (ii) the interest does not result from an investment from a designated source; and

(iii) the investor's interest does not result from an investment made in the fund on or before 22 June 1983, including an amount treated as invested at that date as **pre-1983 investments** under section HR 3(8) (Definitions for section HR 2: group investment funds):

(e) does not include a withdrawable share in a building society, except in the definitions of **investment society dividend** and **withdrawable share**:

(f) is further defined in section CE 6 (Meaning of share: when share acquired) for the purposes of sections CE 2 to CE 4 and CE 7 (which relate to share purchase agreements):

(g) is further defined in section DC 15 (Some definitions) for the purposes of sections DC 12 to DC 15 (which relate to share purchase schemes).

A3. Section YA 1 defines "shareholder" as:

shareholder—

(a) includes—

(i) a holder of a share; and

(ii) a member of a company, whether the company's capital is divided into shares or not:

(b) does not include a holder of a withdrawable share in a building society, except in the definitions of **investment society dividend** and **withdrawable share**:

(c) in subparts HA (Qualifying companies (QC) and loss attributing qualifying companies (LAQC)) and OE (Branch equivalent tax accounts (BETA)) and OJ (Policyholder credit accounts [(PCA)]), in the FDP rules and the imputation rules, and in the definition of **shareholder dividend statement**, includes a sharemilker (as defined in section 2 of the Sharemilking Agreements Act 1937), to the extent to which the sharemilker derives payment for produce transactions directly from a co-operative dairy or milk company.

A4. Section YA 1 defines "shareholder decision-making right":

shareholder decision making right means a right, carried by a share issued by a company or an option over a share issued by a company, to vote or participate in any decision-making concerning—

(a) a dividend or other distribution to be paid or made by the company, whether on a liquidation of the company or otherwise, excluding decision-making undertaken by directors acting only in their capacity as directors; or

(b) the constitution of the company; or

(c) a variation in the capital of the company; or

(d) the appointment of a director of the company.

A5. Section YA 1 defines the relevant portion of "voting interest":

voting interest—

(a) means, for a person and a company and a time, the percentage voting interest that the person is treated as holding in the company at the time under sections YC 2 to YC 20 (which relate to the measurement of control and ownership interests):

…

c) in section YC 13(4) and (5) (Corporate spin-outs), means, for a person and a company and a time, the percentage voting interest that the person is treated as holding in the company under section YC 2 (Voting interests), as modified by section YC 13(7)

A6. Section YA 1 defines "option", "excluded option" and "market value circumstance" as meaning:

option, in sections FB 10 (Continuity provisions: shares and options), GB 5 (Arrangements involving trust beneficiaries), and YC 2, YC 3, YC 5, YC 8 and YC 9 (which relate to the measurement of control and ownership interests), and in the definitions of **excluded option, market value** (paragraphs (a) and (b)), **market value circumstance** (paragraphs (c) to (f)), **pre-1991 budget security, recognised exchange,** and **shareholder decision-making right**, includes an agreement for sale at a time when beneficial ownership of the property sold has not completely passed to the purchaser

excluded option means, for a company, an option to acquire or dispose of a share in the company if—

(a) the directors of the company did not know and could not reasonably be expected to know that the option had been granted; or

(b) neither the grantor of the option nor any person associated with the grantor of the option at the time the option is granted holds a share in the company over which the option is granted at the time the option is granted, whether directly or indirectly, but this paragraph does not apply in a case in which the grantor of the option is the company; or

(c) the option is granted on arm's length terms, without the grant having a purpose or effect of defeating the intent and application of any provision of this Act whose application is dependent on the measurement of voting and market value interests, and the holder of the option does not have, because of it, any right to vote or participate in any shareholder decision-making, except to the extent of any such right that—

(i) arises only in circumstances in which the position of the holder of the option in relation to it may be altered to the holder's detriment; and

(ii) is granted to the holder of the option for the purpose of assisting the holder to prevent the alteration; and

(iii) at the time of the issue of the option, is not expected to arise; or

(d) the price payable to acquire the share on the exercise of the option is equal to or not materially different from the market value of the share at the date of exercise, and the holder of the option does not have, because of it, any right to vote or participate in any shareholder decision-making, except to the extent of any such right that—

(i) arises only in circumstances in which the position of the holder of the option in relation to it may be altered to the holder's detriment; and

(ii) is granted to the holder of the option for the purpose of assisting the holder to prevent the alteration; and

(iii) at the time of the issue of the option, is not expected to arise; or

(e) the share is an excluded fixed rate security, subject to section YC 20 (Credit account continuity provisions: excluded fixed rate securities) in the case of the credit amount continuity provisions; or

(f) the option—

(i) relates to a pre-1991 budget security; and

(ii) was itself granted before 8.00 pm New Zealand Standard Time on 30 July 1991 (the **specified time**), or was granted under a binding contract entered into before the specified time no term of which is altered at any time after the specified time; and

(iii) is not an option any term of which is altered at any time after the specified time (whether under a provision for roll-over or extension or under an option held at the specified time by the option holder or the grantor of the option, or both, or any other person, or otherwise), except when the term is altered under a binding contract entered into before the specified time no term of which is altered at any time after the specified time

market value circumstance , for a company at any time,—

(a) means an occasion or situation in which, at the time, the company has on issue a debenture—

(i) that is not an excluded fixed rate security or pre-1991 budget security; and

(ii) to which section FA 2 (Recharacterisation of certain debentures) or FA 2B (Stapled debt securities) applies:

(b) also means an occasion or situation in which, at the time,—

(i) the company has on issue a share that is not an excluded fixed rate security or a pre-1991 budget security; and

(ii) the payment of a dividend is guaranteed or secured to the holder by some person other than the company; and

(iii) the directors of the company know or could reasonably be expected to know at the time that the payment of a dividend is so guaranteed or secured:

(c) also means an occasion or situation in which, at the time, an option exists that—

(i) is not an excluded option; and

(ii) is to acquire a share in the company; and

(iii) is granted by the company or a person other than the company:

(d) also means an occasion or situation in which, at the time, an option exists that—

(i) is not an excluded option; and

(ii) is to require a person to acquire a share in the company:

(e) also means an occasion or situation in which, at the time, an arrangement or a series of related or connected arrangements exists that—

(i) relates to shares or options over shares in the company issued by the company or any other person; and

(ii) has a purpose or effect of defeating the intent and application of any provision of this Act whose application is dependent on the measurement of voting and market value interests:

(f) does not exist under any of paragraphs (a) to (e) if, at the time, no share in the company has a value higher than zero, except for an excluded fixed rate security or a pre-1991 budget security, and no option over a share in the company has a value higher than zero, except for an excluded option:

(g) also means an occasion or situation in which, at the time,—

(i) under any of paragraphs (a) to (e), a direct market value circumstance exists for another company (the **shareholder company**); and

(ii) the shareholder company is associated with the company; and

(iii) under section YC 4 (Look-through rule for corporate shareholders), any fraction of any market value interest held, or treated under section YC 4 as held, by the shareholder company in the company is treated as held by any other person

Nominees

A7. Section YB 21 states:

(1) In this Act, unless the context otherwise requires, if a person holds something or does something as a nominee for another person, the other person holds or does that thing and the nominee is ignored.

(2) A person holds or does something as a nominee for another person if the person acts on the other person's behalf. However, a trustee is a nominee only if the trustee is a bare trustee.

(3) A person making a nominal settlement at the request of another person is treated for the purposes of this Act as a nominee in relation to the settlement.

Voting interests

A8. Section YC 2 states:

Percentage of shareholder decision-making rights

(1) A person's voting interest in a company equals the percentage of the total shareholder decision-making rights for the company carried by shares or options held by the person.

When decision-making rights vary

(2) Despite subsection (1), if the percentage of shareholder decision-making rights for a company carried by shares or options held by any person differs as between the types of decision-making listed in the definition of shareholder decision-making right, the person's voting interest in the company equals the average of those differing percentages.

A9. Section YC 3 states:

Percentage of market value

(1) A person's market value interest in a company equals the percentage of the total market value of shares and options over shares in the company that the market value of shares and options over shares in the company held by the person represents.

Adjustments for options

(2) For the purposes of subsection (1), the market value of any share in a company that is subject to an option is calculated having regard to the terms of the option.

Continuity provisions

A10. Section YA 1 defines the "continuity provisions" as:

continuity provisions means—

(a) section GB 3 (Arrangements for carrying forward loss balances: companies); and

(b) section GB 4 (Arrangements for grouping tax losses: companies); and

(c) sections IA 3 and IA 4 (which relate to the use of tax losses); and

(d) section IA 5 (Restrictions on companies' loss balances carried forward); and

(e) section IC 1 (Company A making tax loss available to company B); and

(f) section LP 3(4) (Use of remaining credits); and

(g) section OB 41 (ICA debit for loss of shareholder continuity); and

(h) section OC 24 (FDPA debit for loss of shareholder continuity); [4] and

(i) section OE 10 (BETA credit for loss of shareholder continuity); [5] and

(j) section OK 15 (MACA debit for loss of shareholder continuity).

A11. Section GB 3 states:

(1) This section applies when—

(a) a share in a company (the loss company) or another company has been subject to an arrangement, including an arrangement directly or indirectly altering rights attached to the shares; and

(b) the arrangement allows the loss company to meet the requirements of section IA 5 (Restrictions on companies' loss balances carried forward); and

(c) a purpose of the arrangement is to defeat the intent and application of sections IA 5 and IP 3 (Continuity breach: tax loss components of companies carried forward).

(2) The loss company is treated as not meeting the requirements of section IA 5 in relation to the share.

A12. Section GB 4 states:

(1) This section applies when—

(a) a share in a company (the offset company) or another company has been subject to an arrangement, including an arrangement directly or indirectly altering rights attached to the shares; and

[4] The liability of resident companies to pay foreign dividend payments on dividends they receive from foreign companies was repealed as from 30 June 2009. While existing credits to foreign dividend payment accounts are unaffected, no further credits for foreign dividend payments could be generated from that date.

[5] Sections 104 and 126(13) of the Taxation (International Investment and Remedial Matters) Act 2012 repealed s OE 10 and paragraph (i) of the definition of "continuity provisions" (branch equivalent tax accounts credit for loss of shareholder continuity) from 1 July 2012.

(b) the arrangement allows the offset company to meet the requirements of subparts IC and IP, and section IZ 7 (which relate to the use of tax losses by group companies), as applicable; and

(c) a purpose of the arrangement is to defeat the intent and application of those provisions.

(2) The offset company is treated as not meeting the requirements of subparts IC and IP and section IZ 7, as applicable, in relation to the share.

Carry forward of losses

A13. The continuity provisions providing for company losses to be carried forward are in ss IA 3 to IA 5. Section IA 3 states:

(1) A person who has a tax loss for a tax year may use some or all of the amount of the tax loss under section IW 1 (Shortfall penalties) to pay a shortfall penalty.

(2) A company that has a tax loss for a tax year may—

(a) make the amount available to another company under section IC 5 (Company B using company A's tax loss) to subtract from the other company's net income for the tax year; or

(b) use the amount under section RG 6 (Using loss balances) to satisfy a liability for a foreign dividend payment (FDP) payable in the corresponding income year; or

(c) use the amount under sections FM 26 to FM 28, or RM 21, (which relate to FDP) to obtain a refund of an overpayment of FDP made in the corresponding income year.

(3) The amount of a tax loss for a tax year of a beneficiary of a non-complying trust may be used under section HC 22 (Use of tax losses to reduce taxable distributions from non-complying trusts) to adjust the amount of a taxable distribution derived in the corresponding income year.

(4) If a person has a balance of tax loss remaining for a tax year after the uses described in this section, the balance is carried forward to the next tax year as a loss balance.

(5) Sections IA 5, IA 8, and IA 10 override this section.

A14. Section IA 4 states:

(1) A person's loss balance carried forward under section IA 3(4) to a tax year, must—

(a) first, be subtracted from their net income, so far as it extends, for the tax year; and

(b) secondly, to the extent of a remaining loss balance carried forward under section IA 2(2), be included in their tax loss for the tax year.

(2) Sections IA 5 and IA 8 to IA 10 override this section.

A15. The relevant portions of s IA 5 are:

General statement

(1) A company's tax loss component is carried forward in a loss balance only if the minimum continuity requirements of subsections (2) and (3) are met. The tax loss component includes an unused tax loss component carried forward from an earlier income year.

Continuity of voting interests

(2) A tax loss component is carried forward in a loss balance under section IA 3(4) only if a group of persons holds for the continuity period minimum voting interests in the company that add up to at least 49%.

Continuity of market value interests

(3) If a market value circumstance exists for the company at any time during the continuity period, the group of persons must also hold for the continuity period, minimum market value interests in the company that add up to at least 49%.

...

Some definitions

(6) In this section,—

…

minimum voting interest, for a person and a continuity period, means the lowest voting interest they have in the company during the continuity period.

Offset of losses with other companies

A16. The continuity provision relating to the offset of losses between companies is s IC 1 the relevant portions of which are:

(1) This subpart applies if 1 company that is part of a group of companies (company A) has a tax loss for a tax year that it makes available to another group company (company B) to subtract from its net income for the tax year.

(2) The amount of a tax loss that company A has for a tax year may be made available to company B to subtract from its net income for the tax year only if—

(a) the threshold levels in section IC 2 are met;

…

A17. The relevant portions of s IC 2 state:

(1) Company A may group a tax loss in a tax year under section IC 5 only if the requirements of section IA 5 (Restrictions on companies' loss balances carried forward) are met.

(2) In addition to meeting the requirements referred to in subsection (1), company A and company B must have the required common ownership under section IC 3 for the period referred to in section IC 6.

A18. The relevant portions of s IC 3 are:

(1) A group of companies means 2 or more companies, none of which is a multi-rate PIE, in relation to which a group of persons holds—

(a) common voting interests that add up to at least 66%; and

(b) if a market value circumstance exists for a company that is part of a group of companies, common market value interests that add up to at least 66%.

...

(3) In subsection (1)(a), a person's common voting interest in the relevant companies at a particular time is the percentage of their voting interests under section YC 2 (Voting interests) in each of the companies at the time.

(4) In subsection (1)(b), a person's common market value interest in the relevant companies at a particular time is the percentage of their market value interests under section YC 3 (Market value interests) in each of the companies at the time.

Carry forward of credits in memorandum accounts

A19. In certain circumstances, s OA 8 prevents a company from preserving credits in its memorandum accounts. The relevant provisions of s OA 8 are:

Shareholder continuity requirement

(2) An amount that is a credit in the account may be carried forward from a credit date to a later time only if the company or consolidated group that has the credit maintains a 66% continuity of shareholding under subsection (7) from the credit date to the later time. Subsections (3B) to (5) override this subsection

...

When continuity lost

(6) For a memorandum account and for a company or consolidated group that maintains the account when the continuity of shareholding required by subsection (7) is lost, a debit arises under the relevant section in each subpart only to the extent to which an unused amount of credit remains in the memorandum account. The relevant sections are—

(a) section OB 41 (ICA debit for loss of shareholder continuity):

(b) section OC 24 (FDPA debit for loss of shareholder continuity)

(c) section OE 15 (BETA debit for loss of shareholder continuity):[6]

(d) section OK 15 (MACA debit for loss of shareholder continuity):

(e) section OP 42 (Consolidated ICA debit for loss of shareholder continuity):

(f) section OP 73 (Consolidated FDPA debit for loss of shareholder continuity):

(g) section OP 108 (Consolidated BETA debit for loss of shareholder continuity). [7]

Shareholder continuity requirement

(7) The shareholder continuity requirement is that, while some or all of the credit still exists, a group of persons must continue to hold—

(a) aggregate minimum voting interests in a company or consolidated group of at least 66%; and

(b) if a market value circumstance exists for a company or, in the case of a consolidated group, a group company, aggregate minimum market value interests in the company or group of at least 66%.

A20. Section OB 41 states:

(1) An ICA company has an imputation debit for the amount equal to the amount of an imputation credit retained in the imputation credit account and unused at the time at which shareholder continuity is lost.

(2) The imputation debit in subsection (1) is referred to in table O2: imputation debits, row 14 (debit for loss of shareholder continuity).

(3) The debit arises at the time shareholder continuity is lost.

A21. Section OC 24 states:

(1) An FDPA company has an FDP debit for the amount equal to the amount of an FDP credit retained in the FDP account and unused at the time at which shareholder continuity is lost.

(2) The FDP debit in subsection (1) is referred to in table O4: FDP debits, row 13 (debit for loss of shareholder continuity).

(3) The debit arises at the time shareholder continuity is lost.

(3B) This section does not apply to a qualifying company in circumstances other than those set out in section HA 18 (Treatment of dividends when qualifying company status ends), and that section overrides subsections (1) to (3).

[6] In respect of branch equivalent tax accounts (BETAs), ss 80(2) and 104 of the Taxation (International Investment and Remedial Matters) Act 2012 has repealed ss OA 8(6)(c) and (g) and OE 15 for income years from 1 July 2012.

[7] Section OA 8(6)(g) has been repealed from 1 July 2012 (see footnote 5). Section OP 108 was repealed for all income years from 1 July 2009.

(4) Section GB 41 (FDPA arrangements for carrying amounts forward) may apply to treat a company as not meeting the requirements of this section.

A22. Section OK 15 states:

(1) A Maori authority has a Maori authority debit for the amount of a Maori authority credit retained in the Maori authority credit account and unused at the time at which shareholder continuity is lost.

(2) The Maori authority debit in subsection (1) is referred to in table O18: Maori authority debits, row 7 (debit for loss of shareholder continuity).

(3) The debit arises at the time shareholder continuity is lost.

Carry forward of excess tax credits

A23. The continuity provision providing for the carry forward of excess tax credits is s LP 3(4):

(4) If, after applying subsections (2) and (3), the company has an amount of tax credit remaining for the tax year, the amount for the income year must be carried forward to the next tax year as a credit carried forward.

A24. When s LP 3(4) applies, s LP 4 provides the continuity rules that then apply:

When this section applies

(1) This section applies for the purposes of section LA 5(3) (Treatment of remaining credits) when a company has an amount of a tax credit that must be carried forward under section LP 3(4).

Minimum interests required

(2) The amount is available for use under section LP 3(4) if a group of persons exists that has, for the continuity period,—

(a) minimum voting interests in the company that add up to 49% or more; and

(b) when a market value circumstance exists for the company in the continuity period, minimum market value interests in the company that add up to 49% or more.

Companies Act 1993

A25. The following are the sections of the Companies Act 1993 relevant to this Interpretation Statement.

A26. Section 10 states:

10 Essential requirements

A company must have—

(a) a name; and

(b) 1 or more shares; and

(c) 1 or more shareholders, having limited or unlimited liability for the obligations of the company; and

(d) 1 or more directors.

A27. Section 36 provides that a share in a company confers rights on the holder:

36 Rights and powers attaching to shares

(1) Subject to subsection (2), a share in a company confers on the holder—

(a) the right to 1 vote on a poll at a meeting of the company on any resolution, including any resolution to—

(i) appoint or remove a director or auditor:

(ii) adopt a constitution:

(iii) alter the company's constitution, if it has one:

(iv) approve a major transaction:

(v) approve an amalgamation of the company under section 221:

(vi) put the company into liquidation:

(b) the right to an equal share in dividends authorised by the board:

(c) the right to an equal share in the distribution of the surplus assets of the company.

(2) Subject to section 53, the rights specified in subsection (1) may be negated, altered, or added to by the constitution of the company or in accordance with the terms on which the share is issued under section 41(b) or section 42 or section 44 or section 107(2), as the case may be.

A28. Section 37 states:

37 Types of shares

(1) Subject to the constitution of the company, different classes of shares may be issued in a company.

(2) Without limiting subsection (1), shares in a company may—

(a) be redeemable within the meaning of section 68; or

(b) confer preferential rights to distributions of capital or income; or

(c) confer special, limited, or conditional voting rights; or

(d) not confer voting rights.

A29. Section 41 provides that after registration a company must issue shares:

41 Issue of shares on registration and amalgamation

A company must,—

(a) forthwith after the registration of the company, issue to any person or persons named in the application for registration as a shareholder or shareholders, the number of shares specified in the application as being the number of shares to be issued to that person or those persons:

(b) in the case of an amalgamated company, forthwith after the amalgamation is effective, issue to any person entitled to a share or shares under the amalgamation proposal, the share or shares to which that person is entitled.

A30. Section 42 permits a company to issue further shares:

42 Issue of other shares

Subject to this Act and the constitution of the company, the board of a company may issue shares at any time, to any person, and in any number it thinks fit.

A31. Section 44 provides that, despite s 42, the board of a registered company may issue shares in contravention of the constitution:

44 Shareholder approval for issue of shares

(1) Notwithstanding section 42, if shares cannot be issued by reason of any limitation or restriction in the company's constitution, the board may issue shares if the board obtains the approval for the issue in the same manner as approval is required for an alteration to the constitution that would permit such an issue.

(2) Subject to the terms of the approval, the shares may be issued at any time, to any person, and in any number the board thinks fit.

(3) Within 10 working days of approval being given under subsection (1), the board must ensure that notice of that approval in the prescribed form is delivered to the Registrar for registration.

(4) Nothing in this section affects the need to obtain the approval of an interest group in accordance with section 117 (which relates to the alteration of shareholders' rights) if the issue of shares affects the rights of that interest group.

(5) A failure to comply with this section does not affect the validity of an issue of shares.

(6) If the board of a company fails to comply with subsection (3), every director of the company commits an offence and is liable on conviction to the penalty set out in section 374(2).

A32. Section 51 states:

51 Time of issue of shares

A share is issued when the name of the holder is entered on the share register.

A33. Section 84 states:

84 Transfer of shares

(1) Subject to the constitution of the company, shares in a company may be transferred by entry of the name of the transferee on the share register …

A34. Section 89 states:

89 Share register as evidence of legal title

(1) Subject to section 91 of this Act, the entry of the name of a person in the share register as holder of a share is prima facie evidence that legal title to the share vests in that person.

(2) A company may treat the registered holder of a share as the only person entitled to—

(a) exercise the right to vote attaching to the share; and

(b) receive notices; and

(c) receive a distribution in respect of the share; and

(d) exercise the other rights and powers attaching to the share.

A35. Section 96 defines "shareholder" as:

96 Meaning of shareholder

In this Act, the term shareholder, in relation to a company, means—

(a) a person whose name is entered in the share register as the holder for the time being of 1 or more shares in the company …

IS 12/02: INCOME TAX – WHETHER INCOME DEEMED TO ARISE UNDER TAX LAW, BUT NOT TRUST LAW, CAN GIVE RISE TO BENEFICIARY INCOME

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

Summary

1. This Interpretation Statement considers whether income deemed to arise under tax law, but not trust law, can give rise to beneficiary income for tax purposes. If deemed income does give rise to beneficiary income for tax purposes, then the deemed income will be taxed at the beneficiary's marginal tax rate.
2. In this Interpretation Statement, "deemed income" is income deemed to arise under a provision of the Income Tax Act 2007. Where deemed income arises, it generally does not result in an actual cash flow to the trust at all, or at least in that income year. This may cause mismatches between the tax law and trust law treatments. Examples of such deemed income include attributed controlled foreign company income, foreign investment fund income, and look-through company income based on an owner's effective look-through interest.
3. The term "beneficiary income" has a defined meaning in the Act. Under s HC 6, "beneficiary income" is income derived by a trustee that either vests absolutely in interest in a beneficiary, or has been paid to the beneficiary, within the time limits imposed by s HC 6(1B).
4. An amount vests absolutely in interest in a beneficiary when the amount derived is indefeasibly vested in the beneficiary so they obtain an immediate right of present or future possession of the income. The income must not be future property or an expectancy. This means the beneficiary need not receive the amount vested at the time of vesting, but they must have an indefeasible right to that part of the trust property.
5. An amount will be "paid" if it is actually paid, distributed, credited or dealt with in the beneficiary's interest. Case law establishes that a declaration or resolution by a trustee allocating income to a beneficiary will be sufficient for an amount to be "paid".
6. Under the Act, there is no apparent impediment to deemed income giving rise to beneficiary income. However, s HC 6 requires an examination of what has happened within the trust. This is because s HC 6 requires income to actually vest absolutely in interest in, or be paid to, a beneficiary before it can be beneficiary income. The terms of the trust deed and general trust law bind how a trustee may deal with the trust fund. For an amount to vest absolutely in interest in, or be paid to, a beneficiary, the trust deed must provide for such vesting or payment, either by express provision in the trust deed or through appropriate powers of the trustee.
7. As well as having the power to do so, for an amount of income derived by a trustee to be beneficiary income, the amount must actually vest absolutely in interest in, or be paid to, the beneficiary. For an amount of trustee income to vest absolutely in interest in, or be paid to, a beneficiary as beneficiary income for tax purposes, it must be effective for trust law. This is true for all types of income derived by a trustee, not just deemed income.
8. The Commissioner considers that an amount of deemed income cannot itself be vested absolutely in interest in, or paid to, a beneficiary. This is because there is no actual income to vest or pay to a beneficiary. The income is only deemed to arise for tax purposes and does not exist for trust purposes. The trust must have an actual (non-deemed) amount in the trust fund available to be distributed that can be vested absolutely in interest in, or paid to, a beneficiary. Such an amount must actually vest absolutely in interest in, or be paid to, a beneficiary in a way that is effective for trust law. An actual cash payment does not necessarily have to be made to a beneficiary at the time of the vesting or payment. However, at the time of the vesting or payment, the trust must have sufficient amounts in the trust fund available to be distributed to that beneficiary or beneficiaries in accordance with the trust deed. This is because a trustee can only vest or pay amounts of the trust fund to beneficiaries in accordance with the terms of the trust deed.
9. When the trust law income of a trust is the same as or exceeds its tax law income in any income year, this will not pose any problems. Provided an equivalent amount of trust law income is actually vested absolutely in interest in, or paid to, a beneficiary, and that vesting or payment is effective for trust law, the deemed income

will be beneficiary income for tax purposes and taxed at the beneficiary's marginal tax rate.

10. However, when the tax law income of a trust exceeds its trust law income in any income year, it is not possible under trust law for the excess tax law income simply to be vested absolutely in interest in, or paid to, beneficiaries unless the trust deed expressly provides a way for this to happen. The Commissioner considers that deemed income will be beneficiary income only to the extent to which is it reflected by an actual amount vested absolutely in interest in, or paid to, a beneficiary by the trustee or under the terms of the trust deed. Whether this is possible will depend on the terms of the relevant trust deed. In this situation, it will be necessary for a trustee to resolve that the actual amount from the trust fund is being treated as the vesting or payment of deemed income for tax purposes. If an actual amount from the trust fund is used to vest or pay the deemed income for tax purposes, the Commissioner considers that the amount of deemed income will meet the definition of "beneficiary income", and will be taxed at the beneficiary's marginal tax rate.

11. The examples at the end of this Interpretation Statement apply these principles to three types of trusts in a situation where the tax law income of a trust exceeds its trust law income in a particular income year:
    - *The trust deed does not define income.* The tax law income and trust law income of a trust are different. Under the trust deed, the trustee can only vest absolutely in interest or pay income of the trust according to trust law concepts of capital and income. Therefore, trustees will not be able to vest absolutely in interest or pay an amount that equates to deemed income. The deemed income will be treated and taxed as trustee income. This would be the case in any income year.
    - *The trust deed defines trust law income as income calculated for income tax purposes.* The tax law income and trust law income of a trust are the same. Under the trust deed, the trustees can vest absolutely in interest or pay income of the trust to beneficiaries according to tax law. To the extent that there are sufficient amounts available in the trust fund, trustees may vest or pay amounts that equate to deemed income. The deemed income will then give rise to beneficiary income.
    - *The trust deed defines income using trust law concepts of capital and income, but the trustees have the power to distribute trust capital to income beneficiaries.* The tax law income and trust law income of a trust are different, but the trustees have the power to vest or pay amounts that are more than trust law income to income beneficiaries. To the extent the trustees actually vest absolutely in interest or pay amounts equating to deemed income, the deemed income will give rise to beneficiary income.

12. Therefore, deemed income is never of itself "beneficiary income", but by a combination of the relevant trust deed and the trustees' actions, deemed income can in some situations give rise to beneficiary income. However, any vesting or payment of deemed income must be effective for trust law to be beneficiary income for tax purposes. Where it is not vested absolutely in interest in, or paid to, a beneficiary, deemed income that is in excess of trust law income is taxed as trustee income. Trustees should, if uncertain, seek legal advice on whether, in a particular income year, their particular trust deed allows them to vest absolutely in interest or pay amounts from the trust fund equating to deemed income.

Introduction

13. This Interpretation Statement considers whether income deemed to arise under the Act can be beneficiary income under s HC 6. This issue arises most commonly when the income of a trust under tax law is different from the income of a trust under trust law. A divergence between tax law income and trust law income may occur because of the different rules that apply to each area of law. Trust law requires trustees to treat incomings and outgoings in a particular way, and that treatment is not necessarily aligned with the treatment of such incomings and outgoings under the tax rules.

14. In this Interpretation Statement, "deemed income" is income that arises only because of the provisions of the Act. The income has no necessary counterpart in terms of cash flow to a trust, or income for trust law purposes (although there may be a cash flow to another entity). Deemed income arises in several places under the Act, including under s CP 1 (which attributes income to an investor in a multi-rate portfolio investment entity), s CQ 1 (which provides that attributed controlled foreign company income of a person is income), s CQ 4 (which provides that foreign investment fund income of a person is income) and s CB 32B (which provides that look-through company income is income of an owner based on their effective look-through interest).

15. In addition, there are other types of income that arise under the Act that correspond to a cash flow,

but nevertheless create a mismatch between tax law income and trust law income. Sometimes the cash flow may arise in a different income year than the year the trust is treated as deriving it. The financial arrangements rules in subpart EW may give rise to such timing mismatches. Some types of income correspond to cash flows to the trust, but those receipts might be characterised differently under trust law and tax law. For example, the rules in ss CB 6 to CB 15 may treat amounts derived on the disposal of land as income, while a trust may characterise those amounts as being on capital account. While the focus of this Interpretation Statement is on deemed income that does not necessarily correspond to a cash flow, the same reasoning could also apply to these other kinds of income that create a mismatch between tax law income and trust law income.

ANALYSIS

16. The main issue in this Interpretation Statement is whether income that arises under tax law, but not under trust law, can be beneficiary income for tax purposes. The analysis in this Interpretation Statement considers this issue under the following main headings:
    - Tax law (including consideration of the definition of "beneficiary income" in s HC 6 and the meaning of the terms "vests absolutely in interest in a beneficiary" and "paid");
    - Trust law; and
    - Application of the law.

17. Some practical examples are then set out at the end of the Interpretation Statement to illustrate the tax treatment of deemed income when the tax law income of a trust exceeds the trust law income of the trust under general trust law principles.

Tax law

18. To understand beneficiary income under tax law, it is useful to understand broadly how the trust rules in the Act apply. Under the Act, there are three types of trusts: complying trusts, foreign trusts, and non-complying trusts. This Interpretation Statement applies to the vesting or payment of income to beneficiaries by these three types of trusts. Trust income is dealt with in ss HC 5 to HC 7. Section HC 5 provides that an amount of income derived by a trustee of a trust is either trustee income or beneficiary income. Section HC 6 provides a definition of what is beneficiary income. (Section HC 6 is the key provision in determining whether deemed income can be beneficiary income and is discussed in detail below.) Section CV 13(a) provides that an amount derived by a person is income of the person if it is beneficiary income to which s HC 6 applies. Section HC 7 provides that an amount of income derived by a trustee of a trust is trustee income to the extent to which it is not beneficiary income. Therefore, in a sense the default position is that income derived by trustees of a trust will be taxed to the trustees.

