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TAX INFORMATION Bulletin

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Te Tari Taake

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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:

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Inland Revenue
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Wellington 6140

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

IN SUMMARY

Questions we've been asked

QB 14/11: Income tax – Scenarios on tax avoidance 3

This QWBA is about applying section BG 1 to three scenarios we were asked about at a tax conference. The scenarios concern interest deductions, look-through companies and substituting debentures. A fourth scenario about debt capitalisation was included in a draft of this item consulted on earlier this year. At this time, the Commissioner is still considering the issues raised by that scenario.

QB 14/12: Income tax – Foreign tax credits for amounts withheld from United Kingdom pensions 11

This QWBA concludes that a person cannot claim a foreign tax credit in New Zealand for any amounts withheld by their United Kingdom pension provider from a United Kingdom pension. The QWBA considers that as the United Kingdom does not have the right to tax a pension payment made to a New Zealand tax resident (under the New Zealand-United Kingdom double tax agreement), any amounts withheld in the United Kingdom are not "foreign income tax" for the purpose of New Zealand's tax credits rules. This confirms Inland Revenue's longstanding view. HM Revenue & Customs agrees with Inland Revenue's view and refunds amounts incorrectly paid to HMRC.

The Commissioner has prepared an operational position *Commissioner's operational position on foreign tax credits for amounts withheld from United Kingdom pensions*. This explains how to claim repayments from HMRC, how to stop United Kingdom pension providers making deductions and if necessary how to change past New Zealand tax returns.

Commissioner's operational position on foreign tax credits for amounts withheld from United Kingdom pensions 20

The purpose of this item is to inform taxpayers of the operational position being adopted by the Commissioner in relation to this matter.

Legal decisions – case notes

Court had jurisdiction to cure failure to file a notice of pursuit of claim 22

The failure to file and serve a notice of pursuit of claim was a procedural irregularity and did not nullify the proceeding. The Court had jurisdiction to cure that irregularity, hear the strike-out application and enter judgment and did so in this case because there was no prejudice to the appellant.

Judicial review of decision to remove tax agent from list of approved tax agents 23

The High Court dismissed the application for judicial review. The Court found the Commissioner of Inland Revenue fully complied with her obligations under s 34B(9) of the Tax Administration Act 1994 to give the tax agent reasons for any proposed decision to remove the tax agent from the list of approved tax agents.

Judicial review of decision not to recalculate 25

This was a judicial review by Trinity investors asserting that following a tax challenge, the subsequent collection/recovery of tax is a new phase and there is a duty on the Commissioner of Inland Revenue ("the Commissioner") to recalculate the amount owing. The High Court rejected that there was any such duty and noted the Commissioner is entitled to collect the amount fixed in the challenge proceedings.

Taxpayer did not have a permanent place of abode in New Zealand 26

This was an appeal by Mr. Diamond against the Taxation Review Authority finding that he had a permanent place of abode in New Zealand and therefore was a resident in New Zealand for tax purposes for the years in dispute. The High Court on appeal found for the taxpayer and determined that he was not a resident.

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 14/11: INCOME TAX – SCENARIOS ON TAX AVOIDANCE

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

This Question We've Been Asked is about s BG 1.

Introduction

1. At a tax conference held in November 2013, there was a discussion of whether s BG 1 would apply to certain scenarios. This Question We've Been Asked (QWBA) considers three of the scenarios raised at the conference.
2. In the scenarios, the arrangements and the conclusions reached are framed broadly. As the objective is to consider the application of s BG 1, the analysis proceeds on the basis that the tax effects under the specific provisions of the Act are achieved as stated. However, it should not be presumed that this would always be the case. Also, additional relevant facts or variations to the stated facts might materially affect how the arrangement operates and a different outcome under s BG 1 might arise. Accordingly, the Commissioner's view as to whether s BG 1 applies must be understood in these terms.
3. Section BG 1 is only considered after determining whether other provisions of the Act apply or do not apply. Where it applies, s BG 1 voids a tax avoidance arrangement. Voiding an arrangement may or may not appropriately counteract the tax advantages arising under the arrangement. If not, the Commissioner is required to apply s GA 1 to ensure this outcome is achieved.
4. For a more comprehensive outline of the Commissioner's position on the law concerning tax avoidance in New Zealand, reference should be made to the Commissioner's Interpretation Statement *IS 13/01: Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (July 2013).

Scenario 1 – Interest deductions where shareholder loans replaced

Question

5. Whether s BG 1 applies to the following arrangement:
   - Company A is wholly owned by a family trust. The trust has advanced to the company $1m in shareholder loans. Company A has used the shareholder loans to finance its business operations for the purpose of deriving assessable income.
   - Company A borrows $1m from a third-party lender at arm's-length market interest rates to repay the shareholder loans to the trust.
   - The third-party borrowing by Company A is secured over the assets of the trust.
   - The trust uses the repaid funds to acquire a holiday home for use by the trust's beneficiaries.
   - For tax purposes, Company A deducts interest incurred on the loan from the third-party lender from its business income.

Answer

6. The Commissioner's view is that, without more, s BG 1 **would not apply** to this arrangement to deny Company A interest deductions under ss DB 6 or DB 7 for the interest incurred in respect of the loan from the third-party lender.

Explanation

7. Under this arrangement, Company A is replacing funds invested in its business operations by the trust with funds from the third-party lender. The objectives of the arrangement would seem to be to enable the trust to free up capital for reinvestment in other assets (the holiday home) while Company A maintains sufficient working capital in order to continue its business operations. The tax effect for Company A is that an interest deduction will be available under ss DA 1, DB 6 or DB 7 if previously the shareholder loan was interest free. Alternatively, a greater interest deduction will arise if the third-party loan bears a higher interest rate than the shareholder loan. No deduction would have been available had the trust borrowed directly to acquire the holiday home.
8. Parliament's purpose for the general deductibility provisions is to allow expenditure incurred in carrying on a business or deriving assessable income to be deductible as long as it was not capital or private or domestic expenditure. Private or domestic expenditure is expenditure referable to living as an

individual member of society or to a household or family unit. Private or domestic expenditure is not usually referable to carrying on a business or deriving assessable income.

9. However, interest deductions are treated differently in several ways, including not being subject to the limitation on deducting capital expenditure provided in s DA 2(1). The limitation on deducting private or domestic expenditure provided in s DA 2(2) still applies. Generally, for interest deductions Parliament intended interest to be deductible where the loan capital relating to that interest is used in a business or in some other way in the production of assessable income (s DB 6, *Pacific Rendezvous Ltd v CIR* [1986] 2 NZLR 567 (CA)).

10. Parliament has also distinguished between some companies and other taxpayers in respect of interest deductions. Significantly, interest incurred by some companies is deductible under s DB 7 without the need to establish a nexus between the borrowing and carrying on a business or deriving assessable income. Section DB 7 does not apply to qualifying companies, nor does it apply to interest related to tax. There are other rules relating to non-resident companies, wholly-owned groups of companies and consolidated groups. By making this significant distinction, Parliament intended to clarify the interest deductibility rules applying to companies and to reduce compliance costs by simplifying those rules.

11. Where s DB 7 does not apply, the Commissioner's view is that the interest deductibility test is satisfied where borrowed funds are used to replace amounts invested in income-earning activities and to repay those amounts to the persons who invested them (*FCT v Roberts; FCT v Smith* 92 ATC 4380, see also *BR Pub 10/14–10/19: Interest deductibility – Roberts and Smith – Borrowing to replace and repay amounts invested in an income earning activity or business*).

12. Accordingly, in an arrangement involving interest deductions, Parliament would expect to see, as matters of commercial and economic reality, borrowing by a company with attendant interest liabilities in circumstances where there is either compliance with s DB 7 or sufficient nexus or connection with a business or income-earning activity. Also, the interest deductions claimed should not be related to private or domestic expenditure.