19. Section HC 5(2) provides that if a trustee is treated as having an amount of income in an income year under a provision in the Act and that amount is not derived under ordinary concepts, then the amount is treated as derived in the income year.

20. Complying trusts, foreign trusts and non-complying trusts can all vest or pay amounts to beneficiaries and, provided s HC 6 is satisfied, this will be beneficiary income for tax purposes. If a trust does vest or pay beneficiary income, then that income will be taxed at the beneficiary's marginal tax rate. For a complying trust, an amount vested in, or paid to, a beneficiary that is not beneficiary income will be exempt income to the beneficiary: s HC 20. This reflects the fact that the amount will already have been taxed as trustee income. If a non-complying or foreign trust makes a distribution to a beneficiary that is not beneficiary income under s HC 6, then that distribution may potentially be a taxable distribution (if it is not one of the other types of distributions listed in s HC 15(2) and s HC 15(4)).

21. The trustees are responsible for paying the tax on beneficiary income. Section HC 32(3) provides that, in the trustee's capacity as agent, the trustee must satisfy the income tax liability of the beneficiary for their beneficiary income and any taxable distributions derived by the beneficiary.

What is "beneficiary income"?

22. The focus of this Interpretation Statement is on whether tax law income that does not have a trust law counterpart can be beneficiary income for tax purposes. Certain requirements must be satisfied for an amount to be beneficiary income. Section HC 6(1) defines "beneficiary income":

> **HC 6 Beneficiary income**
>
> *Meaning*
>
> (1) An amount of income derived in an income year by a trustee of a trust is beneficiary income to the extent to which—
>
> (a) it vests absolutely in interest in a beneficiary of the trust in the income year; or
>
> (b) it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B).

INTERPRETATION STATEMENTS

23. Section HC 6(1B) provides the date by which income must be allocated for the purposes of s HC 6(1)(b):

    Date by which income must be allocated

    (1B) The date referred to in subsection (1)(b) is the later of the following:

    (a) a date that falls within 6 months of the end of the income year; or

    (b) the earlier of—

    (i) the date on which the trustee files the return of income for the income year; or

    (ii) the date by which the trustee must file a return for the income year under section 37 of the Tax Administration Act 1994.

24. Section HC 6(1) refers to an amount of "income" derived by a trustee. "Income" is defined in s YA 1 to mean income of the person under s BD 1(1). Section BD 1(1) provides that an amount is income of a person if it is their income under a provision in Part C of the Act. The significance of this is that the concept of income derived by a trustee in s HC 6 is a reference to the tax law income of the trustee and not the trust law measure of income of a trustee. Importantly, such tax law income of the trustee is beneficiary income only "to the extent to which" it is vested absolutely in interest in, or paid to, a beneficiary under s HC 6. As will be discussed below, the provisions of the trust deed bind a trustee as to what can be vested absolutely in interest in, or paid to, a beneficiary. Therefore, beneficiary income is fundamentally determined according to trust law.

25. The definition of beneficiary income provides for two specific exclusions: (a) an amount of income derived by a trustee of a trust in an income year in which the trust is a superannuation fund; and (b) an amount of income derived by a trustee that is income to which ss CC 3(2) and EW 50 (which relate to income that arises on the forgiveness of a debt) apply. This suggests that all other income derived by a trustee can potentially be beneficiary income for tax purposes. In addition, income that arises on the forgiveness of a debt, which could be considered a type of deemed income, is specifically excluded. The implication from this is that it might otherwise be trustee income or beneficiary income.

26. Therefore, s HC 6 does not, on its face, preclude other types of income from giving rise to beneficiary income, including amounts of deemed income. Section HC 5(2) would seem to also support this. As noted above, s HC 5(2) provides that if a trustee is treated as having an amount of income in an income year under a provision in the Act and that amount is not derived under ordinary concepts, then the amount is treated as derived in the income year. This subsection is essentially a timing provision for the derivation of income arising under the Act, but it also suggests that amounts of income that are not derived under ordinary concepts can potentially be trustee income. This, coupled with the fact that there are only two specific exclusions in the definition of beneficiary income (one being a kind of deemed income), suggests that other types of deemed income can potentially be beneficiary income.

27. However, it is also necessary to determine whether an amount of income derived by a trustee has been vested absolutely in interest in, or paid to, a beneficiary. This is a central requirement of beneficiary income under s HC 6. The Commissioner considers that s HC 6 requires an examination of what has occurred within a trust to determine whether an amount of income derived by a trustee has actually been vested absolutely in interest in, or paid to, a beneficiary. This is because s HC 6 is based on concepts of trust law, including "trustee", "beneficiary" and "vests absolutely in interest". Whether deemed income may be vested absolutely in interest in, or paid to, a beneficiary under general principles of trust law is discussed further below. However, the meaning of "vests absolutely in interest" and "paid" in s HC 6(1) must be determined first.

Section HC 6(1)(a): "vests absolutely in interest"

28. Section HC 6(1)(a) provides that an amount a trustee derives in an income year will be beneficiary income to the extent it vests absolutely in interest in a beneficiary. The gross income must not only "vest absolutely in interest in a beneficiary", but the vesting must occur "in the income year".

29. The phrase "vests absolutely in interest" is not defined in the Act. Vesting is a trust law concept. Therefore, trust law must be considered to determine the meaning of "vests absolutely in interest".

30. The words "vest" and "vested in interest" are defined in *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis, Wellington, 2005):

    vest 1. To deliver to a person the full possession of land, and so to clothe him or her with the legal estate therein. 2. To become a vested interest.

    vested in interest A phrase used to indicate a present fixed right of future enjoyment, as reversions, vested remainders, and other future interests which do not depend on a period or event uncertain. For an interest to be vested in interest the persons who are to take it must be ascertained and there must be

> no condition precedent other than the determination of the prior interest.

31. The glossary in N Kelly, C Kelly and G Kelly, *Garrow and Kelly Law of Trusts and Trustees* (6th edition, LexisNexis, Wellington, 2005) also defines "vesting" and "vested in interest":

> *Vesting* When a person becomes absolutely entitled to the eventual ownership of certain property or a defined part of a fund, that ownership right is said to be vested. …
>
> *Vested in interest* A vested right to receive property at a future time.

32. Some guidance on the meaning of the term "vests absolutely in interest" can also be gained from considering cases on earlier trust provisions in the New Zealand tax legislation. The cases include *Doody v Commissioner of Taxes* [1941] NZLR 452 (SC), *Commissioner of Taxes v Johnson and Maeder* [1946] NZLR 446 (CA), *Blathwayt v CIR* (1973) 1 NZTC 61,112 (SC) and *CIR v Simpson* (1989) 11 NZTC 6,140 (CA).
33. These cases considered legislation where the relevant statutory test for an amount to be income of a beneficiary was that the beneficiary was "entitled in possession" to the income. The case law continues to be relevant because the test of "entitled in possession" was found to require that the income be vested absolutely in interest in the beneficiary and that the beneficiary be entitled to the receipt of the income. Accordingly, the discussion in those cases of what was required for something to be vested absolutely in interest (as a part of being "entitled in possession") is still relevant to the interpretation of the words "vests absolutely in interest".
34. It has been held in the context of New Zealand trust taxation legislation (in particular s 102(b) of the Land and Income Tax Act 1923) that "vested" means indefeasibly vested in the sense of finally and absolutely vested and not merely defeasibly vested: *Johnson and Maeder*. The use of the word "absolutely" makes it even clearer that income must vest indefeasibly in a beneficiary to satisfy the vests absolutely in interest requirement. In addition, where income is future property or an expectancy the vesting will not be effective until the income is received or receivable: *Garrow and Kelly Law of Trusts and Trustees*, from 45–47; see also *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155 (HC)).
35. In *Doody*, two infant beneficiaries were entitled to one third each of their father's estate under the Administration Act 1908. During the income years in question, the administrators applied some of the infant beneficiaries' entitlement for their maintenance and education. In relation to the beneficiaries' entitlements that had not been applied for their benefit, the court accepted that the shares of the infant beneficiaries in the estate were indefeasibly vested. However, being infants, the beneficiaries could not demand receipt of their entitlements. Smith J said, at 457, that for a beneficiary to be "entitled in possession" they must be a person who has not only a right to the income that is absolutely vested but also be entitled to the actual receipt of that income under the terms of the trust during the income year in question.
36. The Court of Appeal in *Simpson* came to the same conclusion. In that case the Commissioner attempted to tax the taxpayer and his wife as discretionary beneficiaries under a trust. The trustees had resolved to appropriate income for a particular income year to the taxpayer's two infant children. The money was paid into the joint account of the taxpayer and his wife. Richardson J found that the money was paid to the taxpayer and his wife in a fiduciary capacity for the children and not in their own right as beneficiaries under the trust. The court accepted that the resolution of the trustees was validly passed and legally effective to confer on the infants an absolute and indefeasibly vested interest in the income for the year. That decided the issue in the case, but Richardson J went on to approve the earlier New Zealand authorities and expressed doubt that infant beneficiaries could be entitled in possession (which was the legislative requirement for income to be beneficiary income). Somers J also endorsed the earlier decisions of *Doody* and *Blathwayt*, while Wylie J expressed no view on this. The implication is that the income should instead have been taxed as trustee income because, although the income was vested absolutely, the infant beneficiaries were not entitled in possession.
37. In *Davidson and Duke v CIR* (1976) 2 NZTC 61,121 the court considered different ways in which a trustee could vest amounts in (or pay or apply amounts to) a beneficiary. In that case, the trustees signed a memorandum recording their decision that "income from the trust be allocated" to certain beneficiaries on the basis of a two-thirds share going to one of the children and a one-third share to the other. The court found that such an "allocation" was sufficient to vest the amounts in the beneficiaries.
38. The relevant legislation at the time referred to both "vest" and "pay or apply". Somers J did not

differentiate between "vest" and "pay or apply" but concluded that trustee resolutions would be sufficient to "vest" or "pay or apply" income to beneficiaries if they used wording that:

- "allocated" amounts to beneficiaries;
- provided an amount "shall belong to" beneficiaries; or
- stated income "shall be disposed of … to be held for the credit of" beneficiaries.

39. In 1988, the legislation was changed. The test had been whether the beneficiary was "entitled in possession" to the income. This test was changed to the current test of "vests absolutely in interest". This was understood to be a widening of the test for "beneficiary income".

40. Therefore, "vests absolutely in interest" means a present fixed right of future enjoyment. This means that the beneficiary need not receive the amount vested at the time of vesting absolutely in interest, but they must have an indefeasible right to that part of the trust fund. For an amount of deemed income to be vested absolutely in interest in a beneficiary, the amount must be dealt with by a provision of the trust deed, the actions of the trustee, or both. Vesting absolutely in interest may occur because the trust deed specifies that income will be dealt with in a certain way. Alternatively, the trust deed may facilitate the vesting but not provide for it, so it will be vested only if the trustees take some action to vest it. This illustrates an important point: "deemed income" will not always give rise to beneficiary income. A provision of the trust deed, the actions of the trustees, or both, must grant a fixed right of future enjoyment to an amount of deemed income for the deemed income to give rise to beneficiary income under s HC 6(1)(a). Where the deemed income is not beneficiary income for tax purposes, it is trustee income.

41. Based on the cases discussed above, the mechanisms by which an amount can vest absolutely in interest in a beneficiary include:
    - a provision of the trust deed that vests the income in the beneficiaries;
    - a resolution of the trustees vesting the income in the beneficiaries;
    - a payment to, or crediting to an account of, the beneficiaries in the income year (or, as in *Simpson*, even a payment into the beneficiaries' parents' bank account).

Section HC 6(1)(b): "paid to a beneficiary"

42. This part of the analysis considers the meaning of "paid" in s HC 6(1)(b). Section HC 6(1)(b) provides that an amount a trustee derives in an income year will be beneficiary income to the extent it is "paid" to a beneficiary. The word "paid" is not defined in the Act. However, the word "pay" is defined in s YA 1 and provides (as relevant):

    > **pay,—**
    >
    > (a) for an amount and a person, includes—
    >
    > (i) to distribute the amount to them:
    >
    > (ii) to credit them for the amount:
    >
    > (iii) to deal with the amount in their interest or on their behalf, in some other way:
    >
    > …

43. Section 32 of the Interpretation Act 1999 makes it clear that all parts of speech and grammatical forms of a word are to have the same meaning throughout the Income Tax Act, unless the context takes a different meaning (see also *Tax Information Bulletin* Vol 20, No 2 (March 2008), which provides commentary on the rewrite of parts M to Z of the Income Tax Act 2007). Therefore, the definition of "pay" in s YA 1 is relevant in determining the meaning of "paid" in s HC 6(1)(b).

44. Before the Income Tax Act 2007, the definition of "beneficiary income" was different to the current definition in s HC 6. In particular, the definition of "beneficiary income" in s OB 1 of the Income Tax Act 2004 included an amount derived by a trustee to the extent to which the trustee "pays or applies it to or for the benefit of the beneficiary".

45. The new definition of "beneficiary income" removed two parts of the old definition relating to the word "applies":
    - the reference to the trustee applying income "to" a beneficiary;
    - the reference to the trustee applying income "for the benefit of" the beneficiary.

    Section HC 6(1)(b) now applies to an amount to the extent to which "it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B)".

46. The definition of "pay" in s YA 1 is noted in schedule 51 of the Act ("Identified changes in legislation"), but the annotation is as follows:

    > The provision is simplified and structured so it is to apply generally for the Act. This is consistent with the objectives of plain accessible legislation and is thought highly unlikely to result in any material change in law. However, as this change in drafting

could conceivably result in a change in outcome in some circumstances, the change should be identified for readers.

Schedule 51 makes no reference to s HC 6. It would seem this change was intended to simplify the definition of "beneficiary income" by relying on the definition of "pay" in s YA 1, rather than being a change to the definition of "beneficiary income".

47. The definition of "beneficiary income" in s HC 6 no longer refers to a trustee applying income to or for a beneficiary. In addition, the new definition of "pay" does not use the word "apply". The new definition now includes, in subparas (ii) and (iii), crediting a person for an amount, or dealing with an amount in a person's interest or on their behalf. The question that arises is whether the definition of "pay" is wide enough to encompass concepts previously covered by the word "apply". It is therefore helpful to look at case law on "apply" to determine whether that concept is covered by the new definition of "pay" in s YA 1.

48. The leading New Zealand decision on "paid or applied" is *CIR v Ward* [1970] NZLR 1 (CA). This was a majority decision of the Court of Appeal with North P and McCarthy J in the majority, and Turner J dissenting. The facts of the case involved a trust deed under which property was held on trust for four children. The children were entitled to the trust property (including capital and income) when they reached the age of 21. For the year ended 31 March 1963, the trustee made a declaration that she held the trust income in stated amounts for each of the four infant beneficiaries. The declaration was made before the end of the income year, but no entries were made in the trust accounts until after the end of the income year. The Commissioner assessed the trustee with income tax on the whole of the income of the trust, on the basis that the declaration was inadequate to transfer the income to the beneficiaries. The majority of the Court of Appeal found that the income had been applied to the beneficiaries.

49. The majority concluded that once the trustee had made the declaration for the children, who until then merely had a contingent interest, the children became absolutely entitled to the sums allotted to them. The trustee's declaration was an application of income. The majority also considered that when the trustee made her declaration it was a matter for her to determine what income was presently available. There was nothing before the court to justify the conclusion that the income was not presently available. The declaration by the trustee amounted to an application.

50. The decision in *Ward* establishes that a trustee will be able to apply a presently available amount to a beneficiary simply by way of a declaration. The effect of *Ward* is that it is not necessary for that declaration to be reflected in the books of the trust in the relevant period, nor is an actual payment of the amount to the beneficiary or beneficiaries required at the time of the application.

51. Subparagraph (i) of the definition of "pay" refers to the ordinary meaning of "pay": namely, to distribute (cash or other consideration) or to otherwise transfer funds to a person. However, subparas (ii) and (iii) of the definition appear to cover other situations that were previously covered by the word "applies". Subparagraphs (ii) and (iii) apply to crediting the beneficiary for the amount, and dealing with the amount in their interest or on their behalf in some other way. The situation in *Ward*, where a declaration by a trustee amounted to an application, would fall within subparas (ii) or (iii).

52. In addition, a recent case supports the view that the expanded definition of "pay" is broad enough to cover the concepts previously covered by the word "applies". The case is the High Court decision of Clifford J in *CIR v Albany Food Warehouse* (2009) 24 NZTC 23,532. The case concerned the timing of a dividend payment. Section ME 5(1)(a) of the Income Tax Act 1994 provided there would be a debit to the company's imputation credit account for imputation credits attached to a dividend "paid" by the company. Section OB 1 of the Income Tax Act 1994 defined "paid" for the imputation rules to include any amount distributed, credited, or dealt with in the interest of, or on behalf of, a person. On 6 June 2001, the directors of the company declared a fully imputed dividend. The dividend was resolved by the directors to be credited to the relevant shareholders' current accounts, with payment from those accounts conditional on the shareholders agreeing to subordinate their claims to the company's creditors generally and only to be made "as and when finance permits". The shareholders agreed to those terms that day. Later that day, there was a change in shareholding in the company. This change breached shareholder continuity.

53. If the dividend was paid before the breach of continuity, the company would be able to attach those credits to the dividend payment. However, if the dividend was not paid before the breach, the credits would be forfeited and any eventual dividend would potentially have no credits available to be attached. Clifford J concluded (at [27] and [28]):

> [27] I have little difficulty in concluding that the directors' resolution provided for the "crediting" of the dividend to the shareholders' current accounts within the meaning of the word "credited" as it appears in s OB 1 in para (g) of the extended definition of "paid".
>
> [28] In my judgment, and as a matter of general company law, the effect of the directors' resolution, albeit together with the shareholders' resolution agreeing to the subordination terms, was that funds that were previously available to the directors, in their discretion to apply for the purposes of the respondent's business generally, were placed outside the directors' control and became debts due and owing to the shareholders and able to be sued for as such if not paid on their terms, and proved for in liquidation. This substantive change is reflected in the accounting treatment, whereby amounts that had previously stood to the credit of the shareholders' funds of the respondent, were re-categorised by the dividend resolution and became credits in the shareholders' current accounts. As the respondent in my view correctly submitted, the declaration and subsequent crediting of the dividend amount to the shareholders' current accounts therefore constitute a "crediting".

54. The similarities between the resolution in *Albany Food Warehouse* and the declaration in *Ward* suggest that the use of the term "applies" and the extended definition of "paid" (or "pay" in the current legislation) lead to a similar result. As such, the removal of the word "applies" from the definition of "beneficiary income" and its absence from the definition of "pay" do not alter the scope of what is "beneficiary income" under the 2007 Act.

55. Given the decision in *Albany Food Warehouse*, and that schedule 51 suggests there has been no material change in the law, the Commissioner considers that the revisions to s HC 6 and the definition of "beneficiary income", and the reliance on the meaning of "pay" in s YA 1, are not intended to change what is "beneficiary income". Therefore, the previous law and commentary on the meaning of "beneficiary income" (including the case law on the meaning of "applies") are still relevant.

Effect of the deeming provisions

56. Whether there are any limits on the effect of a provision that deems an amount of income to arise must also be considered. In particular, whether the deeming of income is limited so that it can be taxed only as trustee income, or whether the effect is broader so that deemed income could potentially be beneficiary income.

57. In FAR Bennion, *Bennion on Statutory Interpretation* (5th ed, LexisNexis, London, 2008) at 950 the author states that "[t]he intention of a deeming provision, in laying down a hypothesis, is that the hypothesis shall be carried as far as necessary to achieve the legislative purpose, but no further". At 1,004 the author notes that "[w]henever an Act sets up some fiction the courts are astute to limit the scope of its artificial effect. They are particularly concerned to ensure that it does not create harm in ways outside the intended purview of the Act". Both of these comments make it clear that deeming provisions in an Act need to be given effect to, but should not be construed any more widely than absolutely necessary. In a tax context this will often mean that a deeming provision will only have effect within the tax legislation and will not have wider consequences for other areas of law (such as company law or trust law).

58. This Interpretation Statement is concerned with whether deemed income can be beneficiary income. As deemed income can be income of a trustee as a taxpayer, the Commissioner considers that this deeming must take effect at least for a trustee in all relevant contexts in the Act. A trustee cannot argue that the deeming does not apply for all of the trustee's various responsibilities under the Act. The question then is whether, in a deemed income context, there is any indication in the Act that the portion of a trustee's income that relates to deemed income should not be able to be beneficiary income. There does not appear to be any obvious indications of this. There are no clear policy indications or principles that would lead to such a rule. Indeed, as already noted, arguably s HC 5(2) suggests otherwise.

59. Therefore, under the Act, the position is that deemed income can potentially be beneficiary income provided it is vested absolutely in interest in, or paid to, a beneficiary. However, the income deemed to arise under the Act does not exist in trust law. This is because the deeming provisions only operate within the context of tax law.

Summary of New Zealand tax law

60. The discussion of New Zealand tax law above establishes that for income derived by a trustee to be beneficiary income either it must be vested absolutely in interest in the beneficiary within the income year it was derived, or it must be "paid" (in the broad sense of that term) to the beneficiary in the income year or within the time limits in s HC 6(1B).

61. The notion of vesting absolutely in interest in s HC 6(1)(a) is that the amount derived is indefeasibly vested in

the beneficiary. The beneficiary obtains an immediate right of future possession of the income. The income must not be future property or an expectancy. An amount of income is "paid" under s HC 6(1)(b) if it is actually paid, distributed, credited or dealt with in the beneficiary's interest. The *Ward* case establishes that a declaration of trust allocating income to a beneficiary is sufficient. Based on the decision in *Davidson and Duke*, an application of income can occur even if a specific sum is not allocated to a beneficiary, as long as there is some mechanism to apply the income.

62. In practice, there may be some overlap between the concept of "vest absolutely in interest" at common law and the definition of "pay" in s YA 1, particularly since neither concept necessarily requires an immediate payment of an amount in order to be effective.

63. Section HC 6(1) does not make a distinction between different types of income derived by a trustee (except for the two exclusions in s HC 6(2)). Therefore, nothing under the Act appears to prevent deemed income from giving rise to beneficiary income for tax purposes. However, s HC 6 requires an examination of what has happened in the trust. This is because s HC 6 requires income to vest absolutely in interest in, or be paid to, a beneficiary before it can be beneficiary income. A trustee is bound by the terms of the trust deed and general trust law as to how they may deal with the trust fund. For an amount from the trust fund to vest absolutely in interest in, or be paid to, a beneficiary, the trust deed must provide for such vesting or payment, or the trustee must have a power to do so under the trust deed. This is discussed further below.

64. Finally, income deemed to arise under the Act does not exist in trust law. This is because the deeming provisions operate only within the context of tax law. Whether deemed income can vest absolutely in interest in, or be paid to, a beneficiary, as a matter of trust law, will now be discussed.

Trust law

65. Trust law must be considered to understand when amounts derived by a trustee may be beneficiary income. This is because trustees are bound to adhere to the terms of the trust deed when they make distributions from the trust fund to beneficiaries. This applies to amounts vested absolutely in interest in or paid to beneficiaries under s HC 6, whether deemed income or not.

66. One of the leading New Zealand texts on trust law is *Garrow and Kelly Law of Trusts and Trustees*. This text explains the nature of a trust as follows (at 3):

> 1.1.1 A trust is an equitable obligation under which a person (the "trustee") having control of property is bound to deal with that property either:
>
> (a) For the benefit of definite persons (of whom that trustee may be one) and any one of whom may enforce the obligation; or
>
> (b) For some object or purpose permitted by law.

67. Amounts that are deemed income exist only for tax law purposes and do not result in an actual cash flow or an accretion to the trust in the relevant income year, if at all. This is because the deeming provisions in the Act only operate within tax law. The deeming provisions in the Act do not cause the deemed income to exist for trust law purposes. Therefore, such an amount could not itself be distributed to a beneficiary as a matter of trust law.

68. The trust law distinction between capital and income is particularly relevant in determining whether deemed income can be beneficiary income. Traditionally, the need to classify capital and income under trust law is one of the fundamental fiduciary duties of a trustee and this continues to be the case for many modern trusts. There are legal impediments to the trustees treating the amounts differently to accord with a tax treatment.

69. Chapter 22 of *Law of Trusts and Trustees* is entitled "Capital and Income" and refers to the distinction between these two concepts. This distinction is important where a trust has both capital and income beneficiaries. An example is a conventional life estate with a remainder interest—when assets are held on trust to pay the income to "A while A is alive and after A has died to transfer the assets to B".

70. The authors state that the basic duty of a trustee (which is a fiduciary duty) is to ensure that each beneficiary receives everything he or she is entitled to (at 22.1.3). As a result, trustees need to identify carefully what is to be treated as capital and income and ensure the appropriate beneficiaries receive such amounts. The authors observe that the distinction between capital and income is relevant only to the extent the trust deed requires this. Ultimately it is the trust deed that indicates what each beneficiary is entitled to receive. The trust deed may define what is to be treated as capital and what is income. In the absence of any such indication in the trust deed the courts must apply the long-established trust law principles distinguishing capital and income.

71. At 22.1.4 and 22.1.5, the authors comment that capital and income mean different things for income tax, accounting and trust law. At 22.1.6 they state that

for trust law purposes trustees cannot simply rely on tax law, generally accepted accounting principles or international financial reporting standards.

72. The authors say a trust may provide that a life interest beneficiary is entitled to the income of the trust, and the capital reverts to the remainder interest in the estate or the trust. Therefore, only income as determined by trust law can be distributed to an income beneficiary. Any amount greater than this received by the trust must be treated as a capital sum attributable to the capital beneficiary.

73. At 22.2 the authors discuss two cases that demonstrate the importance of distinguishing correctly between capital and income: *Wong v Burt* [2005] 1 NZLR 91 (CA) and *Wendt v Orr* [2004] 6 ITELR 989; [2004] WASC 28. In *Wong*, over $300,000 was wrongly paid to the income beneficiary in 1989 and the capital beneficiary plaintiffs were able to recover that sum 14 years later.

74. Not all trusts provide separately for capital and income beneficiaries. At 22.1.6 the authors state that life interest provisions in wills are less common than they were in the past. Where funds do need to be held on trust for a beneficiary, trustees often have the power to apply capital and income as required. The authors state:

> Similarly most modern family trusts are more flexible discretionary trusts with income and capital payable at the trustees' discretion. Such provisions avoid the sometimes artificial (and difficult) distinction between income and capital.

75. The important point to understand is that under trust law, trustees must act within the powers given to them by the trust deed. Trustees acting under their fiduciary duties must carefully consider any distinctions required under the trust deed to avoid legal consequences. If, as in *Wong*, the trustees must distinguish between capital and income, trustees must be careful when making distributions. Some other relevant trustee duties include the duties to:

- adhere to the terms of the trust;
- act fairly by all the beneficiaries (also called the duty of impartiality or even-handedness); and
- keep proper accounts of the trust.

76. It is not possible to cover all the different types of trust deeds in this Interpretation Statement. Instead, it is essential that trustees are familiar with their trust deeds. Trustees should also, if uncertain, seek legal advice on whether, in a particular income year, their particular trust deed allows them to vest absolutely in interest or pay amounts from the trust fund equating to deemed income.

Application of the law

77. It is helpful to summarise the above discussion of tax and trust law. As discussed above, the definition of "beneficiary income" in s HC 6 refers to an amount of income derived in an income year by a trustee. The word "income" is a defined term in the Act. Therefore, the income of the trustee referred to in s HC 6(1) is a tax law measure of income, and not the trust law measure of income. However, while the income of a trustee may be measured on a tax law basis, such income is only beneficiary income to the extent to which it:

- vests absolutely in interest in a beneficiary; or
- is paid to a beneficiary in the income year or within the time limits specified in s HC 6(1B).

78. Section HC 6 works on the premise that the trustee has derived the income, so it must be the trustee who is paying that income to the beneficiary. Accordingly, although the tax measure of income may exceed the trust measure, no statutory mechanism exists in s HC 6 to make the tax law measure the relevant measure when it comes to beneficiary income. That is, when the tax law income of a trust is greater than its income according to trust law, the excess tax law income does not automatically become beneficiary income.

79. Under s HC 6(1)(a), an amount will vest absolutely in interest in a beneficiary where the beneficiary obtains an immediate right of present or future possession of the income. This means the beneficiary need not receive the amount vested absolutely in interest at the time of vesting, but they must have an indefeasible right to that part of the trust property. In a trust relationship, this can happen only where a provision of the trust deed, the actions of the trustee, or a combination of both, provides for such income to be vested absolutely in interest in a beneficiary. This requires a focus on what is possible under the trust deed. If the trustees attempt to act outside the trust deed they risk breaching their fiduciary duties to the beneficiaries.

80. Beneficiary income includes not only amounts that are vested absolutely in interest but also amounts that are paid (s HC 6(1)(b)). As seen, the word "paid" includes distributing an amount to a beneficiary, to credit a beneficiary for an amount, and to deal with the amount in a beneficiary's interest or on their behalf in some other way. Implicit in the definition is that it is the action of the trustee that gives rise to something

being paid, because the trustee is the person who has the authority to undertake such actions. As with vesting absolutely in interest, this requires a focus on what is possible under the trust deed. If the trustees attempt to act outside the trust deed they risk breaching their fiduciary duties to the beneficiaries.

81. For an amount of income derived by a trustee to be beneficiary income, the amount must actually vest absolutely in interest in, or be paid to, the beneficiary. A trustee is bound by the terms of the trust deed in relation to the vesting or payment of amounts from the trust fund. Therefore, any vesting absolutely in interest or payment of an amount of trustee income must be effective for trust law for it to be beneficiary income. This is true for all types of income derived by a trustee, not just deemed income.

82. However, as noted above in the discussion of trust law, amounts that are deemed income amounts exist only for tax law purposes and do not result in an actual cash flow or an accretion to the trust because the deeming provisions in the Act only operate within tax law. The deeming provisions in the Act do not make the deemed income exist for trust law purposes. Therefore, deemed income could not itself be vested absolutely in interest in, or paid to, a beneficiary as a matter of trust law.

83. In addition, the two limbs of s HC 6 require something to have happened within the trust. That is, the trustee must actually vest absolutely in interest in, or pay something to, a beneficiary. The Commissioner considers a trustee cannot vest absolutely in interest, or pay, notional amounts. However, the Commissioner will recognise deemed income as beneficiary income for tax purposes if an equivalent actual amount of the trust fund is vested absolutely in interest in, or paid to, a beneficiary.

When trust law income is the same or exceeds tax law income

84. When the trust law income of a trust is the same as, or exceeds, the tax law income of a trust in an income year, the Commissioner considers that amounts of deemed income will be able to vest absolutely in interest in, or be paid to, beneficiaries as a matter of trust law. In this situation, sufficient trust income will exist to support the vesting or payment of the tax law income, including the deemed income. Provided sufficient amounts of trust income are actually vested absolutely in interest in, or paid to, beneficiaries in a way that is effective for trust law, the deemed income will satisfy s HC 6 and will be taxed as beneficiary income.

85. The Commissioner considers that the trustees will generally not need to resolve that the actual amount of trust income is a vesting or payment of deemed income for tax purposes (compare the situation discussed below where tax law income exceeds trust law income). However, depending on the terms of the trust deed, to make the vesting or payment effective for trust law, trustees might still need to make a resolution exercising their discretion to actually vest absolutely in interest or pay the trust income.

When tax law income exceeds trust law income

86. When the tax law income of a trust is greater than its trust law income under trust law the excess tax law income cannot simply be vested absolutely in interest in, or paid to, beneficiaries unless the trust deed expressly provides a way for this to happen. This is because the trustee is limited to the amounts in the trust fund available to be vested absolutely in interest in, or paid to, beneficiaries. For deemed income to be beneficiary income under s HC 6, the vesting absolutely in interest in, or payment to, the beneficiary must be effective for trust law.

87. If the trust deed makes a clear distinction between capital and income beneficiaries, or defines the meaning of income by applying traditional trust law concepts, legal impediments will exist to prevent the trustee making payments to a beneficiary to match the amount of deemed income arising under tax law. First, the trustee will be bound by the terms of the trust deed as to what it can vest absolutely in interest in, or pay, to beneficiaries. Trustees may have no discretion as to what each beneficiary is entitled to. Secondly, if the tax law income of the trust exceeds the trust law income, the trustees will be unable to vest or pay an amount from the trust fund equating to the excess tax law income amount. A beneficiary entitled to a fixed amount will not be able to receive any more than their entitlement. Similarly, beneficiaries entitled to a proportion of trust income will only be entitled to receive a share of the trust income as determined under trust law. In such situations, the excess tax law income must be taxed as trustee income.

More flexible trust deeds

88. Some of these legal impediments may be overcome by different formulations of the trust deed. If, under the trust deed, trustees are able to distribute amounts that are more than the trust law definition of income, the trustees may be able to vest absolutely in interest or to pay amounts available in the trust fund equating to deemed income. For instance, some discretionary trusts allow the trustees to distribute capital and

income to beneficiaries as they see fit. Also, some trust deeds give trustees the discretion to distribute capital to income beneficiaries. In these situations, the distinction between capital and income becomes less important and amounts of capital could be used to vest absolutely in interest or to pay deemed income to income beneficiaries. It is, therefore, the terms of the trust deed, or the actions of the trustees (or both), that allows the deemed income to become beneficiary income for tax purposes.

89. If "income" is defined in the trust deed to mean income calculated for income tax purposes, the trustees may vest absolutely in interest or pay amounts that equate to the deemed income to the beneficiaries. In this situation, the tax law income and trust law income of the trust are the same. Similarly, if trustees have discretion as to how they characterise receipts (that is, whether as capital or income), they will be able to vest absolutely in interest in, or pay a greater sum to, income beneficiaries than the conventional trust law definition of income. Where the trust is a flexible trust with all beneficiaries able to receive capital and income, there will similarly be a greater flexibility to vest absolutely in interest or to pay sums greater than the conventional trust law definition of income. To do this, however, the trust must have an actual (non-deemed) amount that can be vested absolutely in interest in, or paid to, a beneficiary. This is because the deemed income does not exist outside tax law. The deemed income does not represent anything that can be vested absolutely in interest in, or paid to, a beneficiary.

90. Accordingly, the Commissioner considers deemed income will be beneficiary income only to the extent to which it is reflected by an actual amount vested absolutely in interest in, or paid to, a beneficiary by the trustee or under the terms of the trust. This means that, at the time the deemed income is purported to be vested or paid, the trust must have sufficient amounts in the trust fund available to be distributed to the beneficiary. This is because the trustees only have the power to deal with the trust fund. This reiterates the point made earlier that the trustee simply deriving deemed income is not sufficient for it to be treated as beneficiary income for tax purposes. If trust law is to be complied with, there must be a provision of the trust deed, or the actions of the trustees, or both, to allow the deemed income to be vested absolutely in, or paid to, the beneficiary. If the trust deed does not allow for deemed income to be vested absolutely in interest in, or paid to, the beneficiaries, or the trustees do not act in such a way as to vest or pay it, then the deemed income will remain as trustee income and be taxed accordingly. There is no automatic process outside of the trust deed, or the trustees' actions, for deemed income to become beneficiary income.

91. Tax law deems an amount of income to exist, and the Act should be read in a way that is consistent with the deemed existence of the income. Therefore, when an actual amount is vested absolutely in interest in, or paid to, a beneficiary by the trustee equal to the amount of "deemed income" (in accordance with an explicit power in the trust deed or the actions of the trustees, or both) the requirements of s HC 6 are met and the amount will be beneficiary income. The "deemed income" is not, of itself, "beneficiary income"; rather, the terms of the trust deed may enable an actual amount that reflects the "deemed income" to be vested in, or paid to, a beneficiary. In this way, the deemed income amount can then be treated as beneficiary income.

Explicit link between actual amount and deemed income required

92. The Commissioner considers that where the trustees exercise their power under the trust deed to vest or pay an actual amount to a beneficiary reflecting the amount of deemed income, then the deemed income will be taxable as beneficiary income. For an amount to "reflect" the amount of deemed income, there must be an explicit link between the amount of deemed income for tax purposes and the amount vested absolutely in interest in, or paid to, the beneficiary. Importantly, the trustees' resolution (or the trust deed) must clearly specify that the actual amount being vested absolutely in interest in, or paid to, a beneficiary is a payment of an income amount for tax purposes. For example, the trustees may resolve that the trustees are paying the sums to the beneficiaries because the amount of tax income exceeds the amount of trust income.

93. If there is no such link, then the payment may be a payment of capital or corpus (ie, the character of the actual amount) instead of a payment of the deemed income for tax purposes. Such a payment may not always be beneficiary income because the Act does anticipate payments of capital and corpus to beneficiaries. For example, if the amount that is vested absolutely in interest in, or paid to, a beneficiary is trust capital, then this will not have the effect of giving rise to beneficiary income. The vesting absolutely in interest or payment will not automatically be treated as the vesting absolutely in interest or payment of income.

94. The Commissioner considers the definition of "beneficiary income" is broad enough to include this use of an actual amount to vest or pay the deemed income amount. This is for two reasons:
    - There is "an amount of income derived in an income year by a trustee of a trust" for tax purposes, as "income" is a defined term measured using tax law concepts (and it includes the "deemed income").
    - Such an amount will be beneficiary income "to the extent to which" it is vested absolutely in interest in, or paid to, the beneficiary of the trust in the required timeframe. This requirement is met because the amount of tax law income is, factually, vested absolutely in interest in, or paid to, a beneficiary of the trust within the required timeframe by the trustees.

Source of the actual amount vested in, or paid to, a beneficiary

95. Therefore, in some situations, trustees may vest absolutely in interest in, or pay to, beneficiaries an amount that represents deemed income. The absence of an actual cash flow for the deemed income could mean that the trustees would have to take funds out of previously taxed income reserves or even trust capital to make the payment. It might be thought that payments from previously taxed income reserves or trust capital should not be taxable as beneficiary income, but should be treated as a payment of corpus or some other type of distribution (depending on the type of trust). However, the Commissioner considers this is not a concern for two reasons.

96. Firstly, the concept of "paid" is not solely about distributions of cash, but includes crediting in account, applying or otherwise dealing with, and can be as simple as a trustees' resolution that the amounts be held in the name of the beneficiaries. The concept of "vesting absolutely in interest" is similarly unconstrained. In saying that of course, as already discussed, a trustee can "vest absolutely" or "pay" only existing property. Also, there must still be a reality to any payment or vesting. Trustees can deal only with the trust fund, and any vesting or payment from the trust fund must be effective for trust law.

97. Secondly, any concern about the actual source of funds being previously taxed income confuses the source of the funds used to make any payment with the actual classification of the deemed income for tax purposes for that particular income year. That is, the key focus ought to be on the amount of income derived in the income year (ie, the deemed income). The trust property that is used to vest or pay the equivalent amount (should vesting or payment occur) is not critical.

98. Further, as a practical matter, some trustees may not necessarily keep track of the actual identity of funds used to allocate amounts to beneficiaries. Sometimes this is because trustees are not actually making a payment of cash (they are just crediting or applying it). Sometimes this is because of the way the trustees treat funds, taking into account the fungibility of money. That is, once the amounts are in a trust bank account they do not require any particular classification under the trust rules. (However, this latter point does not mean that the trust does not keep records of the amounts it earns and how they are distributed, it is just that the actual cash that the trust holds might not be tracked in this way.)

Summary

99. In summary, for an amount of income derived by a trustee to be beneficiary income under s HC 6, the vesting or payment of that amount must be effective for trust law. This also applies to amounts of deemed income. Deemed income does not exist outside tax law and does not, in itself, represent anything that a trustee could vest absolutely in interest in, or pay to, a beneficiary.

100. However, the Commissioner considers the definition of "beneficiary income" in s HC 6 of the Act is broad enough to encompass the situation where an actual amount is used to vest absolutely in interest or pay the deemed income. This will not pose any problems where the trust income under trust law concepts of capital and income is greater than or equal to the tax law income of the trust, provided that actual amounts equating to the deemed income are vested absolutely in interest in, or paid to, beneficiaries in that income year.

101. However, where the tax law income of the trust is greater than the trust income under trust law concepts of income and capital, there may be limits on the trustee's ability to vest or pay actual amounts equating to the deemed income. If it is not possible under the trust deed for an actual amount equating to the deemed income to be vested absolutely in interest in, or paid to, a beneficiary, or the trustees do not vest or pay it (in accordance with their powers under the trust deed), then the deemed income will remain as trustee income and be taxed accordingly. There is no automatic process outside of the trust deed or the trustee's actions for deemed income to become beneficiary income. Even though "paid" and "vests absolutely in interest" are wide concepts, there must

still be a reality to any vesting or payment. Trustees can deal only with the trust fund and any vesting or payment of amounts of the trust fund must be effective for trust law.

Alternative views

102. The Commissioner acknowledges there are alternative views on some aspects of this Interpretation Statement. One view is that deemed income can be beneficiary income by simply making an adjustment in the tax return of the trust. The basis for this view is that deemed income only exists for tax law purposes. Accordingly, the deemed income can be vested absolutely in interest in, or paid to, beneficiaries as beneficiary income purely for tax law purposes. The Commissioner considers this is incorrect because s HC 6 requires that something must have actually happened in the trust. This is evident from the requirement in s HC 6 that an amount of income derived by a trustee must be vested absolutely in interest in, or paid to, a beneficiary within certain time limits in order to be beneficiary income for tax purposes.

103. Another view is that deemed income can, of itself, be vested absolutely in or paid to a beneficiary. There is no need under trust law for an actual amount to be vested absolutely in interest in, or paid to, a beneficiary in order to vest or pay deemed income. In addition, it has been suggested that this is even more true for automatic vesting provisions in trust deeds. The Commissioner disagrees with this view. This is because a trustee is bound by trust law (including the terms of the trust deed) and can only vest or pay amounts from the trust fund to beneficiaries in accordance with the trust deed. The provisions in the Act that deem income to arise only operate for the purposes of tax law. The deemed income does not exist for trust law purposes and notional amounts cannot be vested or paid. An actual amount must be vested or paid that reflects the deemed income amount. This is also the case for automatic vesting situations. If this is done effectively under the trust deed, the Commissioner will recognise this as effective for tax purposes and tax the deemed income amount as beneficiary income.

Examples

104. The following examples are included to assist in explaining the application of the law. The examples deal with situations where, in an income year, the tax law income of a trust exceeds its income according to trust law concepts of capital and income. The examples address the tax implications of deemed income derived by trustees of the following three types of trust, where:

- the trust deed determines the income of the trust according to trust law concepts of capital and income;
- the trust deed defines trust law income as meaning income calculated for income tax;
- the trust deed determines income using trust law concepts of capital and income, but the trustees have the power to distribute trust capital to income beneficiaries.

105. In each example, the trust provides for a mix of entitlements—Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust. In each example, the trust earns $100 of traditional trust law income and $150 of tax law income. For these examples, it is assumed that the amounts are paid within the time limits imposed by s HC 6(1B).

106. The examples show that where the trust deed does not allow the trustees to vest or pay an amount equating to deemed income, or the trustees decide not to vest or pay an amount equating to the deemed income, the deemed income is taxed as trustee income. The beneficiaries may not receive any more than their entitlements under trust law and as represented by amounts available in the trust fund.

Example 1: Trust deed does not define income

107. Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust. In this situation, the trust deed does not define “income”. Therefore it is necessary to determine the income of the trust according to trust law concepts of capital and income.

108. In the 2011/2012 income year, the trust derived $100 of trust law income. However, the trustees derived $150 of income as calculated under the Act ($50 of which is deemed income), and must return this amount in the income tax return of the trust. In this situation the trust law income of the trust is $100 and the tax law income of the trust is $150.

109. The excess tax law income ($50) does not represent trust income according to ordinary concepts. For trust law purposes, it cannot be included in the income of the trust that may be distributed to the beneficiaries. Therefore, in this situation, Fred would receive $50, Mary would receive $50, and

George and Alice would not receive any income. This is because the income of the trust for trust law purposes is only $100.

110. In the case of s HC 6(1)(a) ("vested absolutely in interest in a beneficiary") the same treatment would apply for tax purposes as applies for trust purposes. There is nothing in the Act to provide that the beneficiaries are entitled to anything more than what they are entitled to under trust law. They do not have an immediate fixed right to the income deemed to arise under the Act. As beneficiaries, their rights arise in trust law and not in tax law. For a beneficiary, any immediate fixed right sufficient to amount to vesting absolutely in interest can be established only under the trust deed and/or the relevant trustees' resolutions.

111. Similarly, in terms of s HC 6(1)(b) ("paid to a beneficiary") there is nothing to increase the amounts that the beneficiaries receive by payment from the trustee. Again, the tax law follows from trust law. If a beneficiary is entitled to income only on a trust law basis, there is nothing in s HC 6 to increase that amount.

112. The trustees are bound by the trust deed as to what they can vest absolutely in interest in, or pay to, the beneficiaries. The extra $50 of tax law income cannot be vested or paid to the beneficiaries under the trust deed because the trustee is limited to the trust law concepts of capital and income.

113. In this situation, $100 of the tax law income is taxed as beneficiary income, reflecting the $50 each paid to Fred and Mary. The extra $50 of tax law income must be taxed as trustee income.

Example 2: Trust deed defines trust law income as income calculated for income tax purposes

114. In this situation, the trust deed defines income as income calculated under the Income Tax Act 2007. Therefore, the amount of income under the trust deed will be the same as that calculated under the Act.

115. In the 2011/2012 income year, the tax law income of the trust is $150. Therefore, in accordance with the trust deed, the trust law income of the trust is also $150. However, the trustee only received $100 in cash because $50 of the tax law income was deemed income. As a result, there is a difference between the actual amounts received by the trustee and the income derived under the Act.

116. As stated above, Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust. However, the trustee cannot vest or pay a notional amount. The trust has only received an actual amount of $100. If the trustees took no further steps, Fred and Mary would each derive beneficiary income of $50. George and Alice would not derive any beneficiary income. This is because the trust has only $100 of income available to be vested absolutely in interest in, or paid to, the beneficiaries.

117. However, the trust deed adopts the tax law measure of income which increases the amount that may be distributed to beneficiaries as income. This means the trustees could resolve that, for tax purposes, other amounts from the trust fund (that are available to be distributed to Mary, George and Alice) are to be vested absolutely in interest in, or paid to the appropriate beneficiaries to reflect the $50 of deemed income. In this way, the deemed income could be treated as vested absolutely in interest in, or paid to, the beneficiaries. Mary would then receive a further $10, and George and Alice would receive $20 each in accordance with their entitlements under the trust deed. However, this depends on the trust having an actual (non-deemed) amount corresponding to the amount of deemed income that is available to be vested or paid to the beneficiaries. This is because amounts of income derived by a trustee (including amounts of deemed income) must be able to be actually vested absolutely in interest in, or paid to, a beneficiary to be beneficiary income.

118. In exercising their powers under the trust deed, the trustees determine that there is nothing in the trust fund available to be vested or paid to Mary, George and Alice in that year. Only $100 of trust income has actually been vested absolutely in interest in, or paid to, the beneficiaries. Therefore, the extra $50 of trust income must be taxed as trustee income.

119. If the trustees had determined that there were sufficient amounts in the trust fund available to be vested absolutely in interest in, or paid to, Mary, George and Alice, the trustees could vest or pay some additional amounts to be treated as the deemed income for tax purposes, after making appropriate resolutions. To the extent they do this, the extra $50 of tax law income will be taxed as beneficiary income.

Example 3: Trust deed defines income using trust law concepts of capital and income, but the trustees have the power to distribute capital to income beneficiaries

120. In this situation the trust deed provides that the income of the trust is defined using trust law concepts of capital and income. However, the trust deed also gives the trustees the discretion to distribute capital amounts to income beneficiaries. As before, Fred is entitled to the first $50 of income, Mary is entitled to the next $60 of income and George and Alice are entitled to 50% each of the balance of the income of the trust.

121. In the 2011/2012 income year, the trust derived $100 of trust income. However, the trustees derived $150 of tax law income, as calculated under the Act, and must return this in the income tax return of the trust. In this situation the trust law income of the trust is $100 and the tax law income of the trust is $150.

122. For tax law purposes, the treatment of the vesting absolutely in interest of income in a beneficiary under s HC 6(1)(a), or a payment to a beneficiary under s HC 6(1)(b), would be the same as in the first example. That is, Fred would receive $50, Mary would receive $50 and George and Alice would not receive anything. The extra $50 of tax law income would be treated as trustee income if the trustees took no further action.

123. However, the trustees exercise their discretion and pay $50 from available trust capital to Mary (who receives an extra $10), and George and Alice (who receive $20 each) to match the excess tax law income. In exercising their discretion, the trustees resolve that the payment of the capital amounts to Mary, George and Alice are to be treated as the payment of the deemed income for tax purposes.

124. In this situation, the $150 of tax law income will be taxed as beneficiary income.

References

Subject references
Beneficiary income; Deemed income; Deeming provisions, effect of; Income tax; Pay; Trust; Trustee income; Vests absolutely in interest
Legislative references
Income Tax Act 2007, ss CV 13, HC 5, HC 6, HC 7, YA 1
Interpretation Act 1999, s 32
Case references
Blathwayt v CIR (1973) 1 NZTC 61,112 (SC)
CIR v Albany Food Warehouse (2009) 24 NZTC 23,532 (HC)
CIR v Simpson (1989) 11 NZTC 6,140 (CA)
CIR v Ward [1970] NZLR 1 (CA)
Commissioner of Taxes v Johnson and Maeder [1946] NZLR 446 (CA)
Davidson and Duke v CIR (1976) 2 NZTC 61,121 (SC)
Doody v Commissioner of Taxes [1941] NZLR 452 (SC)
Hadlee v CIR (1989) 11 NZTC 6,155
Wendt v Orr [2004] 6 ITELR 989; (2004) WASC 28
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Other references
Bennion, FAR, *Bennion on Statutory Interpretation* (5th edition, 2008, London, LexisNexis)
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APPENDIX: LEGISLATION

Income Tax Act 2007

A1. Section CV 13 of the Income Tax Act 2007 provides:

> **CV 13 Amounts derived from trusts**
>
> An amount derived by a person is income of the person if it is—
>
> (a) beneficiary income to which sections HC 6 (Beneficiary income) and HC 17 (Amounts derived as beneficiary income) apply; or
>
> (b) a settlement on trust of property of the kind described in section HC 7(3) (Trustee income); or
>
> (c) a taxable distribution from a foreign trust to which section HC 18 (Taxable distributions from foreign trusts) applies.

A2. Section HC 5 provides:

> **HC 5 Amounts derived by trustees**
>
> *Either beneficiary or trustee income*

(1) An amount of income derived in an income year by a trustee of a trust is either—

(a) beneficiary income under section HC 6; or

(b) trustee income under section HC 7.

Statutory amounts treated as derived

(2) For the purposes of subsection (1) and sections HC 6 and HC 7, if the trustee is treated as having an amount of income in the income year under a provision in this Act and the amount is not derived under ordinary concepts, then the amount is treated as derived in the income year.

A3. Section HC 6 provides:

HC 6 Beneficiary income

Meaning

(1) An amount of income derived in an income year by a trustee of a trust is beneficiary income to the extent to which—

(a) it vests absolutely in interest in a beneficiary of the trust in the income year; or

(b) it is paid to a beneficiary of the trust in the income year or by the date after the end of the income year referred to in subsection (1B).

Date by which income must be allocated

(1B) The date referred to in subsection (1)(b) is the later of the following:

(a) a date that falls within 6 months of the end of the income year; or

(b) the earlier of—

(i) the date on which the trustee files the return of income for the income year; or

(ii) the date by which the trustee must file a return for the income year under section 37 of the Tax Administration Act 1994.

Exclusions

(2) Beneficiary income does not include—

(a) an amount of income derived by a trustee of a trust in an income year in which the trust is a superannuation fund; or

(b) an amount of income derived by a trustee that is income to which sections CC 3(2) (Financial arrangements) and EW 50 (Income when debt forgiven to trustee) apply.

Deriving beneficiary income in same year

(3) When an amount derived by a trustee in an income year is also beneficiary income, the beneficiary is treated as having derived the income in the same tax year as that corresponding to the trustee's income year.

A4. Section HC 7 provides:

Trustee income

Meaning

(1) To the extent to which it is not beneficiary income, an amount of income derived by a trustee of a trust is trustee income.

Minors' beneficiary income

(2) An amount of beneficiary income to which section HC 35 applies that is derived in an income year by a person who is a minor is treated as if it were trustee income for the purposes of—

(a) determining the tax rate that applies; and

(b) paying the tax; and

(c) providing returns of income.

Exclusions from corpus

(3) The amount that is the market value of a property settlement referred to in section HC 4(3) to (5) is treated as trustee income of the trustee of the recipient trust derived in the income year of settlement.

A5. Section HC 14 provides:

HC 14 Distributions from trusts

Transfers of value

(1) A trustee makes a distribution when the trustee transfers value to a person because the person is a beneficiary of the trust.

Transfers to other trusts included

(2) Despite subsection (1), a settlement for the benefit of a beneficiary is treated as a transfer of value only—

(a) if the amount or the property being settled would have been beneficiary income of, or a taxable distribution to, a beneficiary, had it been distributed at the time to a beneficiary resident in New Zealand; or

(b) when sections EW 50 or EZ 39 (which relate to forgiveness of debt) applies, if the property being settled is an amount forgiven and treated as paid as described in section EW 44(1) or (2) (Consideration when debt forgiven for natural love and affection) or EZ 39(1).

When distribution made

(3) A distribution is made when what is transferred—

(a) vests absolutely in interest in the person; or

(b) is paid to the person.

Manner of distribution

(4) A distribution may be made directly or indirectly, or by 1 transaction or a number of transactions, whether related, connected, or otherwise.

Nil value of beneficiary relationship

(5) The fact that a person is, or will become, a beneficiary of a trust does not constitute the giving or receiving of value.

A6. Section HC 15 provides:

HC 15 Taxable distributions from non-complying and foreign trusts

When subsection (2) applies

(1) Subsection (2) applies for a trust that is a non-complying trust at the time a distribution to a beneficiary is made.

Taxable distributions: non-complying trusts

(2) The distribution is a taxable distribution to the extent to which it is not a distribution of—

(a) beneficiary income; or

(b) a part of the corpus of the trust; or

(c) a payment or a transaction that represents a distribution of the corpus of the trust.

When subsection (4) applies

(3) Subsection (4) applies for a trust that is a foreign trust at the time a distribution to a beneficiary is made.

Taxable distributions: foreign trusts

(4) The distribution is a taxable distribution to the extent to which it is not a distribution of—

(a) beneficiary income; or

(b) a part of the corpus of the trust; or

(c) a profit from the realisation of a capital asset or another capital gain; or

(d) a payment or a transaction that represents a distribution of either the corpus of the trust referred to in paragraph (b) or a capital gain referred to in paragraph (c).

Determining amount of gain

(5) For the purposes of subsection (4)(c),—

(a) the profit does not include—

(i) a gain that must be taken into account for the purposes of determining an income tax liability; or

(ii) a capital gain derived by the trustee through a transaction or series of transactions between the trustee and a person associated with them:

(b) the amount of the profit is determined after subtracting any capital loss that the trustee incurs in the income year in which the amount was derived.

Amounts not subject to ordering rule

(6) To the extent to which a distribution is made from a trust that is not a complying trust by disposing of property at less than market value or providing services to a beneficiary at less than market value, the distribution is a taxable distribution and is not subject to the ordering rule in section HC 16.

Inadequate records

(7) If the records of a trust that is not a complying trust do not allow an accurate determination of the elements of a distribution under section HC 16, the distribution is a taxable distribution.

A7. Section HC 16 provides:

HC 16 Ordering rule for distributions from non-complying and foreign trusts

When this section applies

(1) This section applies for the purposes of the trust rules when a trustee of a non-complying trust or a foreign trust makes a distribution in an income year to a beneficiary. Subsections (6) and (7) override this subsection.

Order of elements of distribution

(2) The distribution is treated as consisting of the following elements in the following order:

(a) first, an amount of income that the trustee derives in the income year:

(b) second, an amount of income, other than beneficiary income, that the trustee has derived in an earlier income year:

(c) third, an amount that the trustee derives in the income year from the realisation of a capital asset of the trust or another capital gain:

(d) fourth, an amount that the trustee has derived in an earlier income year from the realisation of a capital asset of the trust or another capital gain:

(e) last, the corpus of the trust.

Order and elements

(3) In subsection (2),—

(a) an amount must not be treated as included in the distribution if the amount has been treated under this section as being included in an earlier or contemporaneous distribution from the trust:

(b) the paragraphs are applied in order, and the next paragraph applies only to the extent to which the amount of the distribution is more than the cumulative amounts described in that paragraph and the preceding paragraphs.

Deductions and capital losses subtracted

(4) For the purposes of subsection (2),—

(a) in paragraphs (a) and (b), the amount of income is determined after subtracting the amount of a deduction that is taken into account in the income year in the calculation of net or taxable income for the corresponding tax year:

(b) in paragraphs (c) and (d), the amount is determined after subtracting the amount of a capital loss that the trustee incurs in the income year.

Transactions that are not genuine

(5) In the determination of the elements of a distribution to a beneficiary (beneficiary A), no amount of income or capital gain derived by the trustee of the trust is treated as distributed to another beneficiary of the trust (beneficiary B) if the effect is that some or all of the distribution to beneficiary A would be treated as not being a taxable distribution, unless the distribution to beneficiary B meets all the following requirements:

(a) it is a genuine transaction entered into and carried out in good faith; and

(b) it places the amount beyond the possession and control of the trustee in their capacity as trustee; and

(c) it does not itself constitute a settlement.

Exclusions: terms of trust

(6) This section does not apply to the following distributions which are instead treated as consisting of the amount that reflects the terms of the trust or the terms of the exercise of the trustee's discretion:

(a) a distribution by the trustee of a complying trust which is treated as exempt income under section CW 53 (Distributions from complying trusts), unless an election to pay income tax on trustee income has been made for the purposes of section HZ 2 (Trusts that may become complying trusts); or

(b) a distribution from a non-discretionary trust—

(i) created by will or codicil, or by an order of court varying or modifying the provisions of a will or codicil; or

(ii) created on an intestacy or partial intestacy; or

(iii) on which no settlement has been made after 17 December 1987; or

(c) a distribution from a trust other than a non-complying trust that is settled by a natural person who makes an election under section HC 30(2).

Exclusions: taxable distributions

(7) This section does not apply to a distribution described in section HC 15(6).

Meaning of non-discretionary trust

(8) In this section, a non-discretionary trust is a trust in relation to which the trustee has no discretion as to the source, nature, and amount of distributions to beneficiaries, including but not limited to the classification of trust property as capital or income.

A8. Section HC 20 provides:

HC 20 Distributions from complying trusts

An amount that a person derives in an income year is exempt income of the person under section CW 53 (Distributions from complying trusts) if—

(a) the amount is a distribution from a complying trust other than a community trust; and

(b) the amount is not beneficiary income.

A9. Section HC 32 provides:

HC 32 Liability of trustee as agent

When this section applies

(1) This section applies in an income year when a beneficiary of a trust derives an amount of beneficiary income or a taxable distribution.

Exclusion

(2) Subsection (1) does not apply to a person who derives an amount from a community trust.

Agency

(3) In their capacity as agent, the trustee must satisfy the income tax liability of the beneficiary for their beneficiary income and taxable distributions derived.

Relationship to other provisions

(4) Section HD 4(b) (Treatment of principals) overrides this section.

A10. In s YA 1, the word "pay" is defined as follows:

pay,—

(a) for an amount and a person, includes—

(i) to distribute the amount to them:

(ii) to credit them for the amount:

(iii) to deal with the amount in their interest or on their behalf, in some other way:

(b) for a dividend that is a bonus issue, means to issue shares or to give credit for the shares comprising the bonus issue:

(bb) is defined in section LD 4(7) (Tax credits for payroll donations) for the purposes of that section and section LD 8(1) (Meaning and ranking of payroll donation) and for section 24Q of the Tax Administration Act 1994

(c) is defined in section RD 51(6) (Calculation of all-inclusive pay) for the purposes of that section

Interpretation Act 1999

A11. Section 32 of the Interpretation Act 1999 provides:

32 Parts of speech and grammatical forms

Parts of speech and grammatical forms of a word that is defined in an enactment have corresponding meanings in the same enactment.

IS 12/03: INCOME TAX – DEDUCTIBILITY OF REPAIRS AND MAINTENANCE EXPENDITURE – GENERAL PRINCIPLES

All legislative references are to the Income Tax Act 2007 (the "ITA 2007") unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this statement.

Reader's guide: This Interpretation Statement contains comprehensive analysis of the common law relating to the deductibility of repairs and maintenance expenditure. It is recognised that not all readers require this level of detail. To assist, the statement has been broken into parts with summaries and examples. In particular, the following may be helpful:

- The summary of general principles at paragraphs 1 to 27.
- The flowchart at paragraph 35, setting out how to approach resolving issues of deductibility of repairs and maintenance expenditure.
- "Key points" summaries at paragraphs 97 (identifying the asset being worked on), 175 (identifying the nature and extent of the work done) and 232 (other considerations from the repairs and maintenance cases).
- Examples illustrating the practical application of the principles discussed in each part. The examples immediately follow paragraph 49 (nexus) and each of the "key points" summaries at paragraphs 97, 175 and 232.

Summary

1. This Interpretation Statement considers the deductibility of costs incurred by a taxpayer to repair or maintain their property. The focus of this statement is on tangible property including real property. Expenditure incurred to make repairs or alterations or to maintain assets is commonly referred to as "repairs and maintenance expenditure". For ease of reference, this Interpretation Statement also uses this expression. However, in any individual situation within this statement the expression's use should not be taken as an indication that the Commissioner considers the costs to be of a revenue nature and deductible.
2. This Interpretation Statement restates the Commissioner's view of the general principles relating to the deductibility of repairs and maintenance expenditure. It updates and replaces the Commissioner's earlier statement on repairs and maintenance expenditure published in *Tax Information Bulletin* Vol 5, No 9 (February 1994). It also updates and replaces the following items that were published in *Tax Information Bulletin* Vol 7, No 6 (December 1995): "Rental property – deducting maintenance expenses while property vacant"; "Rental property – deductibility of renovation costs"; and "Rental property – deductibility of interior redecorations".
3. The Commissioner's view on the deductibility of repairs and maintenance expenditure has not changed in any substantial way since the 1994 statement.
4. A deduction for repairs and maintenance expenditure is allowed if the expenditure is deductible under the general permission in s DA 1(1), and if that expenditure is not excluded from deductibility by any of the general limitations in s DA 2. This Interpretation Statement is concerned with the capital limitation in s DA 2(1). The other general limitations (eg, the private limitation) are beyond the scope of this statement. This statement also does not consider any specific deduction provisions in Part D that override the application of the capital limitation for certain types of expenditure.
5. To qualify for a deduction under the general permission in s DA 1(1), the repairs and maintenance expenditure must be incurred in deriving assessable income and/or excluded income, or be incurred in the course of carrying on a business for the purpose of deriving assessable income and/or excluded income.
6. The capital limitation in s DA 2(1) denies a deduction for repairs and maintenance expenditure that satisfies the general permission but is capital in nature.
7. Capital expenditure is not deductible but will be subject to the normal depreciation rules in subpart EE. If those rules are satisfied, a depreciation loss will be available. Since the 2011–2012 income year, certain buildings and any improvements to those buildings have a 0% depreciation rate. The availability or otherwise of a depreciation loss is outside the scope of this Interpretation Statement.
8. The courts have developed a two-stage approach for determining whether repairs and maintenance expenditure is of a capital or revenue nature:
   - The first stage is to identify the relevant asset that is being repaired or worked on.
   - The second stage is to consider the nature and extent of the work done to that asset (*Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702 (PC)).