13. Those requirements appear to be satisfied in the case of Company A. Company A has assumed a real liability in favour of the third-party lender and incurred interest as a matter of commercial and economic reality. Either Company A satisfies s DB 7 or the circumstances are such that the interest deductibility test is satisfied as the borrowed funds are used to replace amounts invested in the company's business.

14. This conclusion is not negated by the fact that the lending is secured over the assets of the trust. The deductibility of the interest turns on the question of the use of the funds borrowed, not the nature of any security given. Similarly, how the trust then uses the funds repaid does not have a bearing on this question. The Commissioner does not consider the circumstances are such that the interest could be characterised as private or domestic expenditure subject to the private limitation. Company A is not receiving any private or domestic benefit from the expenditure. As stated, the borrowed funds are replacing funds previously invested in the company's business operations. The commercial and economic reality is that the borrowed funds are used in the business and there is no private use of those funds.

15. Also, the types of factors mentioned by the court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115 (at [108]), such as artificiality or contrivance, do not appear to be present in this case. If those factors were present, they could indicate that the interest deductibility requirements are not met when the arrangement is viewed in a commercially and economically realistic way.

16. Accordingly, in the Commissioner's view, this arrangement is within Parliament's contemplation for the interest deductibility provisions. As such, it is not a tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and s BG 1 **would not apply**.

Note: The Commissioner has considered a scenario dealing with interest deductions and avoidance in a previous QWBA: *QB 12/11: Income tax – look-through companies, rental properties and avoidance*. In both that scenario and the scenario here, the Commissioner considers that the interest is deductible and s BG 1 **does not apply**. The scenario in *QB 12/11* differed in that it looked at the situation when an LTC borrows funds to buy a shareholder's private house, which the LTC then uses as a rental property. In comparison, the current scenario deals with the situation when a company that is not an LTC replaces a shareholder loan with debt. In both situations, the shareholders use the funds received from the company (in *QB 12/11* as sale proceeds and in this QWBA as return of their shareholder loan) to buy a house that is not used to derive assessable income.

The Commissioner has also considered a scenario dealing with loss attributing companies (LAQCs) and residential housing in Revenue Alert 07/01 *The sale of private homes to loss attributing qualifying companies to generate tax deductions* (October 2007). Revenue Alert 07/01 deals with the situation where a private home is sold to an LAQC and rented back by the former owners so that tax deductions can be claimed by the LAQC for outgoings that would otherwise be considered private expenditure. The Revenue Alert indicates that, generally, such an arrangement would be subject to s BG 1. A key difference between the scenario above and the Revenue Alert is that, even though rent is charged, if there were any borrowings, it would be difficult to conclude that they are used to earn income in the circumstances where the person lives in the home before and after the arrangement and the LAQC has no other income.

Scenario 2 – Look-through company election

Question 1

17. Whether s BG 1 applies to the following arrangement:
    - Company B is owned equally by two family trusts. One of the trusts operates a farming business that is expected to incur losses for tax purposes in the future.
    - Company B is operating a profitable business and has built up significant reserves (both tax paid and untaxed).
    - The directors of Company B elect look-through company (LTC) status for the company and resolve to distribute all reserves as dividends once the LTC election takes effect.
    - The existing reserves of Company B are distributed to the shareholders in the first year after attaining LTC status.

Answer – Question 1

18. The Commissioner's view is that s BG 1 **would not apply** to the arrangement.

Explanation – Question 1

19. The objectives of the arrangement would appear to be for Company B and its shareholders to avail themselves of options provided by the legislation. These are electing to operate as an LTC under the Act and distributing the company's reserves.
20. The relevant tax effects of the arrangement are:
    - For the first year in which the company operates as an LTC, the shareholders will have income from Company B calculated according to s CB 32C (in addition to any look-through company income for that year under s CB 32B). Company B will cease to be an imputation credit account company. However, the shareholders will receive the benefit of the former balance of the company's imputation credit account as part of the calculation in s CB 32C. The result of that calculation in the first year is that the shareholders only pay tax on the company's existing unimputed reserves.
    - In future years, as an LTC under subpart HB, the profits of Company B will no longer be taxed to the company at the company tax rate of 28%. Instead, they will be taxed to the trustee shareholders and taxed at the trustee rate of 33%, unless distributed to beneficiaries.
    - If the profits of the company are distributed by the trustees to the beneficiaries, they will be taxed at the beneficiaries' marginal tax rates.
    - As a result of the look-through nature of an LTC, in future income years, the trustee shareholder operating the farm could offset any farming losses against its share of any profits from Company B.
    - Once operating as an LTC, distributions of company reserves, including the existing reserves, are not subject to further tax in the hands of the shareholders. An LTC is excluded from the definition of a "company" in the Act, which means that most of the rules that apply to companies, including the rules governing the taxation of dividends, do not apply to LTCs.
21. The particular avoidance issue in this scenario is whether the combined tax effect of the company's existing fully imputed reserves not being taxed at any more than the company tax rate where distributed to shareholders on a higher marginal tax rate, is within Parliament's contemplation.
22. The purpose of the LTC rules generally is to integrate a closely-held company's tax treatment with the tax treatment of its owners, similar to that of a partnership. In this they reflect the purpose of the qualifying company rules that they replaced. The qualifying company rules were introduced in 1992 after a review of the tax system by the Consultative Committee on the Taxation of Income from Capital (the Valabh Committee). The Valabh Committee noted that the shareholders of closely-held companies had "a practical choice of operating either as a sole proprietorship, a partnership or a trust" (*Taxation of Distributions from Companies* (November 1990) at paragraph 2.7.1).
23. Accordingly, LTCs are transparent for tax purposes. An LTC's income, expenses, tax credits, rebates, gains and losses are allocated to its owners. These items will

generally be allocated to owners in proportion to the number of shares they have in the LTC. Any profit is taxed at the owner's marginal tax rate. The owner can use any losses against their other income, subject to the loss limitation rule that ensures the losses claimed reflect the level of the owner's economic loss in the LTC. The effect of the LTC rules is that shareholders can have the benefits of limited liability given by a company, as well as the ability to be taxed at the level of the owner.

24. Under the LTC regime company reserves may be distributed or drawn upon without the shareholders being taxed on the distribution. Parliament contemplated existing companies electing into the LTC regime, but the treatment of reserves under the LTC regime was not intended to apply to company reserves previously accumulated by existing companies. Because of this, a mechanism is needed to ensure tax is paid on existing company reserves when a company enters the regime. This mechanism is provided by s CB 32C.

25. Under s CB 32C the company's existing reserves are regarded as held by the shareholders in proportion to their look-through interest and each owner is deemed to have an amount of income arising on the first day of the income year the company becomes an LTC. In the first year after the election, the shareholders of existing companies pay tax at their marginal tax rate on a one-off basis on the company's unimputed reserves that existed at the time of the company becoming an LTC.

26. No further tax is paid by the shareholders on any subsequent distribution of reserves. This is regardless of whether any shareholders have a marginal tax rate greater than the company tax rate at the time. On the other hand, any shareholders with a marginal tax rate of less than the company tax rate will not receive any relief for tax paid by the company in excess of their marginal rate. Had the company not elected LTC status, this relief may have been provided to them in the form of excess imputation credits able to be carried forward to subsequent years and offset from future tax liabilities.

27. Effectively, this means that in the first year after the election the shareholders do not pay tax on existing fully imputed company reserves at their marginal tax rates. Had the arrangement not been entered into, the shareholders would have been required to pay tax at their marginal tax rates when these accumulated profits were distributed as dividends. The shareholders would have been required to pay further tax on fully imputed dividends because the distribution would not have then been from an LTC. As the shareholders in the arrangement are trustees, they would have had to have paid tax on any dividends that were trustee income at the higher trustee rate of 33%.

28. Parliament's purpose, as expressed elsewhere in the Act and in the way the LTC regime applies to new companies or existing companies after the initial year, shows that it generally intends profits earned through a company to be taxed at a shareholder's marginal tax rate. In this scenario, the avoidance issue is whether use of the election, the payment of tax under s CB 32C, and subsequent tax-free distributions is within Parliament's contemplation. In particular the issue is whether it is within, or contrary to, this more general purpose of Parliament for the taxation of shareholders.

29. The Commissioner's view is that Parliament has made an exception to its general approach of taxing company profits distributed to shareholders at the shareholders' marginal rates in the case of the first year following an existing company electing LTC status. Parliament may have made this exception in the case of an existing company electing LTC status for reasons such as reducing complexity and compliance costs. For this provision, considering the text and context of the legislation, it can be concluded that Parliament's purpose for shareholders of an existing company that is an LTC is for them to effectively pay a final tax at 28% on existing fully imputed company reserves so that ongoing distributions can be passed on to shareholders as they arise with no further tax effects.

30. In the Commissioner's view, the circumstances Parliament would expect to be present where an existing company elects to enter into the LTC regime are present in this arrangement when the arrangement is viewed as a whole. As matters of commercial and economic reality, there is a closely-held company that is carrying on a business that satisfies the requirements of entering into the LTC regime.

31. The types of factors mentioned by the court in *Ben Nevis* (at [108]), such as artificiality or contrivance, do not appear to be present in this case. If those factors were present, they could indicate the LTC regime requirements are not met when the arrangement is viewed in a commercially and economically realistic way. In reality, the arrangement consists of an election for a particular tax status by a closely-held company carrying on a business that is available under the Act followed by a distribution of company reserves.

32. The Commissioner considers that this arrangement is within Parliament's contemplation for the LTC regime. Without more, it would not seem to be a

tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and s BG 1 **would not apply**.

Question 2

33. Whether s BG 1 applies to the arrangement described in Question 1 of this scenario if:
    - At the time of electing LTC status, Company B's directors also contracted to sell the company's business and decide to liquidate the company once the LTC election is effective and the sale has settled.
    - The sale of the business is settled and the directors pass the resolution to liquidate the company. A liquidator is appointed who distributes surplus assets to shareholders and ensures the company is removed from the register of companies.

Answer – Question 2

34. The Commissioner considers that s BG 1 **would potentially apply** to the arrangement described in paragraph 33.

Explanation – Question 2

35. The arrangement for the purposes of s BG 1 in this variation of scenario 2 comprises the LTC election, sale of the business and the liquidation of Company B. It would appear the objective of this arrangement is to use the LTC regime to enhance the value obtained by the shareholders from winding up Company B. The relevant tax effect is that no dividends arise when the company winds up as an LTC. The other relevant tax effect is that the shareholders do not pay any further tax on the distribution of the company's fully imputed reserves before the company winds up. Accordingly, the relevant purposes of Parliament for this arrangement are derived from the dividend rules for a company that winds up and the LTC regime as a whole. In comparison to the original arrangement in Question 1, the different aspects of this arrangement of the business sale and wind-up bring a different perspective to discerning Parliament's relevant purposes.

36. An LTC is not treated as a "company" for the dividend rules so they do not apply to Company B when it is wound up. Parliament's purpose for companies that are winding up is for certain amounts to be taxable as dividends. However, Parliament contemplates that LTCs are not subject to these provisions. Accordingly, the election of Company B into the LTC regime circumvents Parliament's purpose for the application of the dividend rules to companies that are winding up. As will be discussed, despite the election, Company B is effectively not operating so the arrangement makes no other use of the LTC regime other than the initial election and treatment afforded an LTC upon wind-up. This is not consistent with Parliament's purposes for the dividend rules.

37. As discussed under Question 1, the purpose of the LTC rules is to provide transparent income tax treatment to closely-held companies operating as LTCs so they could be considered as viable alternative vehicles to partnerships and sole proprietorships for the conduct of businesses or income-producing activities. The rules provide for the treatment of an LTC's income, expenses, tax credits, rebates and losses, and distributions to shareholders. It is notable that a company only retains LTC status if it continues to meet the eligibility criteria. The benefits of the rules are intended to be accessed only by companies with certain characteristics and who continue to have those characteristics.

38. It is the Commissioner's view that Parliament's purpose for these rules is only given effect where a company is operating. That is, where the company has the prospect on an ongoing basis to employ capital to generate income, expenses, tax credits, rebates and losses. Also, several features of the rules anticipate the future tax treatment applicable to LTCs or their shareholders, for instance, the one-off payment of tax on reserves under s CB 32C and the one-off adjustment extinguishing losses that apply upon a company's entry to the regime. The rules ensure the benefits of the regime are limited to LTCs and their shareholders while an LTC is operating. It would follow that Parliament's purpose is that the entity is an operating one or has the prospect of operating when it enters and then uses the regime.

39. The Commissioner accepts arguments can be made to the contrary but considers that, on balance, all the above features of the LTC rules lead to a conclusion that Parliament's intention is for the effects of the regime to apply over time as LTCs continue to operate and carry out transactions with tax impacts. Therefore, the Commissioner's view is that a fact, feature or attribute Parliament would expect to see present in order to give effect to its purposes for the LTC regime is that the election and one-off payment of tax is available where the LTC is ongoing. It would be inconsistent with these purposes for an existing company to elect to become an LTC as part of the wind-up process just to take advantage of what might be a more favourable tax treatment of distributions made to owners taxed at the highest marginal tax rate.

40. It is acknowledged that the regime contemplates an LTC liquidating in s HB 4(3). It also could

be argued that the way LTC elections operate, particularly through s HB 13(4), quick "in-and-out" use of the regime is also contemplated and dealt with. However, the Commissioner views s HB 4(3) as a mechanical provision required to remove any doubt that liquidation is treated as a disposal of a shareholder's owner's interest. It should not be taken that this provision indicates Parliament's acceptance of an LTC's liquidation in the circumstances of Company B. Section HB 13(4) is part of provisions intended to protect the integrity of the regime. In the Commissioner's opinion, it does not indicate Parliament's comprehensive view of all time-related aspects of the regime.

41. In contrast to the arrangement under Question 1 of this scenario, there is effectively no operating company in this scenario, nor is there any prospect of the company operating. Instead, the objective of the arrangement is to wind up Company B. However, the manner by which the arrangement is carried out includes the step of obtaining LTC status, which is an unnecessary step in achieving that objective. It serves only to ensure the wind-up occurs in the most tax advantageous way. This would also be true even if there was an amount of time between the LTC election and the wind-up of the company. The key is whether the arrangement comprises both the wind-up of the company and an LTC election.

42. In Question 1 of this scenario the arrangement is within Parliament's purposes for the LTC regime and, as mentioned, the Commissioner would not seek to apply s BG 1 to that scenario. However, the contrary is the case in this variation of the scenario. In the Commissioner's view, it is strongly arguable that this arrangement is outside Parliament's contemplation for the dividend rules, the LTC regime and how the Act should apply to a company that is winding up. If the Act is being used or circumvented in a way that does not give effect to Parliament's purposes, even though the particular use (or non-application) is not explicitly dealt with in the legislation, s BG 1 will still apply. As such, the present arrangement is likely to be a tax avoidance arrangement as it has tax avoidance as a purpose or effect.