9. However in adopting this two-stage approach, the courts are clear that in any particular situation determining whether repairs and maintenance expenditure is capital or revenue in nature depends on the specific facts. The courts favour the approach of Lord Pearce in *BP Australia Ltd v FCT* [1966] AC 224 at page 264. That is care must be used in applying the capital/revenue tests, and also in applying case authorities to different circumstances (*Auckland Gas* (PC)).

First stage – identifying the relevant asset

10. As a matter of common sense, in deciding whether the capital limitation applies to any repairs and maintenance expenditure, the asset being worked on must be identified. This is important so an assessment can be made as to whether the work undertaken is of a capital or revenue nature in the context of the asset identified. Identifying the relevant asset is always a question of fact, degree and impression. This is not about finding a profit-earning structure or entity but rather focuses on what the courts have coined the "entirety test" – "a physical thing which satisfies a particular notion" (*Lindsay v FCT* (1961) 106 CLR 377, *CIR v Auckland Gas Co Ltd* (1999) 19 NZTC 15,011 (CA)). When considering whether something is an entirety, guidance may be taken from whether it is an entirety by itself and not a subsidiary part of anything else, and whether the thing is separately identifiable as a principal item of capital equipment. Identifying whether something is itself a separate physical thing or simply a component of a wider asset includes considering whether it is physically and functionally distinct. However, a single asset may be made up of interdependent parts. There is a danger of distortion if too large or too small a subject matter is identified (*Poverty Bay Electric v CIR* (1999) 19 NZTC 15,001 (CA)).

11. When considering whether something is a distinct asset it may be helpful to determine whether the thing can be separately identified by physical factors, for example, its location or size (*Lindsay v FCT* (1961) 106 CLR 392 (Full Ct HCA), *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685 (HC), *O'Grady (HM Inspector of Taxes) v Bullcroft Main Collieries Ltd* (1932) 17 TC 93 (KB), *Samuel Jones & Co (Devondale) Ltd v CIR* (1951) 32 TC 513 (IH (1 Div)), *Margrett (HM Inspector of Taxes) v Lowestoft Water and Gas Co* (1935) 19 TC 481 (KB)). Something that is physically divisible and distinct from other things might suggest that it is a single asset (Case F67 (1983) 6 NZTC 59,897, *O'Grady, Samuel Jones, Margrett*). Also, a physical connection between component parts will often be relevant to finding a single asset (*Auckland Gas* (CA)). Subsidiary parts of an integrated system should be considered part of that system rather than assets in their own right (*Poverty Bay Electric, Hawkes Bay Power*).

12. Similarly, determining something's function may also be helpful when identifying the relevant asset being worked on (*Auckland Gas* (CA), *Poverty Bay Electric, Hawkes Bay Power, Case N8* (1991) 13 NZTC 3,052). A smaller thing that is integral to a larger asset's ability to physically function is not likely to be the relevant asset (*Hawkes Bay Power*), while something that is physically capable of separate operation by itself is more likely to be the relevant asset in a repairs and maintenance context (*Poverty Bay Electric, Hawkes Bay Power*).

Relationship with the depreciation rules

13. The principles that the courts have developed to identify the relevant asset for repairs and maintenance purposes are the same principles that apply when identifying an item of tangible property for depreciation purposes. This being the case, when it comes to repairs and maintenance expenditure relating to an item of tangible property that is depreciable, the asset for repairs and maintenance purposes will be generally the same item.

14. In the Commissioner's view, the analysis on how to identify an item of depreciable property in a residential rental property context in IS 10/01: "Residential rental properties – Depreciation of items of depreciable property" *Tax Information Bulletin* Vol 22, No 4 (May 2010) is consistent with the analysis in this Interpretation Statement on identifying the relevant asset being repaired or worked on. IS 10/01 provides a three-step test for identifying the item of depreciable property in a residential rental property context. Any asset in a residential rental property identified for depreciation purposes by applying the three-step test in IS 10/01 will be treated by the Commissioner as the relevant asset for repairs and maintenance purposes.

15. As was noted in IS 10/01, similar principles apply when identifying the asset being worked on in a commercial property context. However, the depreciation rules for commercial buildings were amended in 2010 (after IS 10/01 was released) with the intention that items of commercial fit-out be treated as separate items of depreciable property, distinct from the buildings themselves (see the definitions of "building", "commercial building" and "commercial fit-out" in s YA 1). This means that in the context of commercial fit-out the asset used for depreciation purposes may in some cases be different from the asset identified for

repairs and maintenance purposes. It is anticipated that a legislation change will be made to ensure that in the context of commercial fit-out the relevant asset that is used for depreciation purposes will be similarly treated as the asset for repairs and maintenance purposes. It is anticipated that this change will apply retrospectively from the 2011–12 income year.

Second stage – nature and extent of work done

16. The second stage, when determining whether repairs and maintenance expenditure is deductible, is to consider whether the expenditure is capital or revenue in nature in the context of the asset identified as the entirety (*Auckland Gas* (PC), *Lindsay*). This is achieved by considering the nature and extent of the work done to the asset.

17. Repairs and maintenance problems affecting assets can be resolved in different ways. For example, an asset may be repaired and restored to an "as new" condition, or substantial parts of an asset may be replaced or an asset may be reconstructed using new and sometimes different materials. For income tax purposes, the deductibility of the expenditure incurred on repairs and maintenance depends on a consideration of the nature and extent of the work done to the asset.

18. If the work done to the asset results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, the cost of that work will be capital expenditure (*Auckland Gas* (PC), *Auckland Trotting Club v CIR* [1968] NZLR 193 (SC), *Lurcott v Wakely and Wheeler* [1911] 1 KB 905). Whether there has been such a substantial reconstruction, replacement or renewal will always be a matter of fact and degree.

19. Expenditure incurred to repair or maintain the asset, over and above making good wear and tear, that has the effect of changing the character of the asset will also be capital expenditure. Expenditure incurred to repair or maintain the asset without replacing, reconstructing or renewing the asset, or substantially the whole of the asset, or without changing its character is on revenue account, and is (subject to any other limitations applying) deductible (*Auckland Gas* (PC)).

20. When determining whether the work done is capital in nature, relevant factors to consider are the nature and the scale of the work done to the asset (*Auckland Gas* (PC)). Changes to an asset's value, its earning capacity, its useful life, function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset (*Poverty Bay Electric*, *Highland Railway Co v Balderston (Surveyor of Taxes)* (1889) 2 TC 485 (IH (1 Div)), *Auckland Gas* (PC and CA)). Determining the scale of the work done includes a consideration of the extent of the work done, the importance of the work done to the asset and the business, as well as the cost of the work done (*Auckland Gas* (PC), *Case L68* (1989) 11 NZTC 1,398, *Western Suburbs Cinemas Ltd* (1952) 86 CLR 102, *Case N8*, *Hawkes Bay Power*).

21. The deferral of repairs will not in itself change the character of repair costs from being deductible expenditure to capital expenditure (*Ounsworth (Surveyor of Taxes) v Vickers Ltd* [1915] 3 KB 267, *Rhodesia Railways Ltd v Collector of Income Tax, Bechuanaland Protectorate* [1933] AC 368 (PC)).

22. Repairs and maintenance work that forms part of one overall project to reconstruct, replace or renew an asset, or substantially the whole of an asset, or to change that asset's character will likely take its nature from that project. This is regardless of whether that project concerns work done on a single asset or a group of assets (*Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361 (CA), *Hawkes Bay Power*, *Case X26* (2006) 22 NZTC 12,315).

23. Where repairs and maintenance expenditure is incurred on an ad hoc basis and not as part of one overall plan, the expenditure should take its character from the effect that the work done has on the asset (*Sherlaw v CIR* (1994) 16 NZTC 11,290 (HC)).

24. It is appropriate and possible in some situations to apportion expenditure between deductible repair costs and non-deductible capital works (*Poverty Bay Electric*).

25. There is no deduction for a notional amount that might have been spent on repairs had the work been carried out differently (*Poverty Bay Electric*).

26. No deduction is allowed for expenditure incurred to bring a newly acquired asset up to the condition necessary for it to be used in the taxpayer's business. Such expenditure forms part of the capital cost of acquiring the asset (*Law Shipping Co Ltd v IR Commrs* (1930) 12 TC 621 (IH (1 Div))). A deduction may still be allowed for expenditure on repairs to a newly acquired asset if the purchase price of the asset was not affected by the fact that the asset was in a state of disrepair, and when the asset was acquired it could be used as intended despite its state of disrepair (*Odeon Associated Theatres Ltd v Jones* [1973] Ch 288 (CA)).

27. The nature of the expenditure does not change if the repairs are carried out as a result of a significant event, for example fire, flood or earthquake. The same principles must be applied to repairs arising as a result

of a significant event as are applied to repairs arising for other reasons (*Case F67*). The focus is on the work done.

Introduction

28. Since the Commissioner's 1994 statement on repairs and maintenance expenditure the courts have heard some significant cases (eg, *Auckland Gas*), significant events have occurred (eg, the Christchurch 2010 and 2011 earthquakes) and there has been legislative changes to the depreciation rules. In the Commissioner's view, all these developments warrant a review of the general principles relating to repairs and maintenance expenditure in New Zealand and the publication of this updated Interpretation Statement.

Approach to deductibility of repairs and maintenance expenditure

29. This Interpretation Statement sets out the Commissioner's views on the deductibility of repairs and maintenance expenditure. Usually this type of expenditure will arise when some work is done to an item of tangible property which may be depreciable property. The structure of the analysis in this Interpretation Statement is based on the general provisions, the traditional capital/revenue cases and the repairs and maintenance case law.

30. The Interpretation Statement begins by establishing that first, for a deduction for repairs and maintenance expenditure to be allowed, the expenditure must be deductible under the general permission. The statement then considers how to determine whether a deduction will be denied by the application of the capital limitation.

31. The statement explains how to identify the asset that is being worked on. Then, once the asset is identified, the statement looks at the principles developed by case law for deciding whether the cost of the work done to that particular asset is capital or revenue in nature.

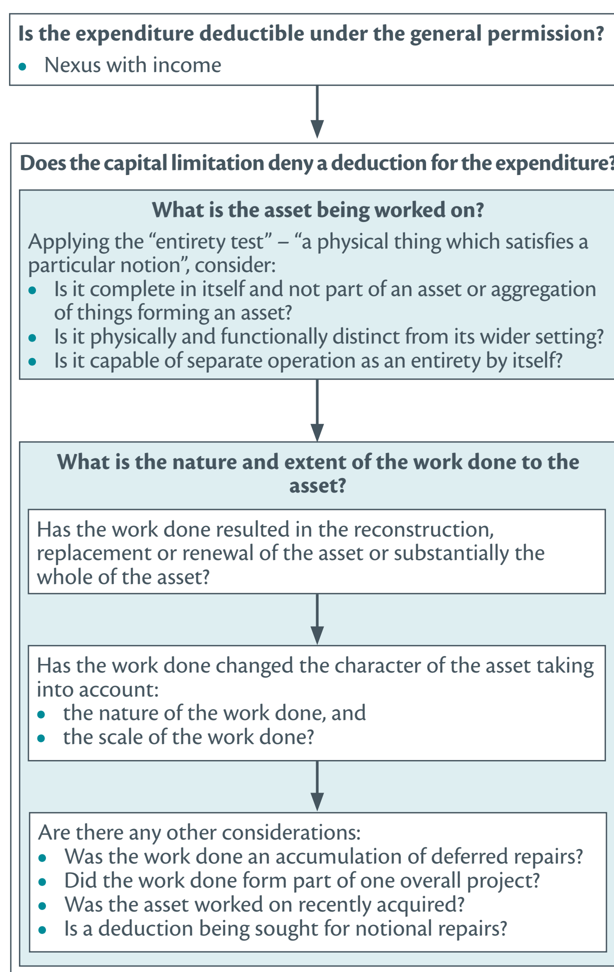
32. If the work done to the asset has resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, it will be capital expenditure. If the work done to the asset falls short of being a reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, then depending on the nature of the work done the expenditure will be either capital or revenue in nature. Generally, work done that goes beyond repairs and changes the character of the asset will be capital, and work done that does not change the character of the asset (and is not a reconstruction, replacement or renewal of the asset, or substantially the whole of the asset) will be revenue.

33. There are some exceptions, for example where the work forms part of one overall project that is capital in nature or the work done relates to the pre-acquisition condition of the asset.

34. If the expenditure is found to be capital in nature a deduction for that expenditure will be denied (assuming no other specific provisions allow for a deduction). If the expenditure is found to be revenue in nature, a deduction for the expenditure will be allowed subject to satisfying any other legislative requirements.

Flowchart – approach to analysis

35. The following flowchart shows the approach the analysis in this Interpretation Statement takes:



36. As noted earlier, other limitations to the general permission might deny a deduction for repairs and maintenance expenditure (eg, the private limitation in s DA 2(2)). However, this Interpretation Statement is concerned only with the application of the capital limitation to expenditure on repairs and maintenance.

37. Capital expenditure is not deductible but will be subject to the normal depreciation rules in subpart EE. If those rules are satisfied, a depreciation loss will be available. Since the 2011–2012 income year, certain buildings and any improvements to those buildings have a 0% depreciation rate. The availability or otherwise of a depreciation loss is outside the scope of this Interpretation Statement.

38. It is also important to remember when considering the capital/revenue distinction that the answer will always be a matter of fact and degree (*BP Australia*). Care must be used in applying the capital/revenue tests and also in applying case authorities to different circumstances (*Auckland Gas* (PC)).

Relevance of case law decided under previous legislation

39. Until the 1993–94 income year, s 108 of the Income Tax Act 1976 governed the deductibility of repairs and maintenance expenditure. Section 108 specifically provided for the deduction of amounts spent on repairs and alterations. An extensive body of case law addresses the deductibility (or otherwise) of repairs and maintenance expenditure under this legislation.

40. Since the repeal of s 108 of the Income Tax Act 1976, the deductibility of expenditure on repairs and maintenance has been tested under the general deductibility provisions. The general permission in s DA 1 and the general limitations in s DA 2 apply. However, as said in the Commissioner's 1994 statement, the body of repairs and maintenance case law that existed before the repeal of s 108 is still relevant.

41. In the Commissioner's view, in practice what was deductible under the old s 108 and what will be deductible under the general provisions of the ITA 2007 is essentially the same. (The most important difference is that under s 108 expenditure on work done to repair or alter an asset that did not increase the value of that asset was deductible (see the second proviso in s 108). Whereas now under the general provisions expenditure on work done to repair or alter an asset will be deductible only to the extent that the expenditure is not capital in nature.) In the Commissioner's view, the cases continue to be relevant to the extent they provide guidance on identifying the particular asset being worked on. This is because identifying the asset continues to be the starting point when approaching the deductibility of any repairs and maintenance expenditure.

42. In addition, many of the well-known repairs and maintenance cases apply the general capital/revenue tests in one form or another. For this reason, in the Commissioner's view, the principles established in these cases over the years remain useful in establishing the deductibility of such expenditure, particularly for the analogies they offer and for the distinctions they make between capital and revenue expenditure in repairs and maintenance circumstances.

43. Therefore, in summary, the Commissioner considers that both the general capital/revenue cases (ie, the cases not about repairs and maintenance) and the cases that specifically address repairs and maintenance expenditure, even if decided under repealed legislation, are relevant when determining whether a deduction for repairs and maintenance expenditure is prohibited by the capital limitation in s DA 2(1).

ANALYSIS

Is the expenditure deductible under the general permission?

44. The first issue to be considered when determining whether expenditure incurred on repairs and maintenance is an allowable deduction is whether the expenditure satisfies the general permission for deductions in s DA 1(1).

45. Under the general permission, a deduction is allowed for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred by the taxpayer:
   - in deriving their assessable income or excluded income or a combination of both (s DA 1(1)(a)); or
   - in the course of carrying on a business for the purpose of deriving their assessable income or excluded income or a combination of both (s DA 1(1)(b)).

Nexus with income

46. The essential feature of s DA 1(1) is the requirement of a nexus between the expenditure and the deriving of assessable income or the carrying on of a business by the taxpayer for the purpose of deriving assessable income. This is referred to as the statutory nexus.

47. The leading cases on deductibility under earlier income tax legislation are *CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA). In both cases, the Court of Appeal highlighted the requirement for a statutory nexus to exist between the expenditure incurred and the assessable income or carrying on of a business of the taxpayer in order for the expenditure to be deductible. The Commissioner considers these decisions remain relevant to the interpretation of s DA 1(1). Earlier statutory provisions that correspond to s DA 1(1)(b) referred to "expenditure necessarily incurred in carrying on a business". Section DA 1 preserves that

requirement for nexus, notwithstanding that the word "necessarily" is no longer included. It is the Commissioner's view that the word "necessarily" did no more than indicate a requirement that there be a sufficient degree of connection between the expenditure and the business.

48. To determine whether the required nexus exists, the true character of the expenditure and its relevance to the taxpayer's income-earning process must be considered. The factual situation must be considered at the time the expenditure is incurred. The expenditure must be connected to a continuous income-earning process. The continuance of an income-earning process will always be a matter of fact and degree. This means that the longer an asset is not used in an income-producing activity the more difficult it is to demonstrate that there is a sufficient nexus between expenditure on that asset and income from the activity or business (*Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes)* (1910) 5 TC 529, *Rhodesia Railways, Case X26*).

49. Paragraph (b) of s DA 1, which applies only to taxpayers who are carrying on a business, permits a wider approach than para (a). In contrast to the requirement under para (a), expenditure under para (b) may still be deductible even where that expenditure "… cannot be directly linked to the derivation of assessable income in some positive way, but [is] … made to … keep the enterprise on foot or reduce expenditure" (*Cox v CIR* (1992) 14 NZTC 9,164 (HC) at 9,168). That is, para (b) permits a deduction for expenditure incurred to protect or advance a business or to avoid or reduce expenditure. Paragraph (b) also permits longer-term objectives to be considered (see also *Thornton Estates Limited v CIR* (1995) 17 NZTC 12,230 (HC)).

Examples – nexus with income

Example 1: Temporary break in rental activity (sufficient nexus established)

Jack owns a rental property. Jack's tenant has just moved out. Although Jack advertised the property he is experiencing difficulty finding a new tenant. He concludes that the reason he cannot find a new tenant is that the property is too run down. Jack decides to tidy up the property to make it more attractive to potential tenants. The property is temporarily unavailable for rental while Jack arranges to have the property repaired, cleaned, and painted. Once this work has been done Jack will look for a new tenant. The expenditure that Jack incurs will have a sufficient nexus to Jack deriving assessable income from his rental activity.

Example 2: Repairs made after rental activity ceased (sufficient nexus not established)

Tina owned a residential rental property for several years. Two years ago she decided to move into the house and use it as her home. This year she has undertaken repairs on the property and had it fully repainted. Tina seeks to claim a deduction for the cost of the repairs to her house on the basis they related to damage sustained when the house was tenanted. However, the repair costs are not deductible because the rental activity has ceased and the house is no longer being used to derive assessable income. At the time the expenditure was incurred it did not have the necessary nexus to Tina's assessable income.

Does the capital limitation deny a deduction for the expenditure?

50. Having concluded a deduction is available for repairs and maintenance expenditure under the general permission, the next step is to determine whether the capital limitation in s DA 2(1) applies to deny a deduction for the expenditure to the extent to which the expenditure is of a capital nature. If an amount of expenditure is found to be capital in nature, it will not be deductible.

51. The courts have formulated various tests for determining whether expenditure is capital or revenue in nature. However, before applying those tests, it is important to consider the approach to be taken when applying those capital/revenue tests in the context of repairs and maintenance expenditure.

52. The courts have used a two-stage approach when determining whether repairs and maintenance expenditure is capital or revenue in nature:
    - The first stage is to identify the asset that has been worked on.
    - The second stage is to consider the nature and extent of the work done to that asset.

53. If the work done to the asset indicates that the expenditure is capital in nature, the capital limitation in s DA 2(1) will deny a deduction for that expenditure.

54. This Interpretation Statement now looks in more detail at these two stages.

What is the asset being worked on?

55. To establish whether expenditure on repairs or maintenance work is of a capital or revenue nature the first step, as Lord Nicholls stated in *Auckland Gas* (PC) at 15,706, "is to identify the object to which the test of repair or replacement is being applied". This is important because then an assessment can be made

as to whether the work undertaken is of a capital or revenue nature in the context of the asset identified.

56. Frequently, as Lord Nicholls explains at 15,706, "this is a straightforward exercise and the answer is obvious". This is demonstrated in cases such as *Colonial Motor, Sherlaw* and *Case X26*. In *Colonial Motor* significant repair work was carried out to an eight-storey warehouse, including earthquake-strengthening and the addition of a storey. The relevant asset in that case was the warehouse. In *Sherlaw* the taxpayers re-piled and carried out other repair work on a boat-shed. The relevant asset was the boat-shed. Similarly in *Case X26*, where the taxpayers earthquake-strengthened a heritage building, the relevant asset was the building. However, there will be situations where the answer is not so obvious. In this regard there are several cases where the courts have provided guidance on how to identify what the asset is that is being worked on in a repairs and maintenance context.

57. In *Auckland Gas* (PC) the taxpayer had major problems with its low-pressure gas-distribution system. The cast iron and steel pipes had leaking joints, corrosion and fracture issues causing significant gas leakage and water entry. By the 1980s, the taxpayer's system was in a poor state of repair, unreliable and expensive to maintain using a "find and fix" system of repairs as each problem was identified. To rectify these issues the taxpayer introduced a programme of inserting polyethylene piping into its existing cast iron and steel gas pipes. The polyethylene pipes allowed the gas to be transmitted at a higher pressure and were less likely to leak. The only remaining function of the old cast iron and steel pipes was to act as a support conduit for the polyethylene pipes.

58. The issue before the court was whether the expenditure on the insertion of the polyethylene pipes was deductible as repairs. The Privy Council, in identifying the object to which the test of repair or replacement was being applied, found the relevant asset to be the "assemblage of linked pipes whose function was to carry gas from one place to another" that made up Auckland's gas-distribution system. The asset was not an abstract concept of the gas-distribution system as a functional entity separate from its physical components. The Privy Council went on to hold that, by inserting new pipes, the character of the existing system was changed as the old pipes no longer discharged their original function of carrying gas, and a significant portion of the system was upgraded. As the character of the identified asset (Auckland's gas-distribution system) had changed substantially, it was found to be capital expenditure.

59. The Privy Council's reference to "an assemblage of linked pipes" suggests that having a degree of physical connection between component parts is relevant to finding a single asset. Consideration also needs to be given to what the asset's function is and what items or components are necessary to carry out that function.

The "entirety test" – "a physical thing which satisfies a particular notion"

60. In the Court of Appeal decision in *Auckland Gas* (which the Privy Council upheld), Blanchard J rejected the "profit-earning entity test" used to identify the asset being worked on by Williams J in the High Court decision (*Auckland Gas Company Ltd v CIR* (1997) 18 NZTC 13,408). Blanchard J noted that this test which concentrated on the relationship of the work to the taxpayer's income earning activity had been rejected in *Auckland Trotting* (CA). Instead, the Court of Appeal in *Auckland Trotting* favoured Kitto J's approach in the Australian High Court case *Lindsay v FCT* (1961) 106 CLR 377 of looking for "a physical thing which satisfies a particular notion". Blanchard J, adopting the words used by the Court of Appeal in the *Poverty Bay Electric* case (when applying Kitto J's approach in *Lindsay*), stated that the correct way to identify the asset being worked on was by inquiry into the totality or entirety of the physical asset in question, pointing out the distortion that can result from misidentification.

61. In *Lindsay*, Kitto J considered that a slipway ought to be considered an entirety by itself and not a subsidiary part of anything else—the slipway being a physical thing that satisfies a "particular notion"—namely a physical thing that is used for landing (and subsequent launching) of boats and ships for the purpose of repairing them. In reaching his conclusion, Kitto J stated at 384:

> But where the question is whether expenditure has been for repairs, and for the purpose of deciding that question one **asks what is the entirety which it is relevant to consider**, one is looking not for a profit-earning structure or entity, as such, **but for a physical thing which satisfies a particular notion**.
>
> [Emphasis added]

62. Kitto J also noted it was necessary to consider whether the asset or property is an "entirety by itself" or whether it is a "subsidiary part of anything else" and concluded at 385:

> I am of opinion that the No. 1 slipway ought to be considered, **for the purposes of the question I have to decide, as an entirety by itself, and not as a subsidiary part of anything else. It is separately identifiable as a principal, and indeed**

> **the principal, item of capital equipment**, so that in a discussion as to whether work done in relation to it constitutes a repair or a renewal in the opposed senses abovementioned, the subject matter in relation to which the choice of description is to be made is the slipway itself, and **not any larger thing or aggregation of things** of which it may be suggested to form part.
>
> [Emphasis added]

63. Kitto J considered it was relevant when concluding that the slipway was "a physical thing which satisfies a particular notion" that the slipway was:
    - an "entirety by itself" and not a "subsidiary part of something else";
    - separately identifiable as a principal item of capital equipment.
64. The first factor, that the slipway was an "entirety by itself", suggests the slipway was whole or complete in itself rather than being a component part of a larger asset or aggregation of things forming an asset.
65. The second factor is a little less clear. The fact the slipway was "separately identifiable" as a principal item of capital equipment suggests it was important enough to be considered as an asset in its own right and could be distinguished in some way from other items. It is not clear from the judgment what characteristics led the court to its conclusion. A principal item of capital equipment is presumably an asset that is important or fundamental to the taxpayer's business (that being the ordinary meaning of "principal"). However, several possible characteristics could make such an item "separately identifiable". For example, an item of equipment could be separately identifiable because it is a functioning unit in its own right. Alternatively, it could be separately identifiable because of physical characteristics, such as not being physically attached to other items or having physical characteristics that differ from those of other items. It may be that all of these are relevant aspects to be taken into account. Later cases discuss this factor (or similar factors) in more detail.
66. *Lindsay* was appealed to the Full High Court ((1961) 106 CLR 392) who agreed with the decision of Kitto J, stating at 393:

> The entirety, it is said, consisted, either, of the whole of the partnership's premises on which its business was conducted and in connexion with which the slipway was used or, alternatively, of a number of what were called components and which together were said to constitute the slipway. These components are identified as the slip, the cradle employed upon it, the hauling machine by which the cradle is moved and the dolphins and warping winches by means of which vessels are manoeuvred onto the cradle. **This method of approach to the problem was rejected by the learned judge of first instance and we have no doubt that he was right.** It would be artificial in the extreme to approach the problem in either of the suggested ways for the slipway was, in itself, **a very substantial erection** and the real question for decision was whether the work which was done was done in the execution of repairs to it. **As we see the problem the answer to this question could not be affected by the fact that there were other buildings or erections on the appellant's premises or by the fact that, on the premises, there were appurtenances, such as those described, for use in connexion with the slipway.**
>
> [Emphasis added]

67. The above quotation suggests the High Court was influenced in its decision by the fact the slipway was a substantial structure in its own right.

Applying the "entirety test"

68. The taxpayer in *Auckland Trotting* (CA) claimed expenditure on the demolition of a trotting track and the construction of a replacement track on the same site as repairs or alterations to the "premises" of the club under s 113(1) of the Land and Income Tax Act 1954. The taxpayer contended that the "premises" of the club subject to the repairs and alterations was the whole of the club's complex of buildings and improvements and not just the trotting track. The Court of Appeal disagreed and, applying the "entirety test" from *Lindsay*, found that the "premises" of the club on which the repair work was to be evaluated was just the track.
69. It is noted that the court in *Auckland Trotting* (CA) considered how the repairs and alterations undertaken by the club applied to "premises". However, in doing so, the court still had to work out a means of determining what the "entirety" was before it could evaluate whether the work carried out on that "entirety" was repair work to premises. Therefore, in that regard, the finding of the court in *Auckland Trotting* (CA) is considered still relevant in a repairs and maintenance context under the current legislation.
70. The Court of Appeal in *Poverty Bay Electric* considered whether expenditure incurred in replacing overhead electricity lines with underground cables was expenditure on "repairs or alterations". The court discussed the importance of correctly identifying the subject matter of the expenditure and noted the implications of incorrectly identifying the asset (in the context of repairs and maintenance). The court then

discussed the relevant asset in the case at hand. In doing so the court warned of the danger of distortion if too large or too small a subject matter was identified, stating at 15,006:

> If a subsidiary part of an asset is regarded as the subject matter and that part has been replaced, there might be a tendency to classify what has occurred as a matter of capital. That could lead to an absurd result, for example, treating the replacement of a car tyre or a spark plug as a capital improvement when, if the subject matter is correctly seen as the whole of the motor vehicle, the work is obviously a repair involving a replacement of a mere component, even a vital component and even if an improved or modified version of that component is substituted.

71. The Court of Appeal agreed with the High Court's finding that the relevant asset was the Gisborne urban reticulation system (rather than the wider Poverty Bay reticulation system) (*Poverty Bay Electric Power Board v CIR* (1998) 18 NZTC 13,779 (HC)). However, the Court of Appeal disagreed with the High Court's suggestion that each separate section of the line could also be viewed as a separate asset. This was because each separate section of line was part of an integrated system and incapable of separate operation. This strongly suggests it is relevant to the entirety test whether an asset can function by itself (ie, it includes all the parts that are necessary for it to function). Similarly, it is relevant whether subsidiary parts of an "integrated system" should be considered part of that system rather than assets in their own right.

72. However, the Court of Appeal also warned against taking this inquiry too far where a "substantial capital work by an individual electricity supply authority might be made to appear so relatively minor as to be thought a matter of repair only" (at 15,007). In other words, if the subject matter is seen as being too broad, then substantial capital work that forms part of the total subject matter could be seen as merely a repair to the whole. Conversely, if a subsidiary part of an asset is regarded as the subject matter and that part has been replaced, there might be a tendency to classify what has occurred as a matter of capital. That could lead to an absurd result. A replacement of a mere component, even a vital component, may still be correctly classified as a repair.

73. In concluding that the relevant asset was the Gisborne urban reticulation system, the Court of Appeal considered it relevant that the system was clearly distinguishable in engineering terms from the rest of the Poverty Bay network, in that "[i]t could be switched (or isolated by electrical means) from the rest of the Poverty Bay network" (at 15,007).

74. In *Hawkes Bay Power* the court considered the issue of whether expenditure incurred in replacing overhead electricity lines with underground cables was expenditure on "repairs or alterations". Goddard J, noting that the starting point is identifying the "nature of the relevant asset", applied the "entirety test" from *Lindsay* (at 13,700–13,701).

75. Goddard J, in applying the analysis from *Lindsay*, determined that the urban residential distribution system constituted the relevant asset by finding it was:
    - a physical thing that satisfied a particular notion,
    - an entirety by itself and not a subsidiary part of anything else, and
    - a separately identified principal item of capital equipment.

76. The "physical thing which satisfies a particular notion" was the network of transformers and distributors that supplied electricity to domestic consumers in a certain area. This suggests that the inquiry is focused on a physical thing (ie, the electricity network) that carries out a particular function (ie, the supply of electricity). Further, a particular part of the network (the urban residential distribution system) was found to be the relevant asset because it was "physically capable of being separately and independently installed underground without recourse to or effect upon the other areas which the distribution system satisfies" (at 13,701). Consequently, it was found to be an entirety by itself and not merely a subsidiary part of a larger distribution system.