Merely incidental test

43. The next step is to test whether the tax avoidance purpose or effect of the arrangement is "merely incidental" to a non-tax avoidance purpose or effect (referred to as the merely incidental test). For a full analysis of the merely incidental test see paragraphs 395 to 438 of IS 13/01.

44. Section BG 1 can only apply where an arrangement fails this test. The Commissioner's view is that the tax avoidance purpose or effect is unlikely to be merely incidental to another purpose or effect of the arrangement, such as the purpose or effect of ceasing the business operations and winding up the company. Unlike the arrangement in Question 1, electing LTC status was an unnecessary step inserted into the arrangement and the tax avoidance purpose or effect appears to have been pursued as a goal in its own right. As such, it does not seem to flow naturally from, or as a mere concomitant to, some other purpose or effect of the arrangement and the arrangement fails the merely incidental test.

Reconstruction

45. If s BG 1 is to apply to this scenario, consideration would have to be given to how the Commissioner would assess the tax liabilities of the relevant taxpayers. The effect of s BG 1 is that the whole arrangement is void as against the Commissioner. In this scenario, voiding the whole arrangement would not appropriately counteract the tax advantages of the arrangement and may remove legitimate tax outcomes. In the Commissioner's opinion, an appropriate action would be for her to exercise her reconstructive power under s GA 1 to tax the sale and liquidation on the basis that Company B is not an LTC.

Scenario 3 – Substituting debentures

Introduction

46. This scenario involves an issue of debt by a company to its shareholders in a manner that potentially circumvents the substituting debenture rule in s FA 2(5).

47. The substituting debenture rule was originally enacted in 1940 as a specific anti-avoidance rule under very different tax policy settings. The repeal of the rule from 1 April 2015 has recently been enacted as part of Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014. Nevertheless, it is considered useful to comment on this scenario as it illustrates the application of s BG 1 where a provision's purpose has become less clear over time. In such situations, the Commissioner considers that the text of the provision, supported by the scheme of the Act, will generally be the key determinant of Parliament's purpose.

48. In a draft version of this QWBA circulated for public consultation, the Commissioner concluded that s BG 1 would potentially apply to the following scenario. The Commissioner now considers that s BG 1 would not apply, for the reasons set out below.

Question

49. Whether s BG 1 applies to the following arrangement:
    - Company C is a joint venture company owned 50% by a New Zealand shareholder and 50% by an unassociated foreign shareholder.
    - Company C is funded by a combination of ordinary shares, non-participating redeemable shares and interest-bearing shareholder debt (which is issued in proportion to the ordinary shares).
    - The terms of the shareholder debt provide that on the occurrence of an insolvency-type event, the company has the option to convert the debt into shares having a net asset value equal to the face value of the loan.[1]

Answer

The following analysis focuses solely on the potential circumvention of the substituting debenture rule, and does not consider s BG 1 in relation to the financial arrangements rules or other tax implications of the arrangement.

50. The Commissioner's view is that s BG 1 **would not apply** to this arrangement.
51. Although not discussed below, the Commissioner considers that s BG 1 may potentially apply to alternative structures that have the effect of circumventing the substituting debenture rule, such as the use of "wrap-around" debt (and similar variants), or undocumented loans.

Explanation

52. The objective of the arrangement appears to be for the shareholders to fund Company C with a combination of debt and equity. The relevant tax effects are that deductions for interest payments on the debt will not be restricted by s FA 2(5), and will therefore be deductible to Company C under s DB 7.
53. The text of s FA 2(5) suggests that Parliament's purpose is that interest payable under a debenture should be treated as a dividend and therefore non-deductible where the debenture is issued to a shareholder and the amount of the debenture is determined by reference, *inter alia*, to the number of shares in the company held by the shareholder. This will often be the case where debentures are issued in proportion to shareholdings. The text also suggests that Parliament's purpose is that the rule should not apply to a debenture that is a convertible note.
54. The legislative history indicates that the original purpose of the substituting debenture rule was to target transactions in which companies were swapping their ordinary equity for debt. However, that purpose has largely ceased to be relevant due to subsequent changes to the tax system. As a result, it is more difficult to determine a clear underlying purpose of the rule from its legislative history. Despite this, Parliament has retained the rule in its current form, and therefore it must be assumed to have a role to play.
55. It remains the case that the Act recognises a distinction between debt and equity. Interest payable in respect of debt is generally deductible, whereas distributions in the nature of dividends are not deductible. In certain instances, such as the current example, Parliament has legislated that particular debt instruments be recharacterised as equity (eg, substituting debentures, profit-related debentures, and stapled-debt securities), due to the equity-like features of those instruments.
56. The Commissioner considers that the text of the provision, supported by the scheme of the Act relating to debt and equity, is the key determinant of Parliament's purpose in this instance. Accordingly, Parliament's purpose in relation to the substituting debenture rule is that debt, where the amount is determined by reference to the number of shares in a company, should be reclassified as equity.
57. Convertible notes were originally excluded from the substituting debenture rule when a specific provision concerning the taxation of convertible notes was introduced into the Land and Income Tax Act 1954. The exclusion remains in s FA 2(5), as convertible notes are now intended to be dealt with under the financial arrangements rules. Accordingly, Parliament's purpose in this respect is that the tax treatment of convertible notes should be determined under the financial arrangements rules, rather than the notes being recharacterised as equity under the substituting debenture rule.
58. In an arrangement where s FA 2(5) does not apply, Parliament would expect to see either:
    - debentures that as a matter of commercial and economic reality have not been issued by reference to the number of shares in the relevant company; or

[1] The terms of the shareholder debt have been amended slightly from the scenario presented at the tax conference to avoid interpretive issues, as the purpose of the scenario is to consider the potential application of s BG 1.

- debentures that are genuinely convertible notes, eg, debentures that as a matter of commercial and economic reality:
  - are issued by a company;
  - relate to money lent to the company; and
  - are convertible, eg, they have:
    - a realistic prospect of being converted; and
    - some practical effect on conversion.

59. In the current instance, Company C has issued debentures to its shareholders in proportion to their shareholdings. This strongly suggests that the amount of the debentures has been determined by reference to the number of shares in Company C. Accordingly, the key issue is whether the debentures are genuinely convertible notes.

60. In the Commissioner's view, the debentures in this example are clearly issued by Company C in relation to money lent to it. Furthermore, the debentures appear to have a realistic prospect of being converted, as the trigger event (ie, an insolvency-type event) is a real possibility in the context of any corporate borrower. This is to be contrasted with a trigger event that may be so highly contingent that the debenture has little prospect of being converted as a matter of commercial and economic reality.

61. The Commissioner considers that Parliament would not have intended the convertible note exclusion in s FA 2(5) to apply in situations where conversion of the debentures would have no practical effect as a matter of commercial and economic reality. Both the High Court in *Alesco New Zealand Ltd v CIR* [2012] 2 NZLR 252 (HC) (at [112]) and the Court of Appeal in *Alesco New Zealand Ltd v CIR* [2013] NZCA 40 (CA) (at [11]) concluded that the convertibility feature of the notes in that arrangement had no practical effect. The High Court concluded that that aspect of the arrangement was artificial.

62. What the relevant practical effect contemplated by Parliament is may vary depending on the provision at issue. In the current instance, the Commissioner accepts that conversion of the debentures would have some practical effect, on the basis that:
    - Company C will be able to enjoy both solvency and cash flow benefits on conversion without having recourse to its shareholders; and
    - conversion is likely to affect its shareholders' priority on a liquidation as against third-party creditors.

63. On this basis, the Commissioner considers that what Parliament would expect to see in the arrangement is in fact present. It follows that the non-application of the substituting debenture rule would be within Parliament's purpose for that rule in this instance, and that the arrangement **is not a tax avoidance arrangement in that respect**.

References

Subject references
Convertible notes; Dividends; Interest deductibility; Look-through company election; Merely incidental; Winding up; Reconstruction; Substituting debentures; Tax avoidance; Tax avoidance arrangement
Legislative references
Income Tax Act 2007 – ss BG 1, CB 32B, CB 32C, DA 1, DA 2, DB 6, DB 7, FA 2(5), GA 1, subpart HB
Case references
Alesco New Zealand Ltd v CIR [2012] 2 NZLR 252 (HC)
Alesco New Zealand Ltd v CIR [2013] NZCA 40 (CA)
Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115
FCT v Roberts; FCT v Smith 92 ATC 4380
Pacific Rendezvous Ltd v CIR [1986] 2 NZLR 567 (CA)
Related rulings/statements
BR Pub 10/14–10/19: Interest deductibility – Roberts and Smith – Borrowing to replace and repay amounts invested in an income earning activity or business
IS 13/01: Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007 (July 2013)
QB 12/11: Income tax – look-through companies, rental properties and avoidance
Revenue Alert 07/01 *The sale of private homes to loss attributing qualifying companies to generate tax deductions* (October 2007)
Taxation of Distributions from Companies (November 1990, Consultative Committee on the Taxation of Income from Capital (Valabh Committee))

QB 14/12: INCOME TAX – FOREIGN TAX CREDITS FOR AMOUNTS WITHHELD FROM UNITED KINGDOM PENSIONS

This QWBA concludes that a person cannot claim a foreign tax credit in New Zealand for any amounts withheld by their United Kingdom pension provider from a United Kingdom pension. This confirms Inland Revenue's longstanding view. HM Revenue & Customs agrees with Inland Revenue's view and will refund amounts incorrectly paid to them.

The Commissioner has prepared an operational position *Commissioner's operational position on foreign tax credits for amounts withheld from United Kingdom pensions*. This explains how to claim repayments from HMRC, how to stop United Kingdom pension providers making deductions and if necessary how to change past New Zealand tax returns.

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

This Question We've Been Asked is about ss LJ 2(1) and LJ 3 and articles 19 and 22 of sch 1 to the Double Taxation Relief (United Kingdom) Order 1984 (including the "principal agreement"[1] and the protocols) (the NZ/UK DTA).

Question

1. Can a person claim a foreign tax credit in New Zealand for any amounts withheld in the United Kingdom by their United Kingdom pension provider from their United Kingdom pension payments?

Answer

2. No. A person cannot claim a foreign tax credit in New Zealand for any amounts withheld in the United Kingdom by their United Kingdom pension provider from their United Kingdom pension payments. A person can only claim a foreign tax credit in New Zealand if "foreign income tax" has been paid. An amount withheld from a pension payment in the United Kingdom by a United Kingdom pension provider is not "foreign income tax" for the purposes of New Zealand's tax credit rules. This is because under art 19 of the NZ/UK DTA the United Kingdom has no right to tax pensions paid to New Zealand tax residents.

Explanation

3. We have been asked whether a person can claim a foreign tax credit in New Zealand for amounts withheld in the United Kingdom from their United Kingdom pension payments. This item considers the situation where:
   - A person with a United Kingdom pension has moved to New Zealand and become a tax resident of New Zealand. (The person is a tax resident of New Zealand under New Zealand's domestic residence test (see s YD 1).
   - If the person is a tax resident of both New Zealand and the United Kingdom, the person may be deemed to be solely a New Zealand tax resident under the tie-breaker tests in art 4(2) of the NZ/UK DTA. For further details on New Zealand's individual residence test and the double tax agreement tie-breaker tests see *IS 14/01: Residence*.)
   - The United Kingdom pension payments are taxable in New Zealand.
   - The United Kingdom pension provider withholds an amount (in the form of United Kingdom PAYE[2]) from the pension payments because:
     – the person has not filled out the relevant HM Revenue & Customs' form, or
     – the form has not been processed by HM Revenue & Customs and a direction to the pension provider to stop the deductions has not been issued.
4. This item does not consider the situation where:
   - A United Kingdom pension is exempt income under s CW 28, such as a United Kingdom state pension that is paid in accordance with an arrangement under s 70 of the Social Security Act 1964.
   - A lump sum withdrawal is made from a foreign superannuation scheme by a New Zealand resident or a New Zealand resident transfers an interest in a foreign superannuation scheme to a New Zealand (or Australian) superannuation scheme.

[1] Convention between the Government of New Zealand and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, (signed 4 August 1983, entered into force on 1 April 1984 in New Zealand, entered into force in the United Kingdom on 16 March 1984).

[2] In the United Kingdom, pension payers are treated as employers and pensioners are treated as employees, so generally pension payments are subject to PAYE: r 11 of the Income Tax (Pay As You Earn) Regulations 2003 (UK).

Double tax agreements

5. The New Zealand Government enters into double tax agreements with other jurisdictions. A key purpose of these international treaties is to prevent double taxation of income. Once signed, these treaties need to be incorporated into New Zealand law by an Order in Council. This Order in Council incorporates the text of the treaty and any protocols to the treaty into New Zealand law. The NZ/UK DTA is part of New Zealand law by Order in Council: Double Taxation Relief (United Kingdom) Order 1984.
6. One way in which the NZ/UK DTA provides relief from double taxation is to allocate the right to tax certain income to either New Zealand or the United Kingdom. For example, the NZ/UK DTA exempts some types of income from taxation in the country where the income is sourced and allocates the taxing rights to that income to the country of residence of the person deriving the income.
7. There are a number of references to double tax agreements in the ITA 2007. Section BB 3(2) provides that under subpart BH a double tax agreement has effect in relation to income tax. Subpart BH specifically deals with double tax agreements. Section BH 1(4), as relevant, provides that:

   BH 1 Double tax agreements

   …

   Overriding effect

   (4) Despite anything in this Act, except subsection (5), or in any other Inland Revenue Act or the Official Information Act 1982 or the Privacy Act 1993, a double tax agreement has effect in relation to—

   (a) income tax:

   (b) any other tax imposed by this Act:

   …
8. A double tax agreement having "effect in relation to income tax" means that the double tax agreement has an overriding effect as to income tax under the ITA 2007, including the income and tax credit parts of the ITA 2007. Therefore, the income and tax credit parts of the ITA 2007 must always be read together with the relevant articles of a double tax agreement. Where there is any inconsistency between the two, the domestic law must be read subject to the double tax agreement.
9. Article 19(1) of the NZ/UK DTA provides that the sole taxing rights for pensions lie with the country of residence:

   Article 19 Pensions and annuities

   (1) **Pensions** (including pensions paid under the social security legislation of a Contracting State), and similar remuneration in consideration of past employment or services, **paid to a resident of a Contracting State**, and any annuity paid to a resident of a Contracting State, **shall be taxable only in that State**.

   [Emphasis added]
10. Article 19(1) provides that a pension paid to a resident of New Zealand shall be taxable only in New Zealand.
11. While art 19 gives New Zealand the sole right to tax the pension income of its residents, it does not require New Zealand to tax such income. For the pension to be taxable in New Zealand, it must also be taxable as income under Part C of the ITA 2007. Some overseas pensions are exempt income in New Zealand and as a result are not taxable in New Zealand: s CW 28.[3] This QWBA assumes that the relevant pension is not exempt income under s CW 28 and is taxable as income in New Zealand. If the pension income is exempt income under s CW 28, then no foreign tax credit will arise. This is because a foreign tax credit can only arise for income that is taxable in New Zealand: ss LJ 2, LJ 4 and LJ 5.