77. Goddard J found this to be the case even though the urban residential distribution system "could not operate as an independent entity" (if disconnected from the national grid) and was "not an entire profit-earning structure" (at 13,701). It is clear from this that in defining an asset, it is not necessary that everything required to earn a profit from it is included.

78. Regarding the "separately identifiable as a principal item" inquiry, Goddard J noted that the urban residential distribution system was separately identified by customer type and area and that its separateness was further identified by the fact most of it was underground. In this regard, customer area and type distinguished "urban residential" from "urban industrial" and "rural" customers. It appears Goddard J was primarily concerned with physical factors, such as location, when determining whether two items were separately identifiable.

79. With regard to whether the "distribution system" was a principal item of capital equipment in itself, Goddard

J noted that the sheer scale of the cost involved in putting the network underground, the comparative cost with overhead lines, and the extent of the system that had been put underground led "to the irrefutable conclusion" that the system was "a principal item of capital equipment" (at 13,701).

80. Goddard J also found that the distribution transformers that were replaced during the course of the conversion to underground lines were a part of the distribution system (the relevant asset in the case). This was because they were an integral part of the distribution system as a whole. The transformers were necessary for the network to reticulate. This suggests items that are integral to an asset's ability to fulfil its physical function (in this case the supply of electricity) tend to be a subsidiary part of the asset.

81. In *Case F67* the taxpayers carried on business as hotel proprietors. Part of the hotel's business was a two-storeyed rental building adjoining the hotel. The lower floor of the building was divided into two shops and the upper floor into two flats. The building was on one title and the taxpayers insured and administered the property as one building. The shops were leased out as a pizza parlour and a knick-knack shop. The upstairs flats were leased as residential flats to the respective shop lessees.

82. The taxpayers carried out significant repair work after a fire extensively damaged the building. The taxpayers claimed a deduction against their income for the portion of the repairs that insurance did not cover. Judge Barber disallowed the deduction on the basis that it was capital expenditure.

83. In reaching his decision, Judge Barber identified that the building was the relevant asset rather than the individual shops and flats within the building. This was because the taxpayers jointly owned the land and building on one title and insured and administered the property as one building. The fact the building was internally partitioned did not change Judge Barber's finding that the building as a whole was the relevant asset.

84. *Case N8* is an example of a situation where the court had to consider whether an aggregation of things made up a single asset. The taxpayer was a substantial manufacturer and supplier of ready-mixed concrete. The case concerned quite substantial works undertaken in relation to a ready-mixed concrete "batching plant". The taxpayer contended that the whole entity was the batching plant (which comprised the ground storage bins; the conveyor and a square-shaped tower; the associated water and electrical equipment and supply; and the dispatch office, control room and dispatch facilities) and that each item of expenditure was for repairs or maintenance in relation to that whole. (The plant was situated on premises that consisted of several acres of land, an office and administrative building, a laboratory, a control and supervisor's office, yards, a truck parking and washing area, and used equipment and storage yards, in addition to the batching plant.) The Commissioner argued the plant should not be seen as one entity, but rather that each individual element should be addressed to consider whether there had been a repair, renewal or replacement. It was further contended that if the plant was a single entity, then the work was of such an extent, size and amount that the expenditure was of a capital nature.

85. Having comprehensively reviewed the nature of the taxpayer's business and the various items of expenditure, Judge Bathgate turned to consider what was the relevant asset or entity against which to consider the nature of the expenditure, noting at 3,070:

> I find there were two entities involved in the work. The first and obvious is that which stores, conveys, mixes and produces the materials making up and contained in the final ready mixed concrete as supplied by the objector. **That entity is physically attached or joined**, or so far as the materials are concerned, **it is continuously involved in the one process** of manufacturing ready mixed concrete. To identify any one part and single it out for separate treatment as an individual item would be unrealistic in this context. **It is a composite whole.** If a motor car has a new spark plug installed in the place of an existing spark plug, so far as the motorist is concerned that is work undertaken in the course of repair or maintenance of the motor car, and is not a renewal of the spark plug as a capital item. **It is a question of fact, degree and impression as to what is included or excluded in an entity for present purposes.** The entity in the example given is the motor car. If the gearbox was replaced, that may be a repair, but if the engine were replaced, that would seem more like a capital item.
>
> **I consider the supervisor's office, the dispatch office and the control room,** which were all housed in a separate and detached building from the ground bins, elevators and tower, **to be a separate and distinct entity from the ground bins, elevators and tower plus its contents. The only connection between the two were the electrical wiring connections and the less tangible connections of electrical controls, administration and supervision from one to the other**.
>
> [Emphasis added]

86. Judge Bathgate identified two separate entities as being the relevant assets. The first entity being the things attached to each other that stored, conveyed, mixed and produced the materials making up and contained in the ready-mixed concrete. The other entity being the separately housed control room and the dispatch and supervisor's offices. Even though the two entities were connected, Judge Bathgate placed importance on the fact they were physically and functionally distinct from each other. Judge Bathgate continued at 3,071:

> Different functions, although associated functions, were carried out in the two entities. The first was the entity handling the raw materials that were manufactured into ready mixed concrete. The second was more in the nature of an administrative office which controlled and supervised the functions of the first entity.

Overseas authorities

87. The New Zealand courts have taken guidance from overseas authorities when identifying the asset being worked on in a repair and maintenance context. Three cases often referred to are *O'Grady*, *Samuel Jones* and *Margrett*.

88. In *O'Grady* the taxpayer built a replacement chimney stack. The chimney was constructed to do the work of the old chimney, which was to carry away smoke and fumes from the furnaces that raise steam and power for colliery purposes. Rowlatt J found the chimney stack to be the relevant asset. Consequently, the expenditure on building the chimney stack was found to be capital. Rowlatt J (referring to *Lurcott*) said at 101:

> As regards the chimney, I think it is really very clear. Of course every repair is a replacement. You repair a roof by putting on new slates instead of old ones, which you throw away. There is no doubt about that. But the critical matter is … **what is the entirety**? The slate is not the entirety in the roof. You are repairing the roof by putting in new slates. What is the entirety? If you replace in entirety, it is having a new one and it is not repairing an old one. **I think it is very largely a question of degree.** … This was a factory chimney to which the gases and fumes, and so on, were led by flues and then went up the chimney. It was unsafe and would not do any more. What they did was simply this: **They built a new chimney at a little distance away in another place; they put flues to that chimney and then, when it was finished, they switched the gases from the old flues into the new flues and so up the new chimney. I do not think it is possible to regard that as repairing a subsidiary part of the factory.** I think it is simply having a new one. And they had them both. Perhaps they pulled down the old one; perhaps they kept it, because they thought it was an artistic thing to look at. There is no accounting for tastes in manufacturing circles. Anyhow, they simply built a new chimney and started to use that one instead of the old one. I think the chimney is the entirety here and they simply renewed it.
>
> [Emphasis added]

89. Rowlatt J found as a matter of fact that the chimney was not a subsidiary part of the colliery. That Rowlatt J noted the chimney was built a little distance away at another place could suggest that the new chimney was physically separate from the rest of the factory and that this influenced his decision.

90. The later decision *Samuel Jones*, also concerned the building of a replacement chimney stack. In this case, the taxpayer processed paper using a large group of buildings with the power being supplied by a steam plant that discharged into a chimney. The chimney was in a dangerous state of repair and was replaced by a new chimney. The new chimney was erected close to the existing chimney, which was demolished once the new chimney could take over the old chimney's function. Both the old and new chimneys were part of the structure of the main factory block. The Court of Session found the chimney to be an inseparable and necessary part of a larger entity, the factory. This meant the factory rather than the chimney stack was the relevant asset to which the test of repair or replacement could be applied. The court found the expenditure on the chimney to be of a revenue nature. The court also noted it was influenced in its decision by the fact the expense incurred in taking down the old chimney and building the substitute was only 2% of the value of the factory. Lord President Cooper stated at 518):

> … but so far as this case is concerned the facts seem to me to demonstrate beyond a doubt that the chimney with which we are concerned is **physically, commercially and functionally an inseparable part of an "entirety"**, which is the factory. It is quite impossible to describe this chimney as being in the words of Rowlatt, J, the "entirety" with which we are concerned. It is doubtless an indispensable part of the factory, doubtless an integral part; but none the less a subsidiary part, and one of many subsidiary parts, of a single industrial profit-earning undertaking.
>
> [Emphasis added]

91. It is considered that his Lordship's reference to the chimney being "commercially … inseparable" does not suggest his Lordship considered that an item must be

an entire profit-making structure to be the relevant asset. Rather his Lordship's reference to "commercially … inseparable" was intended to refer to what a person in business would regard as necessary for the factory to be considered as complete. Even if his Lordship was suggesting this, the New Zealand courts (as seen in *Auckland Trotting* (SC and CA) and *Hawkes Bay Power*) have clearly rejected a profit-earning structure test as a means of identifying the asset in a repairs and maintenance context.

92. The decision of the court in *Samuel Jones* contrasts with that in *O'Grady* where the chimney was found to be the relevant asset. The Commissioners of Inland Revenue in *Samuel Jones* argued they were unable to distinguish the facts in that case from those in *O'Grady*. In considering this point, Lord President Cooper referred to the comment made by Rowlatt J in *O'Grady* that "the critical matter is … what is the entirety? … I think it is very largely a question of degree" (see above at paragraph [88] of this statement). His Lordship found at 518 that "it [was not] part of our duty to review the decision of Rowlatt J, as applied to the facts in the *O'Grady* case, but so far as this case is concerned the facts seem to demonstrate … the chimney … is … part of an entirety". In this regard, his Lordship demonstrates that identifying the relevant asset in any given case will always involve consideration of the specific facts of that case at hand. Although not clearly stated by his Lordship, the distinguishing fact between the cases seems to be that in *Samuel Jones* the chimney was physically connected to the main factory building, while in *O'Grady* the chimney built was larger, situated a little distance away at another place and was not physically connected to any other structure.

93. Whether assets were separately identifiable because of physical characteristics also appears to have been a deciding factor in *Margrett*. In *Margrett*, the taxpayer company owned an old reservoir that was built in 1856 and had deteriorated to such an extent that it was not worth repairing. A new reservoir (which was twice the capacity of and a significant improvement on the old reservoir) was constructed in 1931 on a site away from the old reservoir.

94. The court had to decide whether the expenditure on building the new reservoir was capital expenditure or money "expended for repairs of premises occupied". The court examined the physical nature and physical distinctiveness of the reservoir to decide whether it was a separate asset or part of a larger asset (the water tower).

95. Finlay J stated at 488:

> Now here the subject matter under discussion seems to me to be the reservoir, and I cannot think that it is material, though it is undoubtedly the fact, that the reservoir is part only of the Respondents' whole physical undertaking. **It is a part perfectly clearly divisible from the rest**, and it is the part with which we are dealing here. If authority were needed for that I should find it in the decision of Mr. Justice Rowlatt, to which I referred a moment ago, of *O'Grady v. Bullcroft Main Collieries, Ltd*, because the reservoir here is more clearly a separate and distinct thing than was the chimney in *O'Grady v. Bullcroft Main Collieries, Ltd*.
>
> [Emphasis added]

96. Therefore, when determining whether assets are physically distinct, a practical and visual inquiry can be an appropriate consideration.

Key points on identifying the asset being worked on

97. The Commissioner takes the following key points from the cases on identifying the asset being worked on:

- The "first step is to identify the object to which the test of repair or replacement is being applied". In other words, what is the asset that it is relevant to consider (*Auckland Gas* (PC))?
- Identifying the asset is not about identifying the profit-earning structure or entity; rather it is about identifying a "physical thing which satisfies a particular notion". The fact a particular physical thing realises its economic value only when used in conjunction with other things or business systems does not mean it is not to be regarded as a separate asset (*Lindsay* (HCA), *Hawkes Bay Power, Auckland Gas* (CA)).
- A single asset may be made up of interdependent parts. There is a danger of distortion if too large or too small a subject matter is identified. For example, if a subsidiary part of an asset is regarded as the subject matter and that part has been replaced, there might be a tendency to classify what has occurred as a matter of capital. If the subject matter is too broad then every replacement of a single unit that forms part of the total subject matter could be seen as merely a repair to the whole (*Poverty Bay Electric*).
- It is always a question of fact, degree and impression as to what is included or excluded in an entity or asset. However, the focus remains on the "entirety test" – "a physical thing which satisfies a particular notion" (*Lindsay* (HCA), *Auckland Trotting* (CA), *Hawkes Bay Power, Case N8*). When considering

whether something is "a physical thing which satisfies a particular notion" the courts are guided by whether the thing would be:

- an entirety by itself and not a part of an asset or aggregation of things forming an asset;
- separately identifiable as a principal item of capital equipment.

- Identifying whether a part of a wider asset is itself a separate physical thing or simply a component of a wider asset includes considering whether the item is physically and functionally distinct (*Case N8*). It may be helpful to see whether something can be separately identified by physical factors, for example its location or size (*Lindsay* (Full Ct HCA), *Hawkes Bay Power*, *O'Grady*, *Samuel Jones*, *Margrett*). Something that is physically divisible and distinct from other things may suggest that it is a single asset (*Case F67*, *O'Grady*, *Samuel Jones*, *Margrett*). A physical connection between component parts will often be relevant to finding a single asset (*Auckland Gas* (CA)). Subsidiary parts of an integrated system should be considered as part of that system rather than assets in their own right (*Poverty Bay Electric*, *Hawkes Bay Power*).
- Looking to see what the asset's function is and what parts or components are necessary for the asset to carry out that function may be helpful when identifying the relevant asset (*Auckland Gas* (CA), *Poverty Bay Electric*, *Hawkes Bay Power*, *Case N8*). Something that is integral to a larger asset's ability to physically function is not likely to be the relevant asset (*Hawkes Bay Power*). Alternatively something that is physically capable of separate operation by itself is more likely to be the relevant asset in a repairs and maintenance context (*Poverty Bay Electric*, *Hawkes Bay Power*).

Examples – identifying the asset being worked on

Example 3: Reconditioned car engine (subsidiary part of a larger asset)

Frank is an owner-operator taxi driver. He has driven the same taxi for the past 5 years. Until recently the taxi has been reliable and overall is in good condition. Frank has had his taxi serviced regularly but his mechanic has advised him that the engine is now seriously worn. The mechanic recommends that the worn engine be replaced with a reconditioned engine. The asset in this case is the taxi. The engine is a subsidiary part of that asset, and is physically and functionally connected to that larger asset. The engine is integral to the taxi.

Example 4: Loan trailer (asset as entirety)

Hedgy Landscape Supplies owns trailers that it makes available for its customers to use. Sometimes the company also uses the trailers for making deliveries. The deck of one trailer needs repairing. The trailer is the asset being repaired. It is the entirety and not a subsidiary part of something else. The trailer has all the necessary parts to function and is a composite whole.

Relationship with depreciation rules

98. The principles that the courts have developed to identify the relevant asset for repairs and maintenance purposes are the same principles that apply when identifying an item of tangible property for depreciation purposes. This being the case, when it comes to repairs and maintenance expenditure relating to an item of tangible property that is depreciable, the asset for repairs and maintenance purposes will be generally the same item.

99. In 2010 the Commissioner published an Interpretation Statement IS 10/01 "Residential rental properties – Depreciation of items of depreciable property". IS 10/01 sets out how to determine whether an item in a residential rental property is a separate item of depreciable property or is part of the residential building. In the Commissioner's view, the analysis in IS 10/01 on how to identify an item of depreciable property in a residential rental property context is consistent with the analysis in this statement on identifying the relevant asset being worked on or repaired.

100. IS 10/01 concluded that if an item in a residential rental property is distinct from the building and it meets the definition of "depreciable property", it may be separately depreciated. If an item is found to be part of the building, it cannot be separately depreciated. In its analysis, IS 10/01 relied on the same repairs and maintenance cases as those relied on by this statement. IS 10/01 also provides specific guidance in the form of a three-step test on how to determine whether a particular thing is a separate item of depreciable property or is part of the residential rental property. The Commissioner considers that any outcomes reached by applying the three-step test in IS 10/01 will be consistent with the outcomes reached by applying this Interpretation Statement. Any asset in a residential rental property identified for depreciation purposes by applying the three-step test in IS 10/01 will be accepted by the Commissioner as the relevant asset when considering the deductibility of repairs and maintenance expenditure.

101. As was noted in IS 10/01, similar principles apply when identifying the asset being worked on in a commercial property context. However, the depreciation rules for commercial buildings were amended in 2010 (after IS 10/01 was released) with the intention that commercial fit-outs be treated as separate items of depreciable property, distinct from the buildings themselves (see the definitions of "building", "commercial building" and "commercial fit-out" in s YA 1). This means that in the context of commercial fit-out the asset used for depreciation purposes may in some cases be different from the asset identified for repairs and maintenance purposes. It is anticipated that a legislation change will be made to ensure that in the context of commercial fit-out the relevant asset that is used for depreciation purposes will be similarly treated as the asset for repairs and maintenance purposes. It is anticipated that this change will apply retrospectively from the 2011–12 income year.

What is the nature and extent of the work done to the asset?

102. Once the relevant asset being worked on has been identified, the second stage in the enquiry as to whether repairs and maintenance expenditure is deductible is to consider the nature and extent of the work done to the particular asset. If the nature and extent of the work done to the asset indicates the expenditure is capital in nature the capital limitation in s DA 2(1) will deny a deduction for that expenditure.

103. The general capital/revenue cases and the more specific repairs and maintenance cases provide guidance in this second stage of the enquiry.

General capital/revenue cases

104. The accepted approach for determining whether any outgoing is of a capital or revenue nature is outlined in *BP Australia Ltd v FCT*. The *BP Australia* approach was confirmed as being the preferred approach in New Zealand in the leading decision of *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA). While not addressing the deductibility of repairs and maintenance expenditure, *McKenzies* provides guidance on the factors the courts take into account when deciding whether expenditure is capital or revenue in nature.

105. In *McKenzies* the Court of Appeal said at 5,236:

> In deciding whether expenditure is capital or income the approach generally favoured by the courts in recent years is exemplified in the following observations of Lord Pearce in *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 244 at pp 264–265:
>
> "The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
>
>> 'depends on what the expenditure is calculated to effect from a practical and a business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process'
>
> per Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634, 648. As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other; but those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken."
>
> Amongst the factors weighed by the judicial committee in *BP Australia* were: (a) the need or occasion which called for the expenditure; (b) whether the payments were made from fixed or circulating capital; (c) whether the payments were of a once and for all nature producing assets or advantages which were an enduring benefit; (d) how the payment would be treated on ordinary principles of commercial accounting; and (e) whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.

106. The Court of Appeal in *McKenzies* noted the Privy Council decision in *BP Australia* had been recognised in New Zealand in *CIR v LD Nathan and Co Ltd* [1972] NZLR 209 (CA) and in *Buckley & Young*. Gallen J in *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206 (HC) adopted the principles from *BP Australia*, which Richardson J summarised in *McKenzies*.

107. From these leading New Zealand cases seven tests have been identified to assist in determining whether expenditure is capital or revenue in nature. The courts have considered some of these tests to be more relevant than others. In addition, the tests may point in different directions when applied. As Lord Nicholls of Birkenhead in *Auckland Gas* (PC) comments at

15,707, the tests need to be applied so as to enable the dominant features which guide to a reasoned conclusion to be identified. The tests are:

- *The **need or occasion** that calls for the expenditure:* This test focuses on the principal reason or need for incurring the expenditure. In the context of this test the object of the expenditure is determined by looking not at the actual thing achieved, but at the reason or need for making the expenditure. Clear and accurate application of this test is important because it will often form the basis for applying the other capital/revenue tests. The Commissioner considers this test to be important in the context of repairs and maintenance expenditure; the focus is on why this work was done in this way at this time.
- *Whether the expenditure is **recurrent** in nature:* This test involves a consideration of whether the expenditure is recurrent or a once and for all payment. If the expenditure is recurrent and made to meet a continuous demand, this suggests the payment is part of the cost of ordinary business operations and will be a revenue outlay; capital expenditure is more likely to be spent once and for all. To some extent this test holds true for repairs and maintenance purposes. However, the Commissioner considers the usefulness of the once and for all test is limited as a capital indicator in some repair circumstances. This is because frequently repair work, by its nature, might be unplanned or the result of unexpected damage. Repairs and maintenance work that is undertaken regularly on a recurring basis is likely to be revenue expenditure.
- *Whether the source of the payment is from **fixed or circulating capital**:* This test focuses on whether the source of the payment is from fixed or circulating capital, rather than whether the payment affects the fixed or circulating capital of the business in question. This test is not as useful as other tests in determining whether expenditure is capital or revenue in nature because of the ease with which a taxpayer can choose between financing an asset from circulating capital or financing it from fixed capital, irrespective of the nature of the asset financed. This test has been questioned judicially (*Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 (HC), *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834 (HC)). In the context of repairs and maintenance expenditure, the test has less relevance because how work is funded is not a reliable indicator of its nature.
- *Whether the expenditure creates an **identifiable asset**:* This test indicates that expenditure will be on capital account where an asset of a capital nature has been acquired by the expenditure, or where money is spent on improving an asset or making it more advantageous. Work done to an asset will sometimes result in a new identifiable asset, for example where the work done results in the reconstruction, replacement or renewal of the asset or substantially the whole of the asset. Similarly, where the work done involves the alteration or extension of an asset the identifiable asset test may be satisfied.
- *Whether the expenditure is a once and for all payment producing assets or advantages that are of an **enduring benefit**:* Under this test, expenditure will be regarded as capital where it brings into existence an asset or advantage for the enduring benefit of the business. This test is one of the more relevant and persuasive tests for deciding whether expenditure is on capital or revenue account. However, in the context of repairs and maintenance expenditure, it is often a difficult test to apply, as nearly every repair done to an asset will result in some form of enduring benefit. The Commissioner considers that the more relevant enquiry is the one developed in the repairs and maintenance line of cases as to whether the work done has resulted in a change in the character of the asset being worked on. If a change of character has occurred, then in most situations that will also result in an advantage of an enduring benefit being produced. This "change of character" test is discussed in more detail later.
- *Whether the expenditure is on the **business structure** or **business process**:* This test focuses on the distinction between expenditure on the business structure set up for the earning of profit, and expenditure on the process by which such a business operates to obtain regular returns by means of regular outlay. This test is also one of the more relevant and persuasive tests used to determine whether expenditure is on capital or revenue account. In a repairs and maintenance expenditure context, the deductibility enquiry usually focuses more on the asset being worked on than the business overall. However, in the Commissioner's view the business structure test may still be a relevant indicator of capital expenditure, particularly in circumstances where the asset being worked on is an integral part of the business and the loss or enhancement of that asset would affect the business structure.

- *What the treatment of the expenditure is according to the* ***ordinary principles of commercial accounting****:* The test of applying ordinary principles of commercial accounting to the expenditure, although of some assistance, is not usually determinative. It needs to be remembered that tax and accounting have different aims, and the treatment for one may differ from the treatment for the other. While this test is often used to support an approach that the other tests have come to, it is not a sufficiently conclusive test by itself to determine the issue of whether the expenditure is on capital or revenue account. The Commissioner acknowledges that for some businesses the accounting treatment required for repairs and maintenance expenditure can be quite different from the tax treatment required for that same expenditure. This makes it even more difficult to rely on accounting treatment as an indicator of the appropriate tax treatment of repairs and maintenance expenditure.

108. Therefore, in the context of repairs and maintenance expenditure, some of these general capital/revenue tests will usually be of greater relevance than others. For example, when considering the deductibility of costs to earthquake-strengthen a building, Judge Barber in *Case X26* relied on the identifiable asset test, the enduring benefit test and the business structure test to decide whether the costs were capital or revenue in nature. At [16] Judge Barber stated:

> I agree … that the disputant's expenditure is clearly on capital account and was to bring into existence advantages of a lasting character which improved an identifiable asset, ie the property, as part of the disputant's partnership's income earning structure (as distinct from income earning process).

109. *Case X26*, which was decided in 2006 in the small claims jurisdiction of the Taxation Review Authority, is the first and only reported decision to address the deductibility of repairs and maintenance expenditure since the relevant legislative changes in 1994. Although of limited precedential value given the level of jurisdiction, the Commissioner considers the correct approach to the application of the capital/revenue tests was adopted in this decision.

Repairs and maintenance cases

110. While the deductibility of repairs and maintenance expenditure is solely a question of whether the costs are capital or revenue in nature, the Commissioner considers it remains appropriate to supplement the general capital/revenue tests with the body of cases that specifically address the deductibility of repairs and maintenance expenditure. The repairs and maintenance cases can help taxpayers decide whether expenditure incurred on work done to an asset is capital or revenue in nature. This is despite most of the repairs and maintenance cases being decided under different legislation or in different jurisdictions. It is also despite it sometimes being difficult to extract precise principles from the repairs and maintenance cases where the courts have applied a combination of the traditional capital/revenue tests together with repairs and maintenance concepts to individual fact situations. Nonetheless, when considering the deductibility of repairs and maintenance expenditure, the Commissioner considers that, when applied carefully, the specific repairs and maintenance cases frequently offer the best guidance on the boundaries between deductible repairs and maintenance expenditure and repairs and maintenance expenditure of a capital nature.

Analysis of case law

Has the work done resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset?

111. As a starting point when deciding whether the cost of work done to an identified asset is deductible as revenue expenditure, the first consideration is whether the work done has resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset. If it has, then the work done will be capital in nature.

112. This is consistent with the "identifiable asset test" in *BP Australia*—where the work done results in the creation of a new identifiable asset the expenditure incurred is capital expenditure.

113. One of the earliest authorities used to support this repairs and maintenance principle is *Lurcott*. While this case was not an income tax case, and therefore it does not address the capital or revenue nature of work done, it does support the principle that the reconstruction, replacement or renewal of an asset, or substantially the whole of an asset is capital expenditure. The case considered the recovery of the cost of replacing a wall that formed part of a building. The whole building was identified as the asset, and the work done to that building by replacing a wall was considered only to be a repair and not a renewal of the building. As a result, under the lessee's covenant to repair, the cost of the work done to the building was found to be recoverable from the tenant. Lord Buckley commented on the difference between a repair and a renewal at 923:

> "Repair" and "renew" are not words expressive of a clear contrast. Repair always involves renewal;

> renewal of a part; of a subordinate part. A skylight leaks; repair is effected by hacking out the putties, putting in new ones, and renewing the paint. A roof falls out of repair; the necessary work is to replace the decayed timbers by sound wood; to substitute sound tiles or slates for those which are cracked, broken, or missing; to make good the flashings, and the like. Part of a garden wall tumbles down; repair is effected by building it up again with new mortar, and, so far as necessary, new bricks or stone. **Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion**.
>
> [Emphasis added]

114. This principle from *Lurcott* has been applied by the New Zealand courts in deciding whether expenditure has been incurred on the replacement or repair of an asset, and therefore whether the expenditure was capital or revenue. The Court of Appeal in *Auckland Trotting* upheld Moller J's decision in the Supreme Court that the construction of a new track in place of an old track was not a repair and therefore the cost of the work done was capital expenditure. Moller J in *Auckland Trotting Club v Commissioner of Inland Revenue* [1968] NZLR 193 (SC) at 205 held:

> Having reached this decision [that the track was the asset] I revert back to the work done in respect of it, and find, on all the evidence available, that the amount sought to be deducted by the club was incurred not by way of "repair" or "alteration", but by the construction of what was substantially a new track in place of what was, substantially, the whole of the 1960 track.

115. In the Court of Appeal Richmond J supported Moller J's finding and held at 980 that:

> In the result, the appellant has failed in my opinion to show that the work of replacing the original shell track by a new track of greater depth and constructed substantially of new materials is either a repair or alteration of premises.

116. In *Hawkes Bay Power* Goddard J was satisfied the work Hawkes Bay Power did to its urban residential distribution system, although carried out on a job by job basis over many years, was a total reconstruction project that resulted in the creation of a new asset. At 13,707, she concluded as point seven in her summary that:

> The result in the present case is that substantially the whole of the urban residential distribution system has been placed underground. It follows therefore that the urban residential system is a new and different distribution system; not a repaired system. Thus, Hawkes Bay Power has acquired by its expenditure a "new" underground urban residential distribution system.

117. As noted in *Auckland Trotting* (SC) and *Hawkes Bay Power*, capital expenditure does not only arise when an asset is completely reconstructed, replaced or renewed. Capital expenditure may also arise when substantially the whole of the asset is reconstructed, replaced or renewed.

118. This point is further illustrated by the decision in *Case J92* (1987) 9 NZTC 1,518. This case concerned repairs and maintenance work done to a farm homestead. Some structural parts of the house were retained but there was substantial replacement of framework, linings, interior joinery, plumbing and wiring as well as re-piling and extensive exterior cladding. The taxpayer argued there had not been a complete replacement of the original homestead and that much of the original structure remained. This distinguished it from the new track in *Auckland Trotting* (SC and CA). However, Judge Barber found the building work done was so extensive it could not be regarded as repairs. The work involved the complete reconstruction of the homestead.

119. At 1,522 Barber J stated:

> After a careful analysis and consideration of the evidence I find the building work undertaken by the objector on the homestead was so extensive that it cannot be regarded as "repairs or alterations". The work involved the complete reconstruction of the homestead and, in my view, the expenditure was of a capital nature and was incurred in the improvement of the premises from a capital point of view.

120. The work done to the asset must be looked at in its totality to decide whether the work done is so substantial that the whole, or substantially the whole of the asset is reconstructed, replaced or renewed. This can include looking at the work done over more than one income year as was the case in *Auckland Gas*, *Poverty Bay Electric* and *Hawkes Bay Power*. Blanchard J noted at 15,024 of *Auckland Gas* (CA):

> The work done in a particular year is properly to be seen in its overall context, which was of an ongoing programme to replace all the low-pressure system as a conveyor of gas. The question is: what was being achieved? A taxpayer cannot by artificially treating as separate works portions of an overall programme done in separate income years deny the reality or minimise the extent of what is being effected.

121. A decision as to whether the work done to the asset is so substantial that the whole, or substantially the whole, of the asset is reconstructed, replaced or renewed may not always be easy. However, it is a

judgement that needs to be made, especially when components of an asset are renewed instead of simply being kept in a serviceable condition. Some of the factors the courts have taken into account when making such judgements are set out later in this Interpretation Statement at paragraph [160] under the heading "Scale of the work done". These factors include indicators such as the extent of the work done to the asset, the size and importance of the replacement parts to the asset and the cost of the work done. This enquiry will always be a matter of fact and degree.

122. However, when determining whether expenditure for work done to an asset is capital or revenue in nature, it is not enough only to determine whether the work done to an asset has reconstructed, replaced or renewed the asset, or substantially the whole of the asset. The cost of the work done will still be capital expenditure if it has the effect of changing the character of the asset. This issue is discussed next.

Has the work done changed the character of the asset?

123. Where repair work done to an asset falls short of being a reconstruction, replacement or renewal of the identified asset, or substantially the whole of the asset, then further analysis on the effect of the work done on the character of the asset is required to determine whether the costs are capital or revenue in nature. By character of the asset, what is being referred to is the asset's distinct nature.