Foreign tax credits

12. If a person's pension income is taxable in New Zealand, the question arises whether any foreign tax credits result for any amounts withheld in the United Kingdom from the pension payments. A foreign tax credit recognises tax that has been paid on that income in another country. A foreign tax credit can reduce the amount of tax payable on that income in New Zealand.
13. A person must have paid "foreign income tax" to be entitled to a foreign tax credit: s LJ 2(1). "Foreign income tax" is specifically defined in s LJ 3 for the purposes of the tax credit rules as "an amount of income tax of a foreign country". In the first instance, the amounts withheld by the United Kingdom pension providers in the United Kingdom appear to be United Kingdom income tax (in the form of PAYE), so appear to be "an amount of income tax of a foreign country" under s LJ 3.
14. However, as noted above, pursuant to s BH 1(4), the NZ/UK DTA has an overriding effect on the tax credit provisions in the ITA 2007. This means that the definition of "foreign income tax" in s LJ 3 (which is used only for the purposes of the tax credit rules) must be read together with the NZ/UK DTA. Where there

[3] In some circumstances, a United Kingdom state pension will be exempt income under s CW 28 in New Zealand. For example, a United Kingdom state pension that is paid by the special banking method under s 70 of the Social Security Act 1964 is exempt income under s CW 28(1)(e).

is any inconsistency between the two, New Zealand's domestic law must be read subject to the NZ/UK DTA. Specifically, the term "foreign income tax" in s LJ 3 must be read subject to the relevant articles in the NZ/UK DTA. This approach is consistent with principles of international treaty interpretation.

15. In determining the overriding effect of the NZ/UK DTA on the tax credit provisions, the Commissioner considers that the NZ/UK DTA must be interpreted in accordance with the text of the relevant articles within the context of the NZ/UK DTA and in light of its purpose. This is because the NZ/UK DTA is an international treaty entered into by New Zealand and it must be interpreted accordingly. New Zealand is a signatory to the Vienna Convention[4] so New Zealand's treaties have to be interpreted according to that convention. Article 31(1) of the Vienna Convention provides that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

16. Article 2(1)(a) of the NZ/UK DTA lists United Kingdom income tax (which includes United Kingdom PAYE) as a tax covered by the DTA. However, art 19 provides that only New Zealand has the right to tax pension income paid to a New Zealand resident. Therefore, withholding any amounts in the United Kingdom from pension payments is not in accordance with art 19 of the DTA. As a result, the Commissioner considers that any amounts withheld in the United Kingdom from pension payments paid to a New Zealand resident are not "foreign income tax" under s LJ 3 for the purposes of the tax credit rules. As the amounts are not "foreign income tax" under s LJ 3, no foreign tax credit can arise for such amounts under s LJ 2.

Article 22

17. It might be thought that the NZ/UK DTA article dealing with foreign tax credits for the elimination of double taxation (art 22) would be relevant to this issue. However, the Commissioner does not consider that art 22 gives rise to any credit entitlements in circumstances where the NZ/UK DTA allocates sole taxing rights for certain types of income, such as in the present case.

18. Article 22 deals with the elimination of double taxation. The article sets out the agreement between New Zealand and the United Kingdom as to when New Zealand and the United Kingdom will give foreign tax credits. Article 22(2)(a) sets out the circumstances in which New Zealand agrees United Kingdom tax paid will be allowed as a credit against New Zealand tax payable on the same income. It provides:

> **Subject to the provisions of the law of New Zealand** from time to time in force relating to the allowance as a credit against New Zealand tax of tax paid in any country other than New Zealand (**which shall not affect the general principle hereof**), **United Kingdom tax** computed by reference to income from sources in the United Kingdom and **paid under the law of the United Kingdom and in accordance with this Convention**, whether directly or by deduction, in respect of income derived by a resident of New Zealand from sources in the United Kingdom (excluding in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid), **shall be allowed as a credit against the New Zealand tax** computed by reference to the same income and payable in respect of that income.
>
> [Emphasis added]

19. In other words, art 22(2)(a) provides that:
    - A foreign tax credit is allowed against New Zealand tax for United Kingdom tax paid on the same income.
    - The allowance of the foreign tax credit is subject to New Zealand's domestic laws (that is, as to the timing and the amount of the credit). New Zealand's domestic law must be interpreted so as to uphold the general principle that a foreign tax credit should be available to eliminate double taxation.
    - Any foreign tax credit allowed under art 22 must be for United Kingdom tax that is paid not only under the law of the United Kingdom but also in accordance with the NZ/UK DTA.

20. As noted above, the articles in the NZ/UK DTA must be interpreted in their context and in light of the object and purpose of the NZ/UK DTA. Article 22(2)(a) expressly states that relief from double taxation only arises when United Kingdom tax is paid "in accordance with this Convention" (which includes art 19). Under art 22, therefore, a foreign tax credit will only arise when the tax is paid in accordance with the other NZ/UK DTA articles. No tax is payable in the United Kingdom as New Zealand has the sole taxing rights (art 19). Therefore art 22 does not give rise to any credit entitlements. This is because under the NZ/UK DTA, as it applies to pensions, there is no double taxation to eliminate because New Zealand has been given the sole taxing rights for United Kingdom pensions paid to New Zealand residents.

[4] Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, ratified by New Zealand on 4 August 1971).

21. More generally, in circumstances where New Zealand has agreed to share the taxing rights for a type of income (ie, where New Zealand does not have sole taxing rights to the income) under an article in the NZ/UK DTA then art 22 applies to provide relief from double taxation of New Zealand residents. Under art 22 New Zealand generally agrees to give a tax credit against New Zealand tax payable to the extent that the United Kingdom is entitled by an article in the NZ/UK DTA to tax that same income. If amounts are deducted in excess of what has been agreed under the NZ/UK DTA, New Zealand is not required to provide a tax credit for that excess. This is because any tax paid in the United Kingdom in excess of the level agreed in the NZ/UK DTA is not "foreign income tax" for New Zealand tax credit purposes.

Other arguments

22. The Commissioner is aware of possible counter-arguments that suggest a foreign tax credit might arise in these circumstances. However, the Commissioner considers that these arguments are not consistent with the overriding effect of the NZ/UK DTA under s BH 1(4), New Zealand's domestic tax credit rules and international practice.

23. As noted above, the Commissioner acknowledges that an amount withheld from a pension payment by a United Kingdom pension provider may appear, on the face of it, to be "foreign income tax". This is because there appears to be an obligation on the United Kingdom pension providers to withhold PAYE from the pensions of United Kingdom residents and the PAYE deducted is then paid to HM Revenue & Customs. However, as discussed above, the deductions are not "foreign income tax" in New Zealand for the purposes of the New Zealand tax credit rules because the tax deducted is not tax imposed in accordance with the NZ/UK DTA, and the NZ/UK DTA has an overriding effect in relation to New Zealand's domestic legislation. HM Revenue & Customs accepts that they have no right to tax United Kingdom pension income paid to New Zealand residents. To observe their agreement under art 19 of the NZ/UK DTA HM Revenue & Customs provides a domestic system for New Zealand residents to notify their United Kingdom pension providers that they are no longer United Kingdom residents and to claim repayments of PAYE deducted for periods before their change of residency notification has been processed.

24. Further, it has been suggested that the above approach results in the NZ/UK DTA removing a foreign tax credit that is available under domestic law. Such a result would appear to be inconsistent with the role of double tax agreements only to relieve double taxation and not to remove benefits provided to a taxpayer under domestic law. However, as the NZ/UK DTA has allocated the sole taxing right to New Zealand in these circumstances, the NZ/UK DTA has not denied a foreign tax credit available under domestic law. Instead, the NZ/UK DTA has determined that the income can only be taxable in New Zealand. The allocation of taxing rights is another way, different from the provision of tax credits, for double tax agreements to provide relief from double taxation. This is explained in the commentary to Arts 23A and 23B of the OECD model treaty ("Commentary on Articles 23 A and 23 B – Concerning the methods for elimination of double taxation", in OECD, *Model Tax Convention on Income and on Capital 2010 (Full Version)*, OECD Publishing).