124. In *Auckland Gas* (PC) Lord Nicholls clarified that it is not right to presume that the cost of work done to an asset is deductible as "repairs" where that work falls short of resulting in a reconstruction, renewal or replacement of the asset, or substantially the whole of the asset. Simply put, Lord Nicholls acknowledged that sometimes the work done may well be repairs or maintenance and deductible, but that will not necessarily be the case in every situation. He considered that sometimes repair work can be capital in nature. Lord Nicholls noted that authority on the distinction between "repair" and "replacement" is only of limited assistance and that some objects do not lend themselves easily to this "exercise in characterisation". He commented at 15,706:

> Authority on the question of repair or replacement is of limited assistance. The physical objects to which the test of repair has to be applied vary widely. So does the nature of the work done. Judicial dicta applicable to one set of circumstances may be unhelpful or misleading when applied in different circumstances. This is true even of the celebrated observation of Buckley LJ in *Lurcott v Wakely & Wheeler* [1911] 1 KB 905 at p 294 …

125. His Lordship considered that in cases where the work done to an asset falls short of being a reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, the important consideration for determining the nature of the expenditure is "the effect of the work on the character of the object". Lord Nicholls stated at 15,706:

> … sometimes repair may not be the appropriate description of work even though it falls far short of being a replacement of substantially the whole of the relevant subject-matter. The effect of the work on the character of the object is also an important consideration.

126. If the work done to an asset has the effect of changing its character it will be capital expenditure. If the work done to the asset does not have the effect of changing the character of the asset the cost of the work done will be revenue in nature and deductible.

127. Lord Nicholls went on to identify two factors as being relevant when deciding whether the work done to an asset has the effect of changing the character of the asset: the nature and the scale of the work done. His Lordship stated at 15,707:

> If a significant portion of this series of linked pipes is effectively abandoned and replaced wholesale with new pipes, the work may readily go beyond what would normally be regarded as repair of the existing system. This is especially so if the new pipes are made from materials which perform differently from the old ones. **The work may be of such a nature and scale as to change the character of the existing system. This is to be contrasted with replacing or making good specific leaking pipes or joints. The latter would be repair, the former would do more than repair what was damaged.**
>
> [Emphasis added]

128. In *Auckland Gas* (PC) it was found that as a result of the scale of the work done and the materials used by the gas company the character of the existing gas network had been changed. A significant portion of the network had effectively been abandoned and replaced. It was also found that the function of the old pipes had changed so that they no longer carried gas, but instead had become housing for the polyethylene pipes that now carried the gas. Lord Nicholls stated at 15,708:

> Far from restoring the gas distribution system to its original state, the work changed the character of the existing gas distribution system: a significant portion of it had been upgraded. Substantial portions of the cast-iron mains and steel services were superseded by polyethylene pipes having the differences and advantages mentioned above.

129. This Interpretation Statement now considers the two factors for determining the effect of the work done on the character of an asset:

- the nature of the work done, and
- the scale of the work done.

Nature of the work done

130. Lord Nicholls in *Auckland Gas* (PC) referred to several decisions that formed the basis for his finding that the nature of the work done to the asset, including the choice of materials used, might change the character of the asset. Lord Nicholls stated at 15,706–15,707:

> ... sometimes repair may not be the appropriate description of work even though it falls far short of being a replacement of substantially the whole of the relevant subject-matter. **The effect of the work on the character of the object is also an important consideration**.
>
> This is explicit, or implicit, in several decided cases. In *W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* (1965) 115 CLR 58 at p 72, Windeyer J observed that **repair "involves a restoration of a thing to a condition it formerly had without changing its character"** (emphasis added). In *Highland Railway Co v Balderston (Surveyor of Taxes)* (1889) 2 TC 485 parts of the main railway track were re-laid, not after their existing fashion, but with steel rails and heavier chairs. The Court of Session held this **substitution was a material alteration and great improvement, and contrasted this with taking away any worn rails and renewing them along the line: that "would not alter the character of the line"** (see the Lord President, Lord Inglis, at p488). The Judicial Committee applied this dictum in *Rhodesia Railways Ltd v Collector of Income Tax, Bechuanaland Protectorate* [1933] AC 368 where **the cost of relaying a railway line so as to restore it to its former condition was held to be a legitimate charge against income**. Consistently with this, in *Mitchell v BW Noble Ltd* [1927] 1 KB 719 at p 729, Rowlatt J observed that **replacement of a railing which perpetually falls down or needs painting with a brick wall would be capital expenditure**. In *FC of T v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 **a dangerous ceiling in a cinema was replaced with a new and better ceiling. Kitto J regarded the work as different in degree and kind from the type of repairs properly allowed for in the working expenses of a theatre business**.
>
> [Emphasis added]

131. If the nature and scale of the work done to an asset indicates that the work has gone beyond repairs, and has changed the character of the asset, the cost of that work is capital expenditure.

132. Usually the character of an asset will be changed when the work done improves or enhances the asset in some way or makes it more advantageous. However, an improvement to the asset will not always be determinative of capital expenditure. This is because almost any repair work to an asset will result in some degree of improvement to that asset. To be capital in nature the work done must go beyond ordinary restoration and change the character of the asset.

133. One decision that Lord Nicholls relied on was the well-known Scottish decision of *Highland Railway*, which the Privy Council also applied in *Rhodesia Railways*. These two railway cases are often compared to demonstrate the effect the work done can have on the character of an asset.

134. In *Highland Railway* the court decided that alterations made to the company's main railway line changed its character so that the expenditure incurred was capital in nature. The court held at 488:

> Then when we come to the question of the alteration of the main line itself, it must be kept in view that this is not a mere relaying of the line after the old fashion; it is not taking away rails that are worn out or partially worn out, and renewing them in whole or in part along with the whole line. That would not alter the character of the line; it would not affect the nature of the heritable property possessed by the Company. **But what has been done is to substitute one kind of rail for another, steel rails for iron rails.** Now that is a material alteration and a very great improvement on the corpus of the heritable estate belonging to the Company, and so stated is surely a charge against capital.
>
> [Emphasis added]

135. In contrast, the Privy Council in *Rhodesia Railways* distinguished *Highland Railway* and held that expenditure on repairs to the railway line did not have the effect of changing the character of the line. Instead, the expenditure was found to be an ordinary incident of railway administration. Lord Macmillan stated at 374:

> The periodical renewal by sections of the rails and sleepers of a railway line as they wear out by use is in no sense a reconstruction of the whole railway and is an ordinary incident of railway administration. The fact that the wear although continuous is not and cannot be made good annually does not render the work of renewal when it comes to be effected necessarily a capital charge. The expenditure here in question was incurred in consequence of the rails having been worn out in earning the income of previous years on which tax had been paid without deduction in respect of such wear, and represented the cost of restoring them to a state in which they

> could continue to earn income. It did not result in the creation of any new asset; it was incurred to maintain the appellants' existing line in a state to earn revenue.

136. Lord Macmillan commented on the differences between the situations in *Highland Railway* and *Rhodesia Railways* at 376:

> The contrast between the cost of relaying the line so as to restore it to its original condition and the cost of relaying the line so as to improve it is well brought out in the passage just quoted [ie, the passage quoted at paragraph [134] of this statement], and while the former is recognised as a legitimate charge against income the extra cost incurred in the latter case in the improvement of the line is equally recognized as a proper charge against capital. In the present instance the renewals effected constituted no improvement; they merely made good the line so as to restore it to its original state.

137. Lord Nicholls in *Auckland Gas* (PC) also referred to *FCT v Western Suburbs Cinemas*. That case is often considered with *Conn (HM Inspector of Taxes) v Robins Bros Ltd* (1966) 43 TC 266 (Ch). Both cases involved significant work done to repair buildings, but the court in each case reached a different outcome. Looked at together, the two cases illustrate the effect the nature of the work done can have on the character of an asset. They also demonstrate how the particular materials used can affect the nature of the work done. The assessment of the work done will always be a question of fact.

138. In *Western Suburbs Cinemas* a damaged ceiling was replaced because an architect considered it was impractical to repair. The court decided the cost of replacing the ceiling was expenditure on capital account. The ceiling was *replaced* with a new ceiling constructed from more suitable modern materials than those materials previously used, even though equivalent materials were available. The court held that the work done did much more than meet a need for restoration. The resulting ceiling was new and better and had considerable advantages. It was held that the repair work done was different, in degree and in kind, from the usual allowable working expenses of a theatre business. Kitto J stated at page 105:

> To decide whether a particular item of expenditure on business premises ought to be charged to capital or revenue account is apt to be a matter of difficulty, though the difference between the two accounts is clear enough as a matter of general statement (*Sun Newspapers Ltd. v. Federal Commissioner of Taxation*). **In this case the work done consisted of the replacement of the entire ceiling, a major and important part of the structure of the theatre, with a new and better ceiling.** The operation seems to me different, not only in degree, but in kind, from the type of repairs which are properly allowed for in the working expenses of a theatre business. It did much more than meet a need for restoration; **it provided a ceiling having considerable advantages over the old one**, including the advantage that it reduced the likelihood of repair bills in the future. The case resembles one of the illustrations given by Rowlatt J. in *Mitchell v. B. W. Noble Ltd* [1927] 1 KB 719, at p 729. As his Lordship there observed, if you say, "I will not have a railing which perpetually falls down or wants repainting; I will abolish it and I will build a brick wall which will not fall down or will not want painting", that is a capital expenditure. **The truth is, I think, that the new ceiling was an improvement to a fixed capital asset and that its cost was a capital charge**.

[Emphasis added]

139. *Robins Bros* involved extensive repairs to leased retail premises. The building was over 400 years old and for the most part was original, but a great part of it was rotten. The building was protected and any work done to it could be for preservation purposes only. The work done included renewing some of the roof timbers and replacing the slate roof with corrugated asbestos. Some walls on the lower floor were removed, so steel girders had to be inserted to support the upper storeys. The rotten timber ground floor was re-formed in concrete. In contrast to the decision in *Western Suburbs Cinema*, the court in *Robins Bros* held that although there was extensive replacement of the existing asset, the expenditure was on revenue account. Buckley J's reasoning at 274 was that:

> ... this was expenditure incurred by the Company with a view to enabling it to continue to earn profits from its business, not by acquiring some asset for that purpose but by putting the Company's existing asset into a state of repair which would enable it to continue to use that asset. No doubt in the course of carrying out these works certain structural alterations were made, as one would expect with any extensive repair of a building over 400 years old, when repairs were being carried out at a time when building techniques have completely altered. But the fact that there were alterations in the structural details of the building does not seem to me to be a good ground for proceeding upon the basis that the work produced something new. On the contrary, I think it is implicit in the Commissioners' finding **that the result of this work was not to produce something new but to repair something which had previously existed**. Upon that basis it seems to me that there is no ground for regarding this expenditure as a capital expenditure. It was expenditure incurred for the

> purpose of enabling the Company to continue to earn its profits, and was therefore in my judgment expenditure which would properly be chargeable to income.
>
> [Emphasis added]

140. While the decisions in *Western Suburbs Cinemas* and *Robins Bros* might seem contradictory, the Commissioner considers the two cases demonstrate the subtle factual differences that make decisions in this area so difficult. It is not wise simply to view the cases as irreconcilable or that the approach in one case is to be preferred over the other. What is clear from these two cases is that when major components of an asset are replaced instead of simply being repaired to a serviceable condition, a judgement has to be made as to the nature of the work done to the asset.

141. In *Western Suburbs Cinemas* the court focused on the improvement the taxpayer made by choosing to replace the damaged ceiling with a new ceiling constructed from a superior modern product when other equivalent products were available. The inference is that if the ceiling had been repaired using the equivalent materials then the work would have been more likely to be a deductible repair. In *Robins Bros*, the company took a different approach to maintaining the building (much of which was 400 years old and protected), and viewed the replacement of major components as a natural part of the repair process, using materials that were appropriate for construction at the time the work was done. Arguably, in *Robins Bros* the company did not seek to improve the building but only to maintain the building's inherent utility. The building remained the same size and in the same location. The building was not completely reconstructed, replaced or renewed, nor was substantially the whole of the building reconstructed, replaced or renewed. The court found in *Robins Bros* that, based on its particular facts, while the building was improved as a result of being repaired, the work done to the building did not go beyond repairs. In contrast, the work done to the ceiling in *Western Suburbs Cinemas*, while necessary, went beyond restoration and changed the character of the building.

142. It is also interesting to consider the decision in *Robins Bros* in the light of Lord Nicholl's observations in *Auckland Gas* (PC) regarding *Lurcott*. Lord Nicholls makes it clear that work done to an asset will be capital expenditure where that work results in the asset, or substantially the whole of the asset, being reconstructed, replaced or renewed. As seen, Lord Nicholls also makes it clear that work done to an asset will be capital expenditure where that work changes the character of the asset. Buckley J appeared to be influenced by the lower court finding of fact that the work done was repairs. It could be suggested that if similar facts as in *Robins Bros* arose under the ITA 2007, the expenditure would be found to be capital in nature on the basis that the character of the building had changed, or the work amounted to a reconstruction, replacement or renewal of substantially the whole of the asset, or both.

Use of more modern materials

143. The decision in *Western Suburbs Cinemas* illustrates how the materials used to make repairs can have an important bearing on the nature of the work done.

144. In *Western Suburbs Cinemas* the ceiling of the theatre was predominantly made from sheets of an imported product called "Ten Test". Over time the Ten Test material had become dry, buckled and brittle. Many of the pins affixing the sheets to the ceiling joists had drawn through. An architect concluded that it was practically impossible to repair the ceiling. The product Ten Test was not available, although two equivalent products were available—celotex and caneite. However, the architect would not use any product of this type as he considered them to be unsatisfactory for this purpose. Instead he replaced the ceiling with fibrous plaster, attached to new battens that were attached to new ceiling joists. The plaster had a longer life, was harder, better suited to decorative treatment and could be moulded. Even though the architect had advised against repair, the cinema company still got a price for repairs to the ceiling using equivalent materials. The company considered both options (ie, repair or replacement of the ceiling) and chose not to repair but to replace the whole ceiling. Kitto J concluded at 106 that the result of the work done was a "new and better" ceiling that provided considerable advantages over the old one. He found that "the new ceiling was an improvement to a fixed capital asset" and therefore capital expenditure.

145. These same principles were applied by Judge Barber in the Taxation Review Authority decision, *Case F78* (1984) 6 NZTC 59,951. Judge Barber decided the replacement of a cracked fibrolite roof of a rental property with a new type of tiled roof did not restore the asset to its original character but altered it. The roof could have been repaired by the replacement of the damaged sheets of fibrolite but instead the owners chose to replace the entire roof with a "better" type of tiled roof. This meant the work was capital in nature.

146. In *Auckland Gas* (PC) Lord Nicholls also discussed the use of new materials in repairs and maintenance work. He noted that the use of newer and better technology may not in itself change the character of the asset. At 15,706 he states:

> It often happens that, with improvements in technology, a replacement part is better than the original and will last longer or function better. That does not, of itself, change the character of the larger object or, hence, the appropriate description of the work.

147. However, while the use of new materials may not in itself change the character of an asset, Lord Nicholls went on and found in *Auckland Gas* (PC) that when new materials were used extensively and performed differently, then their use did result in a change of character of the asset. He held that the fact that a significant portion of the gas network had been replaced with new polyethylene pipes, together with the fact that the new pipes were made of materials which performed differently from the old pipes, meant that the nature and scale of the work was such that the character of the existing gas system was changed (at 15,708).

148. With regard to the nature of the work done, the use of new materials in completing the work does not necessarily mean that the asset is improved. However, where different materials are used and as a result the asset is more advantageous or performs or functions better or differently than it did previously, that may indicate a change in the character of the asset. Where a decision is made to use better materials instead of the same or equivalent materials a change in the character of the asset will result and the cost of the work done will be capital expenditure.

149. However, regardless of the choice of materials, as seen above, where new materials are used extensively so that the asset, or substantially the whole of the asset, is reconstructed, replaced or renewed, the expenditure will be capital in nature.

Other factors potentially affecting the nature of the work done

150. From time to time the courts have been asked to take into account other factors when deciding whether the work done to an asset is capital or revenue in nature. The types of factors that the courts sometimes consider include the effect of the work done on:

- the value of the asset;
- the income-earning capacity of the asset;
- the useful life of the asset;
- the function of the asset;
- the operating capacity of the asset.

151. The cases show that these factors are rarely determinative of the nature of the work done. The courts instead consider the overall effect of the work done on the asset when determining whether the character of the asset has changed.

152. For example, an increase in value by itself has not been considered a reliable indicator of work being of a capital nature. In *Poverty Bay Electric* Blanchard J commented at 15,008:

> It is worth observing also that it is hard to see the adding of value as an essential element in capital expenditure when restoration or repair work usually adds value to the object which is restored or repaired.

153. Similarly, the income-earning capacity of an asset does not need to increase for the work done to the asset to be capital in nature. The changes made to the railway line in *Highland Railway* were found to be a "permanent improvement" even though the company "derived no additional revenue from the outlay". Therefore, a comparison of the income-earning capacity of the asset alone cannot always accurately determine whether the work done has changed the character of the asset. This conclusion was also reached by Judge Barber in *Case X26* in response to an argument that the work done to the building did not result in any increase in the rental income the building was capable of generating, and therefore the cost could not be capital expenditure.

154. It is sometimes suggested that the extension of an asset's useful life may indicate the work done to an asset is of a capital nature. Correspondingly, if there is no increase in an asset's useful life that may indicate revenue expenditure. However, the Court of Appeal in *Auckland Gas* noted at 15,022 that if the old gas network had been repaired by merely replacing the joints and corroded sections of pipe the network would have been capable of giving more service and the benefits would have been long lasting. Further, the Court of Appeal observed that where the work done creates a new asset it is not essential that the life of the original asset be extended for the work done to be capital in nature. This means that the effect of the work done on an asset's useful life is not always a reliable indicator of the capital or revenue nature of work done to an asset. Every fact situation is different.

155. In *Auckland Gas* (PC), Lord Nicholls also noted that a comparison of the functional position of an asset before and after the work is done is not a reliable guide by itself as to whether the work done is capital or

revenue in nature. He explained at 15,708 that this was because a maintenance problem can be solved in more than one way:

> The Court of Appeal held, and their Lordships agree, that Williams J [in the High Court] reached a conclusion which did not reflect the reality of the work done. In particular, his comparison of the functional position before and after was made at a level of abstraction which paid insufficient regard to the nature and extent of the operation carried out by Auckland Gas. A maintenance problem such as existed here may be capable of being solved in more than one way. It may be solved by work which would be regarded as a repair of the existing structure. Or it may be solved by scrapping all or much of the existing structure and providing a new one. **In overall functional terms the result may be much the same in the two cases, but that is not by itself a reliable guide.** If the latter alternative is chosen, the expenditure may well be of a capital nature.
>
> [Emphasis added]

156. Lord Nicholls then said at 15,709 that:

> … the desire to solve a maintenance problem is not inconsistent with carrying out work of a capital nature. **The nature and extent of the work carried out to the physical asset are what is determinative of the character of the work.**
>
> [Emphasis added]

157. A further point to note is that sometimes work done to an asset may result in unsought benefits. For example, in *Auckland Gas* the insertion of the replacement pipes meant that the new pipes, although smaller in diameter, would be able to carry gas at a higher pressure than the old pipes. This meant the overall capacity of the network was increased. While this outcome was not a goal in itself, as the existing system already had enough additional capacity for future growth, it was found to be an improvement brought about by the work done, and as such indicated a change in the character of the network.

158. This suggests that where the work done to an asset results in an unsought benefit, the fact that obtaining the advantage was not a goal of the work done does not prevent a finding that the character of the asset has been changed.

159. In summary, factors such as changes to an asset's value, earning capacity, useful life, function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset. However, in some cases the courts have tended to use such factors to support an overall assessment of whether the character of an asset has changed.

Scale of the work done

160. Another important consideration when determining whether the work done to an asset has changed the character of the asset is the scale of the work done. This is also an important consideration when determining whether the work done has resulted in the asset or substantially the whole of the asset being reconstructed, replaced or renewed.

161. When considering the scale of the work done the courts may take into account the extent of the work done, the importance of the work done to the asset and the business, and the cost of work done in the context of the asset.

162. As seen in *Auckland Gas* (PC) Lord Nicholls confirmed that repairs and maintenance expenditure is on capital account when the work done to the asset is so substantial that it is a reconstruction, replacement or renewal of the identified asset or substantially the whole of the asset. Under general capital/revenue principles, one-off expenditure that results in the creation of a new asset, or the production of an advantage of an enduring benefit, may indicate that expenditure is of a capital nature. The courts have also indicated that even where the work done to an asset falls short of being the renewal of substantially the whole of the asset, the more substantial the work is in relation to the asset, the more likely it is that the work will have had the effect of changing the character of the asset and will be of a capital nature. For example, in *Auckland Gas* polyethylene pipes were inserted into 380 km of the network's cast-iron mains and into 150 km of the network's steel services, amounting to 23% of the entire network and 32% of the steel services respectively. The courts found that these were substantial portions of the gas distribution system.

163. In *Case L68* (which concerned work done to two fishing boats—the first had its motor replaced and the second was refitted), Judge Keane considered the scale of work done to refit the second boat indicated the expenditure was capital in nature. He held at 1,401:

> Whether expenditure is for "repairs or alterations", or is more substantial and capital in nature, appears to depend on the scale and significance of the work done, when related to the asset to which it occurs. **The larger and more significant the work, relative to the whole, the more probable it is that capital expenditure is involved.**
>
> …
>
> The refitting of the "S" seems much more to me than an accumulation of repairs. **The sheer scale of what was done tells against the possibility that it was routine.** It was an extraordinary event in the life of

> the vessel. There was nothing piecemeal about what was done. The whole capital entity was affected. Entire aspects of the fabric were replaced. The vessel was restored in the fullest sense, in some respects with more modern materials, to a new and much extended life. The expenditure seems to me to have been capital in nature.
>
> [Emphasis added]

164. It also follows that the bigger, more significant or more integral the part of the asset being worked on or replaced is, relative to the asset as a whole, the more likely the expenditure will be of a capital nature. For example, in *Western Suburbs Cinemas* Kitto J referred to the fact the ceiling was a "major and important part of the structure of the theatre" when reaching his conclusion that the expenditure was capital.

165. In *Case N8* (which concerned the deductibility of repair costs to a cement manufacturing plant), Judge Bathgate found it significant in his analysis of the work done to the plant that the mixer was replaced. The mixer was central to the operation of the plant and was housed in the tower of the central working core of the batching plant. The contents of the tower were replaced to a significant degree.

166. At 3,074 his Honour commented:

> Altogether, item by item by item there was a significant replacement and renewal of the central core parts in the concrete making process. There were also significant replacements by renewal of many stationary parts. When they are together considered with the renewal, replacements and improvements to the structural parts housing or supporting the plant and equipment, the entire entity, as a composite whole had such a quantity and value of work that I think, fairly obviously, it was capital and not revenue in character.

167. Therefore, when the scale of the work done is being considered, the importance of the parts being worked on to the asset and to the business as a whole forms part of that consideration.

168. Judge Bathgate also considered that the cost of the work done relative to the value of the asset can be an indicator as to the nature of the expenditure. In keeping with general capital/revenue principles he suggested an amount incurred regularly and that is small, relative to the whole value of the asset, is more likely to be revenue in nature. On the other hand, one-off expenditure that is substantial in relation to the value of the asset before the work is done is more likely to be capital in nature. He stated at 3,073:

> The expenditure would generally be deductible also if the expense is for an amount that is regularly incurred by reason of ordinary wear and tear, or the **expense is small and subordinate in nature in relation to the whole value of the asset involved**. On the other hand work resulting in a significant increase in value of the asset, a change in its character or kind, of an amount not regularly incurred, **or substantial in amount in relation to the value of the asset prior to the work, may be more likely to be capital expenditure** of the nature not allowed as a deduction under sec 108(1).
>
> [Emphasis added]

169. Judge Bathgate's decision provides one example of how cost can be taken into account in the assessment of the nature and scale of the work done—in that case comparing the cost of the work with the value of the asset. However, in the Commissioner's view, the courts do not provide any consistent authority as to how best to make such cost comparisons, nor the importance of them. The courts tend to focus more widely on the scale of the work done to the asset, of which cost is only one factor.

170. In *Hawkes Bay Power*, when considering the effect of the work done Goddard J said at 13,706:

> The evidence from the valuation experts … was extremely interesting, although varied. In the end, however, it did not assist in determining the key issues. … the fact of the matter is that the degree of expenditure invested by Hawkes Bay Power in its underground conversion programme can only be regarded as capital in nature.

171. In summary Goddard J noted at 13,707 that "the scale and degree of the work involved in the total project and the money expended on it leads to only one conclusion; that is, that the expenditure in question is capital in nature".

172. In the Commissioner's view, cost on its own is not always a reliable indicator of the nature of expenditure. Sometimes the cost of repair work can be very high, for example, if the replacement parts are expensive or the repair work is difficult. This does not mean the nature of the work done has changed from being revenue to capital. Similarly, in some circumstances it may be less expensive to replace an asset than to repair it—but that saving does not change the character of the work done from being capital. That said, the Commissioner considers that as a general proposition the more significant the costs incurred, the more likely the expenditure will be capital in nature.

173. Overall, the courts consider the scale of the work done, including the extent and cost of work done, when deciding whether work done is of a capital or revenue nature. The more important the asset is to

the business, or the more integral the replacement parts are to the asset then arguably the scale of work done increases and the more likely the expenditure will be capital in nature.

174. When both the nature and the scale of the work done are considered, a decision can be made as to the character of the work done—that is, whether it is capital or revenue in nature.

Key points on the nature and extent of the work done to the asset

175. The Commissioner takes the following key points from the analysis of the cases on the nature and extent of the work done:

- If the work done results in the reconstruction, replacement or renewal of the asset or substantially the whole of the asset the cost of that work will be capital expenditure (*Auckland Gas* (PC), *Auckland Trotting* (SC and CA), *Lurcott*).
- Expenditure incurred to repair or maintain the asset, over and above making good wear and tear, that has the effect of changing the character of the asset will also be capital expenditure. Expenditure incurred to repair or maintain the asset without changing its character will be on revenue account (*Auckland Gas* (PC)).
- When determining whether the work done is capital in nature, relevant factors to consider are the nature and the scale of the work done to the asset (*Auckland Gas* (PC)).
- With regard to the nature of the work done, the use of new materials in completing the work does not necessarily mean that the asset is improved. However, where different materials are used and as a result the asset is more advantageous or performs or functions better or differently than it did previously, that may indicate a change in the character of the asset. Where a decision is made to use better materials instead of the same or equivalent materials a change in the character of the asset will result and the cost of the work done will be capital expenditure. Where new materials are used extensively so that the asset, or substantially the whole of the asset, is reconstructed, replaced or renewed, the cost of the work done will be capital expenditure regardless of the choice of materials (*Auckland Gas* (PC), *Western Suburbs Cinemas*, *Case F78*).
- Changes to an asset's value, its earning capacity, its useful life, function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset. Instead in some cases the courts have tended to use such factors to support an overall assessment of whether the character of an asset has changed (*Poverty Bay Electric*, *Highland Railway*, *Auckland Gas* (PC and CA)).
- Determining the scale of the work done includes a consideration of the extent of the work done, the importance of the work done to the asset and the business, as well as the cost of the work done. The greater the extent of the work done, the greater the importance of the work done to the asset and the business, and the more significant the costs incurred, the more likely the expenditure will be capital (*Auckland Gas* (PC), *Case L68*, *Western Suburbs Cinemas*, *Case N8*, *Hawkes Bay Power*).

Examples – nature and extent of the work done to the asset

Example 5: Taxi driver replaces engine (no change in character or substantial renewal)

Frank is an owner-operator taxi driver. He has driven the same taxi for the past 5 years. Until recently the taxi has been reliable and overall is in good condition. Frank has had his taxi serviced regularly but his mechanic has advised him that the engine is now seriously worn. Frank arranges for his mechanic to replace his taxi's worn engine with a reconditioned engine that is comparable to the worn one. The cost of the replacement engine and its installation is revenue in nature. This is because the work done does not go beyond repairs to change the character of the taxi. The work done also does not result in a renewal of substantially the whole of the asset (ie, the taxi).

Example 6: Taxi driver upgrades engine (change in character)

Frank decides that if he needs to install a reconditioned engine in his taxi, rather than replacing the worn engine with a comparable engine he would prefer to upgrade to a more powerful one so that he can tow a luggage trailer. The ability to carry additional luggage will expand his business. Therefore, he asks his mechanic about sourcing and installing a compatible but more powerful engine. In this case the cost of the replacement engine and its installation will be capital expenditure. This is because the work done goes beyond repairs and has changed the character of the taxi.

Example 7: Refurbishment of item of industrial plant (substantial replacement and renewal)

Best Processors Limited owns a large item of specialised industrial plant that is central to its business. Due to wear and tear on the plant, and despite regular maintenance, the company is concerned that the quality of its products is declining. To ensure the company preserves its quality standards the company resolves to refurbish the item of plant. Extensive work is undertaken. The plant casing is repaired. The core processor unit is replaced, along with the drive mechanisms, motors and conveyors. Repairs on related parts are also undertaken. As a result of the work done to the plant, improved production quality is achieved. There have been negligible gains in the operating capacity of the plant. The cost of the work done was significant.

The costs incurred by Best Processors Limited will be capital expenditure. Although the plant may not be functionally different after the work, overall, a replacement and renewal of substantially the whole of the plant has occurred. The nature and scale of the work done supports this conclusion.

Example 8: Replacement of rotary platform in a dairy shed (substantial replacement and renewal)

Loamsdown Farms needs to replace the rotary platform in its rotary dairy shed. The existing platform drive mechanism and motor will be retained. The new platform will have no greater capacity than the old platform. The rotary platform, together with its associated drive mechanism and motor, makes up the rotary platform asset. The replacement of the platform will involve the replacement and renewal of substantially the whole of the rotary platform asset. The platform is a significant and distinct part of the entire rotary system in terms of both its size and value. The cost of replacing the rotary platform will be capital expenditure. An increase in the capacity of the platform is not necessary to establish capital expenditure, if the replacement is so significant that it amounts to the replacement or renewal of substantially the whole of the asset.

(This example is based on findings made in the Commissioner's Interpretation Statement IS0025 "Dairy Farming – Deductibility of certain expenditure" *Tax Information Bulletin* Vol 12, No 2 (February 2000).)

Example 9: Insulation top-up (no change in character or substantial replacement or renewal)

Peter and Alice own a residential rental property in Wellington that was built 30 years ago. After a cold snap, their tenants complain that the insulation in the house has deteriorated and is no longer effective. Peter and Alice arrange for new insulation to be inserted into the house. The cost of the insulation is revenue in nature on the basis that it is a repair to the property and does not change the character of the asset. Nor does it result in a replacement or renewal of substantially the whole of the house. The work done only restores the property to its former condition.

Example 10: New insulation (improvement that changes character)

Ralph and Bridget own a residential rental property that has never been insulated. Their tenants have been asking for years for the walls and floors to be insulated. Finally, Ralph and Bridget agree and insulation is installed. The cost of this new insulation is capital expenditure. It is not a repair to the rental property. The addition of insulation to the house improves the house and changes its character.

Example 11: Replacement of garage roof using equivalent materials (no change in character or substantial reconstruction, replacement or renewal)

Natalie and Albert own a residential rental property. The rental property has a lean-to garage attached to it which has an asbestos roof. The roof has recently cracked and started leaking. It is no longer appropriate to use asbestos as a roofing material, so the roof of the lean-to is replaced with a comparable pre-painted steel roofing product. The cost of replacing the garage roof is revenue in nature. In this case the work done does not change the character of the asset. This is even though a newer, more modern material was used. The roofing material selected reflects current building practices, was an equivalent product and did not improve the lean-to beyond restoring it to its original condition. Nor did the work result in a reconstruction, replacement or renewal of substantially the whole of the house.

Example 12: Leaky home repairs (no change in character or substantial reconstruction, replacement or renewal)

Cath and Simon own a residential rental property. A few years ago they added a two room extension to the property. The extension has been leaking. The timber framing within the extension is rotten and needs replacing. To make the repairs the cladding and windows need to be removed from the extension and refitted. The cost of the repairs is revenue in nature. The work done to the house does not amount to a reconstruction, replacement or renewal of substantially the whole of the house. Nor do the repairs change the character of the house.