25. It has also been suggested that art 22 allows a foreign tax credit for any tax covered by art 2 of the DTA. However, the Commissioner considers that this argument does not take into account the fact that art 22 must be read in light of the other articles of the DTA—in this case art 19. Under art 19, pensions paid from the United Kingdom to New Zealand residents are only taxable in New Zealand. Consequently, art 22 does not give rise to any credit entitlements.

26. The Commissioner is aware of an argument that the existence of s LJ 7 suggests that a foreign tax credit is available. Section LJ 7 deals with the situation where a person has paid foreign income tax and is entitled to a tax credit but receives a refund. Essentially, it requires that the refund be taken into account in the calculation of the credit (if the credit has yet to be determined) or that the lesser of the refund amount and the foreign tax credit amount be paid to the Commissioner (if the credit has already been claimed). It has been suggested that this provision is available to taxpayers in the circumstances of this item ie, where an amount has been paid to a foreign tax authority on certain income where that authority does not have the taxing rights to that income. Further, it is suggested that the existence of s LJ 7 shows that a credit is available up to the time a refund is provided.

27. The Commissioner considers this argument is not consistent with the overriding effect of s BH 1(4). Section LJ 7 only applies to refunds of "foreign income tax". As explained above, the amounts withheld from United Kingdom pension payments in the circumstances of this item do not satisfy that definition. In addition, the statutory history of s LJ 7

supports the conclusion that it was not intended to apply to such amounts. Further, New Zealand and the United Kingdom have entered into the NZ/UK DTA, which specifies the taxation rights in relation to pension payments between the two states. As a result, the context suggests that any foreign tax credit should be determined by the terms of the NZ/UK DTA. Section LJ 7 applies where the foreign tax authority has the taxing rights over the income but subsequent adjustments are made to the calculation of that foreign income tax resulting in a refund to the taxpayer.

28. Finally, the Commissioner is also aware of an argument that s LJ 1(5) operates to allow a foreign tax credit under s LJ 2 for an amount that is contrary to the NZ/UK DTA. Section LJ 1(5) deems s BH 1 (and other sections) to apply as far as applicable, and modified as necessary, for the purposes of s LJ 2, as if that section were a double tax agreement. The original purpose of the predecessor to s LJ 1(5), when the unilateral and bilateral credit rules were in distinct and separate parts of the predecessors of the ITA 2007, was to ensure that unilateral foreign tax credits were subject to the same rules as bilateral foreign tax credits. Following the consolidation of the provisions in the ITA 2007 unilateral and bilateral foreign tax credits are dealt with together and are subject to the same rules. This suggests that the original purpose for s LJ 1(5) no longer exists. However, even if s LJ 1(5) is able to be given an interpretation based on the plain meaning of its words, s LJ 1(5) itself would still need to be read together with the NZ/UK DTA. The Commissioner considers that allowing a foreign tax credit under subpart LJ would be inconsistent with s BH 1(4) and would undermine the taxing rights allocated under the NZ/UK DTA.

Summary

29. In summary, a person is not entitled to a foreign tax credit for the amounts withheld in the United Kingdom from a United Kingdom pension because the amounts are not "foreign income tax" under s LJ 3 for the purposes of the tax credit rules. The Commissioner considers that where a NZ/UK DTA applies the definition of "foreign income tax" must be read together with the articles of the NZ/UK DTA. This means "foreign income tax" is a tax that is covered by the NZ/UK DTA and paid in accordance with the articles of the NZ/UK DTA. The amounts withheld in the United Kingdom are not "foreign income tax" because under art 19 of the NZ/UK DTA the United Kingdom has no right to tax pensions paid to New Zealand residents. New Zealand has not agreed under art 22 to allow a foreign tax credit for any United Kingdom tax deducted from the pensions.

References

Subject references
Double tax agreements; Foreign tax credits; Pensions
Legislative references
Income Tax Act 2007 – ss BB 3(2), BH 1, CW 28, LJ 1(5), LJ 2(1), LJ 3, LJ 4, LJ 5, and LJ 7
Double Taxation Relief (United Kingdom) Order 1984 – articles 2(1)(a), 19 and 22 of sch 1
Vienna Convention – article 31(1)
Other references
"Commentary on Articles 23 A and 23 B – Concerning the methods for elimination of double taxation", in OECD, *Model Tax Convention on Income and on Capital 2010 (Full Version)*

APPENDIX – LEGISLATION

Income Tax Act 2007

30. Section BB 3(2) provides:

BB 3 Overriding effect of certain matters

…

Double tax agreements: subpart BH

(2) Under subpart BH (Double tax agreements) a double tax agreement has effect in relation to—

(a) income tax; or

(b) any other tax imposed by this Act; or

(c) the exchange of information that relates to a tax, as defined in paragraphs (a)(i) to (v) of the definition of **tax** in section 3 of the Tax Administration Act 1994.

31. Section BH 1 provides:

BH 1 Double tax agreements

Meaning

(1) Double tax agreement means an agreement that—

(a) has been negotiated for 1 or more of the purposes set out in subsection (2); and

(b) has been agreed between—

(i) the government of any territory outside New Zealand and the government of New Zealand; or

(ii) the Taipei Economic and Cultural Office in New Zealand and the New Zealand Commerce and Industry Office; and

(c) has entered into force as a result of a declaration by the Governor-General by Order in Council under subsection (3).

Purposes

(2) The following are the purposes for which a double tax agreement may be negotiated:

(a) to provide relief from double taxation:

(b) to provide relief from tax:

(c) to tax the income derived by non-residents from any source in New Zealand:

(d) to determine the income to be attributed to non-residents or their agencies, branches, or establishments in New Zealand:

(e) to determine the income to be attributed to New Zealand residents who have special relationships with non-residents:

(f) to prevent fiscal evasion:

(g) to facilitate the exchange of information:

(h) to assist in recovering unpaid tax.

Entry into force

(3) An agreement to which subsection (1)(a) and (b) apply enters into force on the date specified by the Governor-General by Order in Council.

Overriding effect

(4) Despite anything in this Act, except subsection (5) or (5B), or in any other Inland Revenue Act or the Official Information Act 1982 or the Privacy Act 1993, a double tax agreement has effect in relation to—

(a) income tax:

(b) any other tax imposed by this Act:

(c) the exchange of information that relates to a tax, as defined in paragraphs (a)(i) to (v) of the definition of tax in section 3 of the Tax Administration Act 1994.

Agreement for recovery of tax

(5) An agreement that provides for the recovery of unpaid tax is subject to Part 10A of the Tax Administration Act 1994.

Foreign account information-sharing agreements

(5B) A foreign account information-sharing agreement is subject to Part 11B of the Tax Administration Act 1994.

Reference to profits

(6) A reference in a double tax agreement to the profits of an activity or business is to be read, if possible, as a reference to the amount that would be a person's net income if that activity or business were their only activity or business.

Reference to unrelated persons

(7) A reference in a double tax agreement to 2 persons being unrelated is to be read, if possible, as a reference to 2 persons being not associated

32. Section CW 28 provides:

CW 28 Pensions

Exempt income

(1) The following are exempt income:

(a) a pension or allowance under the War Pensions Act 1954, other than a veteran's pension:

(b) a pension or allowance of any other kind granted in New Zealand or overseas by any government relating to any war or to disability attributable to or aggravated by service in the armed forces or the police:

(c) a payment of portable New Zealand superannuation:

(d) a payment of portable veteran's pension:

(e) an overseas pension.