Example 13: Leaky home improvements (change in character)

Cath and Simon are unlucky and have discovered that another of the rental properties they own is a "leaky home". In this case the solution is not as straightforward as in Example 12 above and the remedial work required is extensive. Cath and Simon decide to re-clad all the house's exterior walls using a superior concrete block construction system rather than the equivalent substitute cladding system. While the concrete block construction system is more expensive, it should be more durable, and require less maintenance. The cost of repairs will be capital expenditure. The work done goes beyond repairing the house and the character of the house is changed. This is the outcome in this case regardless of whether the work done results in the reconstruction, replacement or renewal of the house or substantially the whole of the house.

Example 14: Major repairs to leaky building (substantial reconstruction)

Stuart owns a stand-alone single-storey commercial building in Onehunga that he leases to a small manufacturing business. The building has been leaking badly and the walls and timber framing are extensively damaged. To rectify the damage and prevent it recurring, extensive work is undertaken. All the exterior wall cladding is removed and replaced with an equivalent recommended product. Large sections of the building's framing are replaced with treated timber. Also, damaged sections of the floor are replaced. New flashings are installed around the windows, and portions of the interior walls are relined. The cost of the work done to the building is significant. The cost is capital expenditure. This is because the remedial work done is so extensive it has resulted in the reconstruction of substantially the whole of the building.

Example 15: Repair to land improvement (no change of character or substantial reconstruction, replacement or renewal)

Andrea owns a rental property. The house is built on a steep slope, and rests on a terrace that has been cut into the hillside. The hillside is supported by a large retaining wall. The retaining wall is deteriorating in some places and needs to be repaired. The asset in this case is the retaining wall (a land improvement). The expenditure on the work done to repair the retaining wall is revenue in nature. The work done is not extensive enough to amount to a reconstruction of substantially the whole of the retaining wall. The work done also does not change the character of the wall.

Other considerations from the repairs and maintenance cases

176. Over the years the courts have considered many different situations relating to the deductibility of repairs and maintenance expenditure. To deal with some of these situations the courts have developed a number of principles that can provide assistance when deciding whether repairs and maintenance expenditure in these types of situations is deductible. This Interpretation Statement will now consider some of these situations along with the principles that have been developed by the courts:
    - What if repairs are deferred and then completed all at once?
    - What happens when the repair work forms part of one overall project?
    - What are notional repairs?
    - Is a deduction available for expenditure incurred to repair a newly acquired but dilapidated asset?
    - Does the nature of the expenditure change if damage is repaired as a result of a significant event?

What if repairs are deferred and then completed all at once?

177. Where the work done is the result of accumulated repairs the expenditure may be deductible. The timing of repairs can vary. Some businesses undertake repairs and maintenance of their business assets on a regular basis. Other businesses may undertake repairs as and when they become necessary. Some businesses may choose to defer their repairs and maintenance work and carry them out infrequently at a time that is convenient to the business. Other businesses may undertake regular maintenance but from time to time they may also be required to perform a major overhaul of an asset.

178. Where repairs are deferred, then accumulated and completed all at once, the resulting scale of work done can be substantial. Similarly, where significant overhaul costs are incurred occasionally in addition to regular repairs costs, the issue can arise as to whether the work done, through its scale and because it occurs irregularly, is capital expenditure.

179. The courts have considered issues relating to the timing of repairs and whether the deferral of repairs can result in the cost of those repairs being capital expenditure.

180. *Ounsworth* considered the deductibility of costs incurred by a ship-building company to regain access to the sea. The previous shipping channel available to the company had silted up through neglect. A local railway company was responsible for keeping the channel clear but it had not carried out dredging for several years. Rowlatt J commented that the cost of dredging the existing shipping channel would have been revenue expenditure to the railway company if the channel had been dredged year by year, or even if it had only been dredged as and when seriously required. However, in this case he held that the cost incurred by the ship-building company in regaining access to the sea by dredging some of the channel itself and constructing a deep-water berth was capital expenditure. The company had effectively abandoned its old means of access and constructed a new means of access to the sea.

181. However, the obiter comments Rowlatt J made in *Ounsworth* demonstrate that deductibility of expenditure on repairs and maintenance is not limited to expenditure incurred regularly year by year. Expenditure incurred on repairs and maintenance as and when required can also be deductible. Rowlatt J said at 273 that "the real test is between expenditure which is made to meet a continuous demand, as opposed to an expenditure which is made once [and] for all".

182. The Privy Council's decision in *Rhodesia Railways* supports the view that the deferral of repairs should not change the character of those repairs from being revenue expenditure to capital expenditure. Lord Macmillan stated at 374:

> The periodical renewal by sections of the rails and sleepers of a railway line as they wear out by use is in no sense a reconstruction of the whole railway and is an ordinary incident of railway administration. **The fact that the wear although continuous is not and cannot be made good annually does not render the work of renewal when it comes to be effected necessarily a capital charge**.
>
> [Emphasis added]

183. Sometimes repairs can take a lengthy period to complete. Again, the courts have held that this does not determine whether the expenditure incurred is revenue or capital in nature. Lord Nicholls commented at 15,708 of the Privy Council's decision in *Auckland Gas* that "the speed or slowness with which the work was carried out cannot affect its nature or, hence, its proper characterisation".

184. The Commissioner notes however, that if the repairs become so extensive that they amount to the reconstruction, replacement or renewal of the asset or substantially the whole of the asset, the cost of that work will be capital expenditure. Similarly, if the deferred repairs form part of one overall project that is capital in nature, then those repairs will take their character from the project. The cases show that different taxation outcomes can result depending on what the particular taxpayer did and when. This will always be a question of fact and degree in the particular circumstances.

What happens when the repair work forms part of one overall project?

185. When repair work forms part of one overall project the courts have suggested that it is not appropriate to separate out the different costs of the project for tax purposes where that project is of a capital nature. This is the case whether the project concerns work done on a single asset or work done on a group of assets.

186. In *Colonial Motor* the Court of Appeal considered whether the work done to convert a building from a warehouse to an office building, including seismic strengthening, was one project or whether the work done on the seismic strengthening could be considered separately from other work done on the building. The local city council considered the building to be an earthquake risk and without the strengthening work the building would have been demolished. The work done involved the construction of new concrete walls, the removal of a mezzanine floor, the addition of a penthouse, and general refurbishment and seismic strengthening. The taxpayer divided the expenditure incurred into three categories: revenue, seismic strengthening and capital. The Commissioner and the taxpayer agreed on the deductibility status of the expenditure, with the exception of the expenditure on seismic strengthening. The taxpayer argued it was deductible being repairs and alterations that did not increase the capital value of the building in terms of the proviso to s 108 of the Income Tax Act 1976.

187. The Court of Appeal suggested that if the work undertaken is all part of one overall project then the work must be evaluated holistically to determine whether the work did no more than repair or alter the asset in question. This was despite the fact that the dispute only concerned the expenditure on the seismic strengthening and not the expenditure that the Commissioner and the taxpayer had already agreed was either revenue and deductible or capital and non-deductible. Richardson J stated that the mere accounting allocation of the total expenditure did not change the character of the work done. Looking at the total work carried out and the magnitude of the work involved, Richardson J found that the work was not the subject of two independent unrelated projects. It was a single project that converted the eight storey warehouse destined for demolition into a nine storey office block. His Honour stated at 11,366:

> **That statutory inquiry relates to the work that was actually done. If there was one overall construction project, it is the total work involved in relation to the particular premises which has to constitute "repairs or alterations of any such asset" so as to come within the proviso**. In such a case it begs the question to say that the taxpayer could have confined itself to certain specific parts of the work done in which case that limited work would have constituted alterations. **The allocation of the total expenditure to different categories of work does not change the character of the work that was done.**
>
> **On the facts of this case it is essential to consider the total work carried out**. It was not and could not sensibly have been the subject of two independent unrelated contractual projects, one for strengthening the building and the other for new and repair work. **It was a single project** which converted the eight storey warehouse-type structure otherwise destined for demolition into a nine storey office block with a 50 year revenue earning life. … The magnitude of the work involved is reflected in the total expenditure of $5.7 million of which the great bulk was in new work ($3.47 million) and the major part of the strengthening ($1.28m) was the construction of two new concrete walls. That was an entirely new structural addition.
>
> …While strengthening alone or capital and repairs alone might have added little if anything to the value, it was their combined effect that was so significant.
>
> [Emphasis added]

188. The Commissioner recognises that the decision in *Colonial Motor* was addressing whether the work done was "repairs or alterations" for the purposes of s 108 of the Income Tax Act 1976. However, in the Commissioner's view, the principle Richardson J put forward in *Colonial Motor* continues to be relevant when considering whether expenditure incurred on work carried out as part of a larger project is capital or revenue in nature. Where repair work is done as part of one overall project to reconstruct, renew or replace an asset, or substantially the whole of an asset, or to change its character, the nature of the expenditure on the repair work is taken from the character of the overall project, and the repair work is not looked at in isolation.

189. *Colonial Motor* is often compared with *Sherlaw*. In *Sherlaw* a boat-shed needed re-piling. However, the re-piling work caused the roof and floor of the boat-shed to be substantially damaged. As a result the taxpayer was required to replace a substantial part of the damaged roof that was unable to be repaired. Also, because of the changes in the roof, the floor was relocated to a slightly higher level. In carrying out the repairs the taxpayer used materials that were second-hand or salvaged from the original boat-shed. The building was the same dimensions before and after the work.

190. The Commissioner, relying on *Auckland Trotting* (SC and CA) and *Colonial Motor*, contended that the work done on the boat-shed in *Sherlaw* was a reconstruction of substantially the whole of the boat-shed. Therefore, all the work done was non-deductible being capital in nature. Doogue J disagreed. His Honour found that the taxpayer carried out nothing more than necessary maintenance of the piles. The course adopted (of doing, wherever possible, work by himself and with friends with second-hand and salvaged materials) indicated this was not an endeavour to improve the structure of the building but simply to ensure that necessary maintenance was carried out to it.

191. Doogue J distinguished *Colonial Motor* on the grounds that the building in *Colonial Motor* was transformed and strengthened with a completely new layout and refurbishment. In *Sherlaw* the boat-shed layout and size were not altered, and substantial parts of the boat-shed remained unchanged. No overall construction project to change the character of the boat-shed existed, and neither did a project to reconstruct, renew, or replace the boat-shed or substantially the whole of the boat-shed. While the scale of the work done was extensive, Doogue J attributed that to the amount of maintenance that had been deferred rather than to any decision by the taxpayer to reconstruct most of the premises. Doogue J stated at [22]:

> In this case the taxpayer sought to repair the piles to the building. That was his objective. That was what he tried to do. The consequences of those

> necessary repairs resulted in other work being required to be done. Unlike the cases to which the Commissioner referred me, this is not one overall construction project in the manner submitted for the Commissioner. In this case once the essential work was commenced other work became necessary. Upon the evidence it may indeed be doubtful whether the taxpayer would necessarily have incurred all the work and expense that he ultimately was involved in if he had known of the extent of it at the beginning. It is true that he undertook it all once he was committed, because that was the practical way for him to deal with the problems which faced him after he had been committed. **This is not a case, however, of the kind referred to me where there was one overall construction project resulting in the complete reconstruction of the boat-shed or of a project for the deliberate improvement of the boat-shed. Here the taxpayer chose to repair the boat-shed and, as a result of that decision, he was faced with consequential repair work and upgrading becoming necessary.**
>
> [Emphasis added]

192. In the Commissioner's view, *Sherlaw* highlights a situation where repairs are undertaken and those repairs have a flow-on effect, causing further repairs to be required. The repairs when looked at in totality, might be extensive. However, they were not undertaken as one overall plan to reconstruct, replace or renew an asset, or substantially the whole of an asset or to change its character.
193. Doogue J noted the Commissioner had not sought to categorise separately any of the work additional to the original re-piling and floor work as capital work. Doogue J then went on to say that if the Commissioner had submitted that certain aspects of the works carried out were of a capital nature there may have been a point to the submission. This suggests that as the work done on the boat-shed was not part of one overall project to substantially reconstruct or renew, or to change its character, different aspects of the work could be identified as being either capital or revenue in nature depending on the effect that the work had on the boat-shed.
194. Both *Colonial Motor* and *Sherlaw* were considered by Goddard J in *Hawkes Bay Power*. In *Hawkes Bay Power* the taxpayer contended that it did not have one overall objective to replace the overhead system in its urban residential areas with an underground system. Hawkes Bay Power contended that each conversion job was simply carried out on an ad hoc basis according to the particular reason for the job.
195. Goddard J, basing her reasons on the documentary evidence before her and Hawkes Bay Power's own acknowledgement of its long-standing policy to convert those areas to an underground system, disagreed. On that evidence Goddard J found the work done by Hawkes Bay Power to replace its overhead wires with underground cables was done with an overall objective to replace the entire overhead system in its urban residential areas with an underground system. Goddard J concluded that given the scale and degree of the work involved in the total project and the money expended on it, the expenditure in question was capital in nature.
196. Hawkes Bay Power, relying on *Sherlaw*, had separately classified expenditure on work done to replace the overhead wires with an underground cable system into capital and non-capital items. For example the expenditure on the replacement of the worn out overhead wires with underground replacements was treated as revenue while the expenditure on the distribution transformers was capitalised. On this point Goddard J held at 13,707:

> In the context **of the total project** and the extent to which it has been achieved to date, **it is artificial to dissect the work into capital and revenue categories, or to further dissect the "purported" revenue category into capital and non-capital items.**
>
> As Kitto J said in *FC of T v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 at p 108:
>
> "... the capital or income character of expenditure actually incurred depends upon the nature of the purpose for which it was incurred. **If a total expenditure is of a capital nature, so is every part of it**; you cannot take a portion of the work done such as the erection of a scaffolding and, closing your eyes to the purpose for which it was in fact erected, attribute to the cost of that portion an income nature for no better reason than that the same scaffolding, would have been erected in order to serve a purpose which, if it had existed, would have made the total expenditure an income charge."
>
> And as Richardson J said in *Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361 at p 11,366:
>
> "That statutory enquiry relates to the work that was actually done. **If there was one overall construction project, it is the total work involved in relation to the particular premises which has to constitute 'repairs or alterations of any such asset' so as to come within the proviso.** In such a case it begs the question to say that the taxpayer could have confined itself to certain specific parts of the work done in which case that limited work would have constituted alterations. The allocation of the total expenditure to different categories of work does not change the character of the work that was done.

> "On the facts of this case it is essential to consider the total work carried out. It was not and could not sensibly have been the subject of two independent unrelated contractual projects, one for strengthening the building and the other for new and repair work. It was a single project which converted the eight storey warehouse-type structure otherwise destined for demolition into a nine storey office block with a 50 year revenue earning life."
>
> The case of *Sherlaw v CIR* (1994) 16 NZTC 11,290 on which Hawkes Bay Power sought to rely as authority for separate classification of expenditure into capital and non-capital items falls into a different category to the present case on the issues of both scale and degree. **On the facts in *Sherlaw* Doogue J found there was not one overall construction project resulting in a complete reconstruction or that the expenditure was so disproportionate as to indicate that it was of a capital nature.**
>
> [Emphasis added]

197. *Hawkes Bay Power* makes it clear that where work forms part of one overall project of capital work, then that work will take its character from the character of that overall project. In such a case, it is artificial to dissect the work forming part of that project into capital or revenue categories. This is because work done in every part of that project is calculated to achieve the same objective from both a practical and business point of view.

198. Goddard J in *Hawkes Bay Power* also observed that the taxpayer had treated all expenditure on repairing or replacing existing overhead lines with new overhead lines as being revenue in nature. Goddard J accepted that this expenditure was not part of the overall plan to put in underground cables. Goddard J found that the nature of this expenditure had to be determined on its own facts as to the extent and scale of the work done.

199. Goddard J noted that even if the overall plan was not viewed as a total project in terms of the conversion of the entire urban residential distribution system but rather in terms of the individual conversion of individual streets serviced by a distribution transformer, her finding would not have changed. Her Honour observed at 13,700:

> Alternatively, even if the "final objective" were not to be viewed as a 'total project' but in terms of the individual conversion jobs undertaken on a year by year basis in respect of individual streets containing groups of consumers serviced by a distribution transformer, that would not alter the picture. All of those jobs were undertaken pursuant to the one "firm policy" instituted by the old Board in 1969 and continued by Hawkes Bay Power after incorporation in 1987. On this basis all have resulted in the creation of a new asset. Each individual conversion project completed and each individual distributor installed underground would constitute a new asset, whatever the particular reason that motivated Hawkes Bay Power to effect each conversion project and each underground installation.

200. This suggests that where there is one overall capital project involving a group of assets, the nature of the expenditure on any repair work done on those assets is taken from the character of that one overall project, and the repair work is not looked at in isolation.

201. *Case X26* considered the deductibility of earthquake-strengthening costs incurred as part of one overall project. It followed the decision in *Colonial Motor*, and Judge Barber found that costs incurred to earthquake-strengthen a building were capital costs. In reaching that decision Judge Barber applied the general capital/revenue principles, together with the *Colonial Motor* decision, and found at [39] that:

> In *Colonial Motor Co Ltd v C of IR*, as in the present case, from a practical and business point of view, the total work undertaken was to transform an unsound building with a potentially very limited or, possibly, non-existent revenue-earning capacity into a sound building capable of being used to earn income.

202. Judge Barber found at [43] that the earthquake-strengthening work was done as a consequence of a single plan, rather than as an ad hoc response to issues arising when undertaking other work. On this basis, he distinguished the decision in *Sherlaw*.

203. Judge Barber noted that, while the work done in *Case X26* was less extensive than that done in *Colonial Motor*, it was of the same character. At [43]:

> Of course, in the present case the work undertaken was not as extensive as that in *Colonial Motor Co Ltd v CIR*, but the same result must follow. There was work undertaken to improve the building's earning-capacity by making it earthquake code compliant and thus avoiding the sterilisation of the asset. While the work in this case was to make the building earthquake-code compliant, it ensured the continued availability of the asset as part of the income-earning structure of the taxpayer's partnership. That structure is a concept of capital. The process of earning income is revenue in concept.
>
> [Emphasis in original]

204. In the Commissioner's view, expenditure on repairs forming part of one overall project should take its character from that project.

205. However, the Commissioner agrees that in some situations apportionment may be appropriate. For example, as was the case in *Hawkes Bay Power*, a

taxpayer may do work on an asset while at the same time undertaking an overall project. If it can be demonstrated that the work done is not part of that project the nature of the work must be determined on its own facts. Consequently, if that work does not reconstruct, renew or replace an asset or substantially the whole of an asset or change its character the expenditure on that work is likely to be revenue in nature and deductible.

206. To determine if apportionment is appropriate in any particular situation, it is necessary to consider the work done from a practical and business point of view. For example, in the Commissioner's view, apportionment of expenditure between capital and revenue will be appropriate where the work done is a repair, but at the same time some upgrading of a capital nature can be identified (*Sherlaw*). In contrast, where repairs and maintenance work forms part of one overall project, where the objective of that project is to reconstruct, replace or renew the asset or substantially the whole of the asset or to change the asset's character, then apportionment will not be appropriate and all the expenditure incurred as part of that project will take its nature from the overall project (*Colonial Motor, Hawkes Bay Power* and *Case X26*).

207. In the Court of Appeal's decision in *Poverty Bay Electric* Blanchard J also acknowledged that an apportionment of costs between deductible repair costs and non-deductible capital costs is possible and appropriate in some situations, but that apportionment was not appropriate in every case. Blanchard J made this acknowledgement in response to the taxpayer's alternative submission that having capitalised a portion of the expenditure to recognise the improvements in the work done it was then entitled to claim a deduction for the balance of the expenditure. Blanchard J commented at 15,008:

> In particular situations an apportionment of an amount of expenditure is possible and appropriate – where a part of the money spent has been applied to work which is truly a repair and at the same time some upgrading of a capital nature has been done. It is often possible to distinguish which is which. But this is not such a case.

208. Blanchard J, relying on *Auckland Trotting* (CA) and *Western Suburbs Cinema*, found on the facts of the case that, as a new asset had been created, no repair work had in fact been carried out by the taxpayer. His Honour concluded that the taxpayer was not entitled to a deduction on the basis that none of the work done by the taxpayer consisted of repairs.

What are notional repairs?

209. Where capital expenditure is incurred the courts have held that no deduction can be claimed for an amount that might have been spent on repairs had the work been carried out differently.

210. As stated above Blanchard J made this clear in *Poverty Bay Electric* where he discussed the decision of the Court of Appeal in *Auckland Trotting*. At 15,008:

> In *Auckland Trotting Club (Inc) v C of IR* [1968] NZLR 967 at p 980 *Richmond* J said that **no part of the money spent on constructing the new trotting track was, in fact, spent on repairs and it was not possible to treat part of it as notionally spent on repairs when that is not what happened**. *North* P and *Turner* J expressed their agreement (p 977). The Court adopted the reasons of *Finlay* J in *Margrett (HM Inspector of Taxes) v Lowestoft Water and Gas Co* (1935) 19 TC 481 at pp 488–489 and of *Kitto* J in *FC of T v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 at pp 107–109. At p 107 *Kitto* J said:
>
> ... when a taxpayer has two courses open to him, one involving an expenditure which will be an allowable deduction for income tax and the other involving an expenditure which will not be an allowable deduction, and for his own reasons he chooses the second course, he cannot have his income tax assessed as if he had exercised his choice in the opposite way. Section 53 is concerned with expenditure which was in fact incurred, not with expenditure which could have been incurred but was not.
>
> ...
>
> To similar effect is the judgment of this Court in *Colonial Motor Co Ltd v C of IR* (1994) 16 NZTC 11,361.
>
> **We agree that it is not possible to claim as expenditure on a repair a payment which has not actually been expended for that purpose. There cannot be a dissection of what is spent upon a capital work because part of it might otherwise have been laid out on repairs, but was not.**
>
> [Emphasis added]

211. Where a taxpayer could have done the work differently but chose not to, a deduction cannot be claimed for a notional amount of expenditure on repairs. A taxpayer cannot deduct expenditure for work they have not done.

Is a deduction available for expenditure incurred to repair a newly acquired but dilapidated asset?

212. Where expenditure is incurred on repairs and maintenance soon after an asset has been acquired, that expenditure is likely to be considered part of the capital cost of acquiring the asset.

213. *Law Shipping* addressed the special situation of deductions for repairs to a recently acquired asset. *Law Shipping* concerned a company that purchased a ship in a poor state of repair for £97,000. The company used the vessel while in the poor state of repair for one voyage and then carried out repairs to the value of £51,558. The court held that the cost of the repairs was not deductible but was part of the capital cost of acquiring the ship. That decision was followed in *Collector of Inland Revenue, Cook Islands v AB Donald Ltd* [1965] NZLR 679 (SC), which also addressed the deductibility of repairs to a recently acquired ship.

214. The court in *W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* (1965) 115 CLR 58 endorsed *AB Donald Ltd*. In *W Thomas* the taxpayer company acquired a building that required work to be done to it, some of which was necessary to make the building suitable for use in the company's business. Windeyer J held that the repairs done to the building to make it suitable for use were not deductible. The cost of getting the building ready to be used by the taxpayer company formed part of the acquisition cost of that asset, so was a capital cost.

215. Windeyer J observed at 72:

> Expenditure upon repairs is properly attributed to revenue account when the repairs are for the maintenance of an income-producing capital asset. Maintenance involves the periodic repair of defects that are the result of normal wear and tear in operation. It is an expense of a revenue nature when it is to repair defects arising from the operations of the person who incurs it. **But if when a thing is bought for use as a capital asset in the buyer's business it is not in good order and suitable for use in the way intended, the cost of putting it in order suitable for use is part of the cost of its acquisition, not a cost of its maintenance.**
>
> [Emphasis added]

216. It is well settled by the courts that expenditure incurred to repair a newly acquired asset so that it is in good order and suitable for use in the way intended by a taxpayer is a capital cost and forms part of the acquisition cost of that asset.

217. The limits of the principle in *Law Shipping* are demonstrated in *Odeon Associated Theatres*. The English Court of Appeal found that expenditure on deferred repairs to a movie theatre acquired in a dilapidated condition was deductible. In that case the taxpayer acquired a fully operational but run down movie theatre in 1945. The theatre had not been repaired for a number of years. The taxpayer repaired the theatre gradually over seven years. Salmon LJ distinguished *Law Shipping* on the following grounds at 296:

> There seem to me to be many important distinctions between that case [*Law Shipping*] and the present case.
>
> (1) In the *Law Shipping Co. Ltd. v. Inland Revenue Commissioners, 12 T.C. 621* the purchase price was substantially less than it would have been had the vessel been in a fit state of repair … and that they made good this defect at the first opportunity. …
>
> In the present case, the purchase price paid by the taxpayers was in no way affected by the fact that the cinema was in disrepair at the date of its acquisition. The sellers could not lawfully have executed the repairs prior to the acquisition since no licence to execute such work was then obtainable.
>
> (2) In the *Law Shipping* case the vessel was not in a state to pass survey at the time of purchase …. In the present case, the cinema was a profit-earning asset at the date of its acquisition in spite of its state of disrepair. It remained so, although no money was spent on deferred repairs for a number of years after its acquisition.
>
> (3) In the *Law Shipping* case there was no evidence that on established principles of sound commercial accounting the £39,558 could properly be charged by the taxpayer as revenue expenditure. … In the present case, however, the commissioners held, on ample evidence, that it was in accordance with the established principles of sound commercial accounting to charge the disputed items to revenue expenditure, and these principles in no way conflict with any statute.

218. Even though the expenditure was to repair an asset acquired in a dilapidated state, the expenditure was still found to be deductible. Significantly, the purchase price paid by the taxpayer had not been discounted to take account of the condition of the theatre, as all theatres at that time were in a similar condition due to restrictions imposed by the war. Further, the theatre was immediately profitable, despite its run-down condition.

Does the nature of the expenditure change if damage is repaired as a result of a significant event?

219. The Commissioner considers that the nature of the expenditure does not change if the damage to be repaired occurs as a result of a significant event such as an earthquake, a fire or a storm. Consequently, the same issues as considered in this statement need to be addressed to determine whether any expenditure incurred on repairs and maintenance is capital or revenue expenditure. If the repair work is on revenue account, the expenditure will be deductible; if it is on capital account, it will not be deductible. This

is because the deductibility of the repair costs is determined more by the effect that the work has on the asset, rather than when the work was done or what caused the damage to the asset.

220. This is demonstrated in *Case F67* where the taxpayers' building was extensively damaged by fire. The taxpayers leased the lower floor of the building as two shops (a pizza parlour and a knick-knack shop). The taxpayers leased the upstairs part of the building to the respective shop lessees as residential flats.

221. The fire significantly damaged the wall linings of the knick-knack shop. The pizza parlour also suffered considerable water and smoke damage. To bring the shops back into working condition the lining of the knick-knack shop was replaced, while in the pizza parlour some of the lining was cleaned and re-plastered. Both shops were redecorated. The electrical wiring was replaced and substantial plumbing repairs were undertaken. The upstairs portion of the building was gutted. The roof structure was replaced and the parts of the iron roofing destroyed by fire were also replaced. However, the upstairs flats were left gutted.

222. The builder who undertook the work stated that at the conclusion of the repairs the overall structure was probably in a far worse condition than it was before the fire. This was mainly because the upstairs flats, the larger of which had recently been refurbished before the fire, had been left gutted. The downstairs shops were restored to their pre-fire condition with no improvement. The taxpayers claimed a deduction for the portion of the repairs that the insurance payment did not cover. The Commissioner disallowed the deduction on the basis it was capital expenditure.

223. Judge Barber identified the building as the asset that was the subject of the work rather than the individual shops. He found the building work undertaken was so extensive in relation to the building that it amounted to the replacement, reconstruction or renewal of a substantial part of a capital asset that went beyond the normal concept of repair. Judge Barber did accept the building was not totally destroyed and a major portion of the basic building structure remained intact after the fire. However, he concluded that as the expenditure by the taxpayers was not to repair the building but to rebuild it, it was capital and not deductible.

224. The Federal Court of Appeal of Canada has also considered the deductibility of repairs and maintenance expenditure after a significant event (*Bowland v R* 2001 FCA 160, [2001] 3 CTC 109). In *Bowland* the taxpayer's rental property was damaged by fire. Before the fire the building was valued at $80,000 of which $5,000 was attributable to the land. The taxpayer claimed that after the fire he spent $66,472 on repairing the property. The court concluded the renovations were so extensive in nature that the house was virtually rebuilt and resulted in a new capital asset. Consequently, the court concluded the cost of the work was not deductible because it was capital in nature.

225. In both *Case F67* and *Bowland* the courts looked at the nature and scale of the work undertaken and the effect that work had on the asset when determining whether the expenditure was on capital or revenue account. In making its decision neither court focused on when the work was done or what caused the damage to the asset.

226. In the Commissioner's view, where the work done is to repair damage caused by a significant event, and the work done results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, or the character of the asset is changed, the expenditure will be capital in nature. However, where some necessary repair work must be done to an asset as a result of a significant event and further repair work comes about as a consequence of the necessary repairs, then the repair costs, while extensive, may be deductible (*Sherlaw*). This will always be a question of fact and degree.

Significant events and dilapidated assets

227. As found in *Case F67* and *Bowland*, the deductibility of repair costs is determined by the nature and scale of the work undertaken and the effect it has on the asset. The deferral of repairs, before a significant event, should not in itself change the character of whether expenditure on repairs is deductible.

228. The Canadian Tax Court demonstrated this in *Martinello v R* 2010 TCC 432, 2010 DTC 1300. In *Martinello* the taxpayer owned a house that she rented out. In October 2004 a substantial hurricane-strength storm significantly damaged the property, making it uninhabitable for a time. The winds had lifted the house off its foundation causing the main wooden beam to give way. Dampness over the years had weakened the sills and joists, which caused much of the rest of the floor to fall in. In addition, the storm waters rushed underneath the house leaving much of the floor and parts of the sidewalls sitting in mud. The storm also blew down an old chimney that was no longer used. The property had also suffered some tenant wear and tear and damage. Eight years before the storm, the taxpayer had replaced the house's

windows and doors and updated the plumbing and wiring. Other than this, and painting and cleaning between tenants, the taxpayer had not undertaken other work on the house.

229. The taxpayer paid to have the house repaired. Much of the expenditure related to the floor that was damaged when the house was lifted up off its foundations. The work included straightening the footings and reinforcing them with more cement, removing silt and debris, and putting in new sills, joists and, where necessary, new floor boards. The footing of the walls was also replaced. Once the house was back on its foundations the existing plumbing and electrical supply had to be reconnected. The house's wiring was replaced. The fallen chimney was removed, the roof and walls were patched, and half the roof was re-shingled. The old aluminium siding was reused in the gable ends of the house and a new vinyl siding was used to clad the bottom of the house. The inside of the house was repainted where needed. A small, attached wooden mud room (for removal of outdoor footwear) at the back entrance and modest wooden deck had to be replaced.

230. The house was repaired to its original rentable condition. The court found that all the damage that had occurred was the result of tenant damage, normal wear or tear, depreciation over the time it was rented out, or storm damage while it was rented out. The repairs did not improve the house beyond its original condition in any manner. Therefore, the costs of the repairs and maintenance, although all done at once, were properly deductible as current expenses and were not required to be capitalised.

231. The Commissioner considers that the court reached this conclusion because, while the work the taxpayer undertook was extensive, the storm damage was largely as a result of deferred repairs—from tenant damage, normal wear and tear, and depreciation (eg, the weakened floor joists and sills). Therefore, while the significant event (the storm) did create damage that required repairing, the nature of the work undertaken after the storm was repairs that had accumulated over the period that the house was tenanted. Implicit in this is that the court in *Martinello* considered the work done by the taxpayer did not reconstruct, replace or renew the house, or substantially the whole of the house or, change its character.

Key points relating to other considerations from the repairs and maintenance cases

232. The Commissioner takes the following key points from the analysis relating to other considerations from the repairs and maintenance cases:

- The timing of repairs is not a critical factor when deciding whether the expenditure incurred is deductible—repairs can be deferred and completed as and when required without necessarily giving rise to capital expenditure (*Ounsworth*).
- The deductibility of repair costs is determined more by the nature of the work carried out and the effect that it has on the asset, rather than on when the work is carried out (*Rhodesia Railways*).
- The speed or slowness with which the work is done is not usually relevant to deciding whether the expenditure is capital or revenue in nature (*Auckland Gas* (PC)).
- Where deferred repairs become so extensive that they amount to the reconstruction, replacement or renewal of the asset or substantially the whole of the asset or where deferred repairs form part of one overall project that is capital in nature then those repairs will be capital in nature. This will always be a question of fact and degree in the particular circumstances (*Auckland Gas* (PC)).
- Repairs and maintenance work that forms part of one overall project to reconstruct, replace or renew an asset or substantially the whole of an asset or to change that asset's character will take its nature from that project. This is regardless of whether that project concerns work done on a single asset or work on a group of assets (*Colonial Motor Co Ltd v CIR* (CA), *Hawkes Bay Power, Case X26*).
- Where repairs and maintenance expenditure is incurred on an ad hoc basis and not as part of one overall plan, the expenditure should take its character from the effect that the work done has on the asset (*Sherlaw*).
- It is appropriate and possible in some situations to apportion an amount of expenditure between deductible repair costs and non-deductible capital works (*Poverty Bay Electric*).
- No deductions are available for a notional amount of expenditure for repairs. A taxpayer cannot deduct expenditure for work they have not done (*Western Suburbs, Auckland Trotting* (CA), *Poverty Bay Electric*).

- Expenditure incurred to repair a newly acquired asset so that it is in good order and suitable for use in the way intended by the taxpayer is a capital cost and forms part of the acquisition cost of that asset (*Law Shipping, W Thomas*).
- Depending on the circumstances, a deduction may still be allowed for expenditure on repairs to a newly acquired asset if the purchase price was not affected by the asset's state of disrepair and, when the asset was acquired, it could be used as intended despite its state of disrepair (*Odeon Associated Theatres*).
- Where an asset is damaged as a result of a significant event, the deductibility of expenditure to repair the asset depends on the nature and scale of the work undertaken and the effect that work has on the asset and not on the occasion that caused the work to be done (*Case F67, Bowland*).
- If an asset damaged as a result of a significant event was dilapidated before the event, the deductibility of repairs and maintenance expenditure continues to depend on the nature and scale of the work undertaken and the effect that work has on the asset. This may mean that, although extensive work is undertaken all at once, the cost of that work could still be considered to be revenue in nature (*Martinello*).

Examples – other considerations from the repairs and maintenance cases

Example 16: Repairs to rental property (deferred repairs done all at once)

Phil owns a rental property. A long period has passed since repairs were last made to the property but the tenants have recently vacated and Phil is taking the opportunity to restore the property to a good condition before letting it again. He has to incur significant expenditure on the property. The work done includes extensive cleaning, repainting, easing windows (ie, repairing windows to enable them to open and shut smoothly) and replacing cracked panes, sanding and re-varnishing the floors, replacing the kitchen bench top, fitting a new hand basin to replace a cracked one, and having a plumber check and repair all the taps. Phil does not replace, reconstruct or renew the property or substantially the whole of the property. The work done also does not change the character of the property. Although the costs incurred by Phil are significant, they arose from repairs that had been allowed to accumulate and are revenue in nature.

Example 17: Project to refurbish and strengthen building (one overall project to change character)

Lot Developments Limited has owned an older commercial building for 10 years. The building is looking shabby and the company has recently been informed that earthquake-strengthening work needs to be done if it is to comply with council requirements for that type of building. The company decides the building would benefit from a complete refurbishment, including structural changes that will extend the floor plan and enhance the common areas as well as earthquake-strengthen the building. All the expenditure incurred will be capital expenditure as it forms part of one overall project to change the character of the building. No deduction is allowed for the cost of any repairs that are included within the project.

Example 18: Repair to building that led to more repairs (repair; no overall project of substantial reconstruction, replacement or renewal or change in character)

As a result of ground subsidence, Northern Roasters Limited set about repairing the uneven floor of the small factory premises that it owns. This involved minor foundation work. As a result of the foundation work, several windows and walls cracked. These had to be repaired, and the walls then had to be re-plastered and painted. Although the work done to the factory was costly, the repairs were completed on an ad hoc basis. The work done was not done as part of one overall plan to reconstruct, replace or renew the premises, or substantially the whole of the premises, or to change the character of the premises. Further, the actual scale and nature of the work done did not have this effect. Therefore, the repair costs are revenue in nature.

Example 19: Double glazing (one overall project to change character with no apportionment available)

Erica has a restaurant in an old villa that she owns. The villa is used exclusively for the restaurant. The villa is located near a very busy thoroughfare. To keep noise levels down inside the restaurant Erica has decided to install double glazing. While installing the double glazing the builder discovers that two window frames on the south side of the villa are rotten. The windows are repaired to enable the installation of the double glazing. Erica's objective in this case was to install double glazing in her villa. The work done has changed the character of the villa. The work done to repair the windows formed part of Erica's objective to double glaze the villa and

therefore is part of one overall project to change its character. Consequently, all the expenditure incurred by Erica is capital in nature.

Example 20: House painting and extension (one overall project to change character along with maintenance work where apportionment is available)

George owns a rental property. George decides that by adding on two new bedrooms and another bathroom to the property he will be able to get a much higher rental. George employs a builder to build the new extension. George also thinks the property is looking tired and needs a new coat of paint so he employs a painter to paint the property. The painter also paints the new extension. George's objective in this case was to add on the two bedroom extension. The work done to extend the house changed the character of the property and so is of a capital nature. The painting of the new extension is part of George's project to change the character of his rental property and is also capital in nature. However, George can establish from a practical and business point of view that re-painting the remainder of the house was not part of his project to change the character of his property. Re-painting the remainder of the house is maintenance work. Therefore, George can treat the portion of the painting expenditure that relates to painting the house but not the extension as being revenue in nature.

Example 21: Newly acquired but damaged rental property (part of capital cost)

Anne and Jane bought a property at a discounted rate because of earthquake damage. The roof of the property has partially collapsed and a corner of the house has been damaged. Anne and Jane want to rent the property out, so spend money fixing the roof and the damaged part of the house to put it in a tenantable state. The expenditure on the repairs is capital in nature. Anne and Jane's costs in getting the property to a tenantable state are treated as part of the property's acquisition cost.

Example 22: Damaged and dilapidated commercial building (repairs; not substantial reconstruction, replacement or renewal or change in character)

David and Angus own a commercial building that was superficially damaged in an earthquake. David and Angus have owned the property for a long time. When David and Angus purchased the property it was in excellent condition. Over time it has become dilapidated, so when the earthquake occurred the poor state of the roof led to more repairs then being necessary. The tenants are unhappy and request that the building be fixed. David and Angus spend money on the building: inside the building the interior walls are re-plastered and repainted and the stairwells are repaired; outside the building the roof is repaired, cracked and broken windows are replaced, and the exterior walls are repainted. The work done brings the building back to the standard it was when David and Angus bought it. The work done does not reconstruct, replace or renew the building or substantially the whole of the building. The work also does not change the building's character. The expenditure undertaken by David and Angus is for accumulated repairs and is revenue in nature.

Example 23: Reconstruction of damaged rental property (substantial reconstruction, replacement and renewal)

Jennifer and Peter own a residential rental property that was significantly damaged in an earthquake. Before the earthquake the property was in a good state of repair. After the earthquake, to get the property in a tenantable state, Jennifer and Peter replace the property's severely damaged foundations, reconstruct the floors, rebuild three of the property's collapsed external walls and replace the badly damaged roof. Jennifer and Peter also demolish the property's partially collapsed chimney, which is a hazard. In this case, the cost of the work Jennifer and Peter have done is capital expenditure and not deductible. Where work is so extensive that it results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, the cost of that work will be capital expenditure.

References

Subject references
Capital/revenue; Deductions; Income tax; Repairs and maintenance
Legislative references
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Related rulings/statements
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IS10/01 "Residential rental properties – Depreciation of items of depreciable property" *Tax Information Bulletin* Vol 22, No 4 (May 2010)

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CIR v Auckland Gas Co Ltd [1999] 2 NZLR 418 (CA)
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Hawkes Bay Power Distribution Ltd v CIR (1998) 18 NZTC 13,685 (HC)
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Law Shipping Co Ltd v IR Commrs [1924] 12 TC 621 (IH (1 Div))
Lindsay v FCT (1961) 106 CLR 377 (HCA); (1961) 106 CLR 392 (Full Ct HCA)
Lurcott v Wakely and Wheeler [1911] 1 KB 905
Margrett (HM Inspector of Taxes) v Lowestoft Water and Gas Co (1935) 19 TC 481 (KB)
Martinello v R 2010 TCC 432, 2010 DTC 1300
Milburn NZ Ltd v CIR (2001) 20 NZTC 17,017 (HC)
Odeon Associated Theatres Ltd v Jones [1973] Ch 288 (CA)
O'Grady (HM Inspector of Taxes) v Bullcroft Main Collieries Ltd (1932) 17 TC 93 (KB)
Ounsworth (Surveyor of Taxes) v Vickers Ltd [1915] 3 KB 267
Poverty Bay Electric Power Board v CIR (1998) 18 NZTC 13,779 (HC); [1999] 19 NZTC 15,001 (CA)
Rhodesia Railways Ltd v Collector of Income Tax, Bechuanaland Protectorate [1933] AC 368 (PC)
Thornton Estates Limited v CIR (1995) 17 NZTC 12,230 (HC)
Samuel Jones & Co (Devondale) Ltd v CIR (1951) 32 TC 513 (IH (1 Div))
Sherlaw v CIR (1994) 16 NZTC 11,290 (HC)
Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes) (1910) 5 TC 529
W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia [1965] 115 CLR 58

APPENDIX: LEGISLATION

Income Tax Act 2007

A1. Section DA 1(1) and (2) provides:

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**.

A2. Section DA 2(1) provides:

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**.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

ORDER IN COUNCIL

FIF DEEMED RATE OF RETURN SET FOR 2011–12

The deemed rate of return for taxing foreign investment fund interests is 7.58% for the 2011–12 income year, down from the previous year's rate of 8.52%.

The deemed rate of return is set annually and is one of the methods that can be used to calculate income from a foreign investment fund interest. The rate is based on taking an average of the five-year Government bond rate at the end of each quarter, to which a 4% margin is added.

The new rate was set by Order in Council on 25 June 2012.

Income Tax (Deemed Rate of Return on Attributing Interests in Foreign Investment Funds, 2011–12 Income Year) Order 2012 (SR 2012/154)

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 12/10: DO THE HISTORIC DEPRECIATION RATES CONTINUE TO APPLY TO GRANDPARENTED STRUCTURES ACQUIRED BEFORE 1 APRIL 2005?

Question

1. We have been asked whether the historic depreciation rates continue to apply to grandparented structures acquired before 1 April 2005, following the issue of determinations DEP79: *Remedial matters relating to the depreciation of buildings Depreciation Determination Number 79* ("DEP79") and DEP81: *Fertiliser storage facilities and remedial matters relating to the depreciation of buildings and grandparented structures* ("DEP81").

Answer

2. Yes. The historic depreciation rates continue to apply to grandparented structures acquired before 1 April 2005. DEP79 and DEP81 do not replace the historic depreciation rates. The historic depreciation rates that are published in IR 267 will always continue to apply to items acquired before 1 April 2005 (or to buildings acquired before 19 May 2005).

Discussion

3. Grandparented structures are items that have been regarded and treated as "structures" in the past for depreciation purposes, but now come within the meaning of "buildings" following the issue of Interpretation Statement IS 10/02: *Meaning of "building" in the depreciation provisions* ("IS 10/02").

4. "Grandparented structure" is defined in section YA 1 of the Income Tax Act 2007 ("ITA"):

> **Grandparented structure** means, for a person, any item on the following list, if the person acquired the item, or entered into a binding contract for the purchase or construction of the item, on or before 30 July 2009:
>
> (a) barns, including barns (drying):
>
> (b) carparks (buildings):
>
> (c) chemical works:
>
> (d) fertiliser works:
>
> (e) powder drying buildings:
>
> (f) site huts

5. The definition of "building" in section YA 1 of the ITA specifically excludes a grandparented structure for the purposes of subparts EE and EZ of the ITA. So for depreciation purposes, those items listed as grandparented structures that were acquired, or entered into a binding contract for the purchase or construction of the item, on or before 30 July 2009 are not treated as buildings, despite them coming within the meaning of "buildings" in IS 10/02. Any of these items acquired after that date are treated as a building.

6. DEP79 and DEP81 set the rates applicable to these items acquired after 30 July 2009, by using the formula for calculating depreciation rates for buildings, to apply from the 2011–12 income year. DEP79 and DEP81 also clarify the rates that continue to apply to items acquired on or before 30 July 2009, by separating the asset classes into those acquired on or before 30 July 2009 and those acquired after that date.

7. However, these two determinations do not replace the historic depreciation rates. The historic depreciation rates published in IR 267 are calculated using a different formula that must be applied to any items acquired before 1 April 2005 (or to buildings acquired before 19 May 2005).

8. The following table is a compilation of the depreciation rates that correspond to the acquisition periods, applicable to the items listed as a "grandparented structure":

	Estimated useful life	Acquired before 1 April 2005		Acquired between 1 April 2005, and 30 July 2009 (both dates inclusive)		Acquired on or after 31 July 2009	
		Diminishing value %	Straight-line %	Diminishing value %	Straight-line %	Diminishing value %	Straight-line %
Barns	20	9.5	6.5	10	7	8.5	5
Barns (drying)	20	9.5	6.5	10	7	8.5	5
Chemical works	33.3	6	4	6	4	4.5	3
Fertiliser works	33.3	6	4	6	4	4.5	3
Powder drying buildings	15.5	12	8	13	8.5	11	6.5
Note: The asset classes "Carpark (buildings and pads)" and "Site huts" have been reviewed following the issue of IS 10/02. The asset class "Carpark (buildings and pads)" has been split into "Carparking buildings" (treated as a building) and "Carparking pads" (continues to be treated as a structure). Site huts, by their very nature, will be either portable huts or portable buildings. Therefore, two new asset classes replace the asset class "Site huts": "Buildings (portable)" and "Portable huts (not buildings)". See the notes to DEP79 for more information.							
Carparking buildings	50	4	3	4	3	0	0
Carparking pads	50	4	3	4	3	4	3
Buildings (portable)	12.5	15	10	16	10.5	13.5	8
Portable huts (not buildings)	12.5	15	10	16	10.5	16	10.5

QB 12/11: INCOME TAX – LOOK-THROUGH COMPANIES, RENTAL PROPERTIES AND AVOIDANCE

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

This question we've been asked applies in respect of s BG 1.

Question

1. We have been asked whether s BG 1 would apply to the following arrangement:
   - a person sells their family home to a look-through company (LTC);
   - the home is used by the LTC as a rental asset and is rented to a third party on an arm's length basis;
   - the person owns 100% of the shares in the LTC;
   - the sale of the home is at market value;
   - the LTC borrows from a bank to fund the purchase;
   - the person then uses the funds raised from the sale to purchase a new family home;
   - the person, in their capacity as holder of an effective look-through interest in the LTC, is able to deduct the interest incurred by the LTC on the loan.

Answer

2. As the property has been rented to a third party on an arm's length basis, the Commissioner's view is that s BG 1 would not apply to the above arrangement.
3. If an arrangement were to vary materially from the arrangement outlined in the question above, or if there were other relevant facts that might materially affect how the arrangement operates, then the Commissioner would need to consider the matter further and a different outcome might apply.

Explanation

Background

4. In 2011, the Commissioner published QB 11/03: "Income tax – look-through companies and interest deductibility" *Tax Information Bulletin* Vol 23, No 10 (December 2011): 16.
5. This item considered whether interest deductions previously allowed would continue to be allowed where a loss-attributing qualifying company (LAQC) becomes an LTC if:
   - a person had previously sold their family home to an LAQC as a rental asset;
   - to be rented to a third party on an arm's length basis;
   - the person owned 100% of the shares in the LAQC;
   - the sale of the home was at market value;
   - the LAQC borrowed from a bank to fund the purchase;
   - the person then used the funds raised from the sale to purchase a new family home;
   - the LAQC becomes an LTC.
6. QB 11/03 concluded that interest deductions previously allowed would continue to be allowed, subject to the limitation on deductions in ss HB 11 and HB 12. The item also commented that the position would be the same where a person sells their family home at market value directly to the LTC.
7. Since the publication of QB 11/03, we have been asked whether s BG 1 would apply where a person sells their family home at market value directly to an LTC.

Discussion

Interest deductibility

8. QB 11/03 confirms that, on the facts set out in the item, interest is deductible under s DB 6. This is because, in the Commissioner's view, there is a sufficient connection between the interest incurred and the assessable income.
9. The fact that the LTC is tax transparent for income tax purposes does not affect deductibility. Section HB 1(4) attributes the actions of the LTC to the person in their capacity as holder of an effective look-through interest. This means that for income tax purposes the person is treated as borrowing the funds to acquire the rental property. As a result, the person is entitled to the interest deductions, subject to the limitation on deductions in ss HB 11 and HB 12.
10. Section HB 1(4) does not operate in reverse. The person's use of the borrowed funds in their personal capacity (in this case, to purchase a new family home) is not attributed to the LTC. The person's use of the borrowed funds in their personal capacity is irrelevant to the issue of interest deductibility on the borrowed funds.

Section BG 1 – tax avoidance

11. Section BG 1 applies to void a tax avoidance arrangement. It is the Commissioner's view that s BG 1 will not apply to the arrangement outlined in the question above. However, if an arrangement were to vary materially from that outlined, or if there are other relevant facts that would materially affect how the

arrangement operates, then the Commissioner would need to consider the matter further and a different outcome might apply.

12. The Supreme Court in *Ben Nevis Forestry Ventures Ltd & Ors v CIR*; *Accent Management Ltd & Ors v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188, set out the approach to be used to determine whether an arrangement is a tax avoidance arrangement under s BG 1. The approach, known as the "Parliamentary contemplation test", is to ask whether the tax outcomes are what Parliament would have intended for the provisions used or circumvented, having regard to the commercial reality and economic effects of the arrangement.
13. The first step in this test is to identify the commercial reality and economic effects of the arrangement. In the arrangement outlined in the question above, an LTC borrows from a bank to buy a rental property. The rental property is purchased by the LTC at market value. The LTC then carries on a genuine rental activity, renting to a third party on an arm's length basis. The reality is that interest is incurred on funds borrowed to purchase a rental property. The interest is economically incurred, in that the arrangement is not structured in a way that allows the person to be reimbursed for the interest paid out. This is not a situation where the loan or the interest paid is not at arm's length or not at market value. In other words, the loan really is used to purchase a rental property and the interest is genuinely incurred.
14. The second step is to identify Parliament's purpose for the provisions used. Parliament's purpose for the general deductibility provision was discussed in *Accent Management Limited & Ors v CIR* [2007] NZCA 230, (2007) 23 NZTC 21,323. The Court of Appeal said the deductibility provision applies when a person "incurs real economic consequences" of the type contemplated by Parliament when the rules were enacted. Case law has established that there must be a sufficient nexus between the expenditure incurred and the income earning process for the expenditure to be deductible (see, for example, *CIR v Banks* (1978) 3 NZTC 61,236). Therefore, the purpose of the deductibility provision is that income that is otherwise taxable should be reduced by any expenses that are truly incurred in deriving that income to arrive at the amount of net income received.
15. Parliament's purpose in enacting the LTC regime was to introduce an income tax treatment for closely-held companies that allows an owner of a company to obtain the benefits of limited liability while permitting that owner to be taxed at their own marginal tax rate. Shares in an LTC can only be held by individuals, trusts or other LTCs. Furthermore, an LTC can only have five or fewer look-through owners. So it was clearly envisaged that LTCs would be used by taxpayers (some who might own 100% of the shares in the LTC) who wanted the protection of limited liability while at the same time being able to take advantage of lower personal tax rates. Parliament intended that the LTC regime apply to closely-held companies and that, despite the entity being "transparent" for income tax purposes, the company would be recognised as a separate entity.
16. Putting the two steps of the "Parliamentary contemplation test" together: the reality is that the LTC suffers a real economic cost in incurring interest, and it is incurred in the derivation of income. The shares in the LTC are held by one person so the company is closely-held. This is the type of shareholding that the LTC regime was intended to apply to. Accordingly, the commercial reality and economic effects are within Parliament's purpose for the deductibility provision and the LTC regime.
17. The nature of the asset (the house) fundamentally changes for tax purposes. It changes from a private asset (accommodation for the person and their family) to an income-earning asset (a rental property). This is so, even though the funds borrowed by the LTC are ultimately used by the person to purchase a new family home, and even though, were it not for the existence of the LTC in this case, the interest deductions would not be allowed.
18. The arrangement outlined in the question above can be contrasted with the arrangement in Revenue Alert RA 07/01 where a person rents their family home back to themselves. In more detail, the facts in Revenue Alert 07/01 were that a person, who was also the sole shareholder of the LAQC, sold their family home to an LAQC. The person then rented back their family home from the LAQC at a market rate. Following this, the LAQC tried to claim income tax deductions for the related property costs. It is the Commissioner's view that s BG 1 would apply in this situation. The commercial reality and economic effects of this arrangement is to make private expenses deductible by purporting to engage in a rental activity. The Act does not intend that private expenses should be deductible. Therefore the deductibility provision is not being used as Parliament intended.
19. The Commissioner's view is that the situation in the Revenue Alert is quite different from the facts in the

present question. In this question, the person has structured their arrangement in a way that achieves deductibility. The person has sold their family home to an LTC. The property is then used by the LTC as a rental property, rented to a third party on an arm's length basis. The borrowing to fund the purchase is deductible because the property is used by the LTC to derive assessable income.

References

Related rulings/statements
QB 11/03: "Income tax – look-through companies and interest deductibility" *Tax Information Bulletin* Vol 23, No 10 (December 2011): 16
Revenue Alert RA 07/01
Subject references
Look-through companies; Interest deductibility; Tax avoidance
Legislative references
Income Tax Act 2007, ss BG 1, DB 6, HB 1, HB 11, HB 12
Case references
Accent Management Limited & Ors v CIR [2007] NZCA 230, (2007) 23 NZTC 21,323
Ben Nevis Forestry Ventures Ltd & Ors v CIR; Accent Management Ltd & Ors v CIR [2008] NZSC 115, (2009) 24 NZTC 23,188
CIR v Banks (1978) 3 NZTC 61,236

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.

SUFFICIENT ARGUMENT TO DECLINE STRIKE-OUT

Case	Chesterfield Preschools Limited & Others v the Commissioner of Inland Revenue & Others
Decision date	12 June 2012
Act(s)	High Court Rules
Keywords	Judicial review, application to strike out, tort of misfeasance, public official, failure to act

Summary

A review of an earlier decision not to strike out a misfeasance claim against the Commissioner and others resulted in the strike-out again being declined. It was held that it was arguable the Commissioner can be liable for the tort of misfeasance; a failure to act can be misfeasance; and that the cause of action against a Crown Solicitor who had given advice should be allowed.

Impact of decision

The decision confirms the reluctance of the court to "strike out" a tort of misfeasance claim on purely technical grounds when a plaintiff shows that there may be some wrongful exercise of power by a public official. The decision of the Judge also indicates there is an issue regarding whether or not the misfeasance needs to be performed by a named individual and the extent to which others acting for public officials can be included in the claim.

Facts

Chesterfield Preschools Limited and other parties associated with Mr David Hampton ("Mr Hampton") have been involved in a number of tax disputes and litigation against the Commissioner for a number of years. This case involves a claim of misfeasance against the Commissioner and other officials, and the Crown Solicitor from Christchurch. It relates to the alleged actions of a number of persons who represented the Commissioner when dealing with Mr Hampton and the associated entities. Most of the persons involved performed independent roles, for example, debt officer, investigator or manager.

The basis of the allegation is that the Commissioner "knowingly or recklessly" allowed penalties to accumulate and to spiral out of control over an extraordinary number of years (1993 to 2006). It is also alleged that severe hardship and damage occurred because of delay or refusal to address complaints. Furthermore, immediate enforcement of debt and the use of seizure powers without respite were used to intentionally cause harm to the plaintiff.

An initial strike-out application was heard by an Associate Judge who, in his judgment of 5 August 2011, found against the Commissioner on the basis that:

1. it is arguable that the Commissioner can be liable in the tort of misfeasance vicariously even though there is no evidence that he had made the relevant decisions, *CIR v Reid* [2007] NZCA 576 at [33];
2. failure to act can be a misfeasance;
3. the tort exists to protect those who are vulnerable to the wrongful exercise of a public officer's powers or functions;
4. the Commissioner's management of the plaintiffs' goods and services tax (GST), and tax positions generally, were arguably part of the exercise of public office in this case. Whether they were in fact so, and whether the conduct was tortious, was a matter properly for trial;
5. the cause of action against the Crown Solicitor (who had given advice) was allowed following *New Zealand Defence Force v Berryman* [2008] NZCA 392.

A review was made by the Crown against the decision of the Associate Judge on the basis that:

1. the claim alleged "corporate responsibility" and the tort attached to conduct by individuals; and

2. there was no basis for concluding the Crown Solicitor exercised the power of public office as he is advising and not the holder of a power.

Decision

The decision of the Associate Judge not to strike out the proceedings was correct. Consistent failure to exercise powers can be an abuse of statutory power [53].

There is room to argue for a development of the tort of misfeasance to encompass a failure to act by a class [57].

It is too early to decide the action must fail before the facts are proved.

APPLICATION FOR CROWN LAW TO CEASE TO ACT FOR COMMISSIONER ON TRINITY MATTERS

Case	Commissioner of Inland Revenue v Accent Management Limited (and others) and Garry Albert Muir
Decision date	22 June 2012
Act(s)	Income Tax Act 1994, Lawyers and Conveyancers Act 2006
Keywords	Debar solicitors, cease acting, Trinity scheme, abuse of process

Summary

An application by various taxpayers to prevent Crown Law from acting for the Commissioner of Inland Revenue in certain proceedings related to the Trinity scheme was dismissed. The High Court considered that the application had no relevance to the proceedings and no arguable factual foundation.

Impact of decision

This judgment is precedent for the remaining challenges in the on-going Trinity litigation.

Facts

In a Trinity-related matter, an application was made by the taxpayers seeking orders that Crown Law cease acting as the solicitors for the Commissioner of Inland Revenue and that no Crown counsel appear as counsel in certain proceedings for the Commissioner.

The application, which is the subject of this judgment, was made with respect to three proceedings. Two of the proceedings are appeals by Dr Muir against decisions of the Taxation Review Authority ("TRA") on 1 February 2011 and 16 June 2011. Dr Muir had, in his challenge proceedings, raised a preliminary issue to the effect that the assessments he challenged were invalid and the TRA had no power to consider whether the assessments were correct. The Commissioner responded by arguing that Dr Muir's challenge could not be advanced having regard to the Supreme Court's decision in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115; [2009] 2 NZLR 289. Dr Muir's application was dismissed and the Commissioner's application was granted. In the later decision of 16 June 2011, the TRA dismissed an application by Dr Muir to recall the decision of 1 February 2011.

The third proceeding is in respect of a transfer and consolidation application by the Commissioner to transfer from the TRA to the High Court, 66 challenge proceedings and have them consolidated with two challenge proceedings in the High Court and the two Dr Muir appeals.

Decision

Justice Woodhouse dismissed the application for two reasons. Firstly, he held that the allegations had no relevance to the proceedings in question. Secondly, he held that from looking at the history of past Trinity litigation, in which most of the taxpayers have been involved, including final determinations of fact in the High Court, the taxpayers cannot establish an arguable factual foundation to support the applications.

Justice Woodhouse reviewed the litigation history starting with the original challenge proceedings, which culminated in the Ben Nevis proceeding where the Supreme Court upheld the Commissioner's assessments. He also reviewed the judicial review proceeding *Accent Management Limited v Commissioner of Inland Revenue* (2010) 24 NZTC 24,126 (HC) and quoted at length from Keane J's strike-out judgment. Finally, he reviewed the setting-aside proceeding *Redcliffe Forestry Venture Ltd v Commissioner of Inland Revenue* [2011] 1 NZLR 336 and subsequent appeals from that decision.

Justice Woodhouse noted the legal principles from the case *Clear Communications Ltd v Telecom Corporation of New Zealand Ltd* (1999) 14 PRNZ 477 (HC) at 482–483, that "there must be something truly extraordinary before removal could be contemplated" and that the courts need to be alert to applications to debar being used as a tactical weapon or gaming the system.

Justice Woodhouse stated that the remaining challenges may give rise to material questions of fact and will give rise to material questions of law. With regard to the questions of fact, he reasoned that in the challenges, the hearing authority will decide as a matter of law that certain questions of fact were conclusively determined in the *Ben*

Nevis proceeding. Accordingly, the taxpayers' allegations of fact relating to the conduct of Crown Law, and the conduct of the Commissioner, are irrelevant.

The Judge went further to state that, with regard to the questions of law that will be before the hearing authority, the taxpayer's allegations against Crown Law are also irrelevant because they are allegations of fact which cannot assist in answering the questions of law which will arise in the challenges. In particular at [42]:

> The hearing authority's determination as to what the law is, in respect of the challenged assessments, cannot be advanced in any way by determining whether or not the Commissioner acted in a particular way in the past and whether or not Crown Law promoted the particular conduct or in some way participated in it.

Justice Woodhouse noted that the heart of the taxpayers' argument was in relation to the applicability of subpart EH of the Income Tax Act 1994 to the assessments. In this regard, he stated (at [45]) that "... [t]he obligation of counsel to ensure that the court has all the relevant law before it cannot be converted into an obligation for counsel on one side to concede the legal argument that is being advanced on the other side".

Justice Woodhouse referred to the majority decision in *Tannadyce Investments Ltd v Commissioner of Inland Revenue* [2011] NZSC 158; [2012] 2 NZLR 153 and the principle that "[t]here is ... no potential for separation of matters of legality from matters of correctness" when holding that the past conduct of Crown Law, and the past conduct of the Commissioner, in respect of the 1997 and 1998 assessments dealt with in *Ben Nevis*, do not have any relevance to the current challenges.

Justice Woodhouse referenced the comments of Tipping J in *Tannadyce* about "gaming the system" and was satisfied that this application was an attempt to game the system. He found (at [53]) that:

> ... it is an attempt to game the system within the statutory procedures. I am satisfied that the taxpayers have not brought this application because of a sincere and well-founded concern that their tax affairs will not be properly adjudicated on, but in an endeavour to cause unjustified difficulties for the Commissioner and to delay resolution of the tax disputes. The attempt to game the system, through the present applications, may be seen from the litigation history.

Justice Woodhouse went on to state that the allegations of the taxpayers were essentially the same as those in their judicial review proceeding and in that context, Keane J made findings of fact which were sufficient for the purposes of these applications to conclude that the taxpayers do not have a reasonably arguable factual foundation to advance the applications to debar. He was "satisfied that these applications are an abuse of process" (see [54]).

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 Orders in Council.

Litigation Management

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

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