Meaning of overseas pension

(2) In this section, **overseas pension** means—

(a) an overseas pension, to the extent of sums subtracted under section 70 of the Social Security Act 1964, by the department currently responsible for administering that Act, from—

(i) a monetary benefit paid under that Act; or

(ii) a monetary benefit, other than New Zealand superannuation or a veteran's pension, paid under the Social Welfare (Reciprocity Agreements, and New Zealand Artificial Limb Service) Act 1990:

(b) an overseas pension to the extent to which it is subject to an arrangement under section 70(3) of the Social Security Act 1964.

33. Section LJ 1(5) provides:

LJ 1 What this subpart does

…

Double tax agreements

(5) This subpart and sections BH 1 (Double tax agreements) and CD 19(1) (Foreign tax credits and refunds linked to dividends) and section 88 of the Tax Administration Act 1994 as far as they are applicable, and modified as necessary, apply for the purposes of section LJ 2, as if that section were a double tax agreement.

34. Section LJ 2(1) and (2) provides:

LJ 2 Tax credits for foreign income tax

Amount of credit

(1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year.

The amount of the New Zealand tax payable is calculated under section LJ 5.

…

35. Section LJ 3 provides:

LJ 3 Meaning of foreign income tax

For the purposes of this Part, foreign income tax means an amount of income tax of a foreign country.

36. Section LJ 4 provides:

LJ 4 Meaning of segment of foreign-sourced income

For the purposes of this Part, a person has a segment of foreign-sourced income equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

37. Section LJ 5 provides:

LJ 5 Calculation of New Zealand tax

What this section does

(1) This section provides the rules that a person must use to calculate the amount of New Zealand tax for an income year in relation to each segment of foreign-sourced income of the person that is allocated to the income year.

Calculation for single segment

(2) If the person has a notional income tax liability of more than zero, the amount of New Zealand tax for the income year relating to the allocated segment is calculated using the following formula, the result of which cannot be less than zero:

$$\frac{\text{(segment − person's deductions)}}{\text{person's net income}} \times \text{notional liability.}$$

Definition of items in formula

(3) In the formula in subsection (2),—

(a) **segment** is the amount of the segment of foreign-sourced income for the income year:

(b) **person's deductions** is the amount of the person's deduction for the tax year corresponding to the income year that is attributable to the segment of foreign-sourced income:

(c) **person's net income** is the person's net income for the tax year corresponding to the income year under section BD 4(1) to (3) (Net income and net loss):

(d) **notional liability** is the person's notional income tax liability for the income year under subsection (5).

When subsection (4B) applies

(4) Subsection (4B) applies for the income year when the total amount of New Zealand tax for all segments of foreign-sourced income of the person calculated under subsection (2) is more than the notional income tax liability

Modification to results of formula for single segment

(4B) Each amount of New Zealand tax calculated under subsection (2) in relation to each segment of foreign-sourced income is adjusted by multiplying the amount by the following ratio:

$$\frac{\text{person's notional income tax liability}}{\text{NZ tax.}}$$

Definition of item in formula

(4C) In the formula in subsection (4B), NZ tax is the amount given by adding together the result of the calculation under subsection (2), for each segment of assessable income from all sources, including assessable income sourced in New Zealand.

Person's notional income tax liability

(5) For the purposes of this section, a person's notional income tax liability for a tax year is calculated using the formula—

(person's net income − losses) × tax rate.

Definition of items in formula

(6) In the formula in subsection (5),—

(a) **person's net income** is the person's net income for the tax year:

(b) **losses**—

(i) is the amount of the loss balance carried forward to the tax year that the person must subtract from their net income under section IA 4(1)(a) (Using loss balances carried forward to tax year):

(ii) must be no more than the amount of the person's net income:](c)tax rate is the basic rate of income tax set out in schedule 1, part A (Basic tax rates: income tax, ESCT, RSCT, RWT, and attributed fringe benefits).

(c) **tax rate** is the basic rate of income tax set out in schedule 1, part A (Basic tax rates: income tax, ESCT, RSCT, RWT, and attributed fringe benefits

38. Section LJ 7 provides:

LJ 7 Repaid foreign tax: effect on income tax liability

Who this section applies to

(1) This section applies to a person who has—

(a) paid an amount of foreign income tax, or in relation to whom an amount of foreign income tax has been paid, on a segment of foreign-sourced income in relation to which they are entitled to a tax credit under section LJ 2; and

(b) received a refund, amount, or benefit (the refund) determined directly or indirectly by reference to some or all of the payment of foreign income tax.

When refund received before assessment

(2) If the person receives the refund before they assess their income tax liability for a tax year, the amount of the tax credit for the foreign income tax paid is reduced by the lesser of—

(a) the amount of the refund:

(b) the amount of New Zealand tax payable on the foreign-sourced income calculated under section LJ 5.

When refund received after assessment

(3) If the person receives the refund after they have assessed their income tax liability for a tax year, have used an amount of foreign tax credit in satisfying that liability, and have not taken the refund into account in that assessment, the person is liable to pay the Commissioner the lesser of—

(a) the amount of the refund:

(b) the amount of New Zealand tax payable on the foreign-sourced income calculated under section LJ 5.

Date for payment

(4) In subsection (3), the date for payment is 30 days after the later of—

(a) the date on which the person receives the refund:

(b) the date of the notice of assessment in relation to which the person has used the credit.

Associated persons

(5) For the purposes of this section, the refund is treated as received by the person, whether it is received by the person, a person who paid the foreign income tax, or a person associated with either of them.

Double Taxation Relief (United Kingdom) Order 1984, Schedule 1

39. Article 2(1)(a) provides:

Article 2 Taxes covered

(1) The taxes which are the subject of this Convention are:

(a) in the United Kingdom:

(i) the income tax;

(ii) the corporation tax;

(iii) the capital gains tax; and

(iv) the petroleum revenue tax;

(hereinafter referred to as "United Kingdom tax");

…

40. Article 19 provides:

Article 19 Pensions and annuities

(1) Pensions (including pensions paid under the social security legislation of a Contracting State), and similar remuneration in consideration of past employment or services, paid to a resident of a Contracting State, and any annuity paid to a resident of a Contracting State, shall be taxable only in that State.

(2) The term "annuity" means a stated sum payable periodically at stated times during life or during a specified or ascertainable period of time under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

41. Article 22 provides:

Article 22 Elimination of double taxation

(1) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof):

(a) New Zealand tax payable under the law of New Zealand and in accordance with this Convention whether directly or by deduction, on profits, income or chargeable gains from sources within New Zealand (excluding, in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the New Zealand tax is computed.

(b) In the case of a dividend paid by a company which is a resident of New Zealand to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 percent of the voting power in the company paying the dividend, the credit shall take into account (in addition to any New Zealand tax for which credit may be allowed under the provisions of subparagraph (a) of this paragraph) the New Zealand tax payable by the company in respect of the profits out of which such dividend is paid.

(2) (a) Subject to the provisions of the law of New Zealand from time to time in force relating to the allowance as a credit against New Zealand tax of tax paid in any country other than New Zealand (which shall not affect the general principle hereof), United Kingdom tax computed by reference to income from sources in the United Kingdom and paid under the law of the United Kingdom and in accordance with this Convention, whether directly or by deduction, in respect of income derived by a resident of New Zealand from sources in the United Kingdom (excluding in the case of a dividend, tax paid in respect of the profits out of which the dividend is paid), shall be allowed as a credit against the New Zealand tax computed by reference to the same income and payable in respect of that income.

(b) In the event that the Government of New Zealand should impose tax on dividends received by companies which are resident in New Zealand the Contracting States will enter into negotiations in order to establish new provisions concerning the taxation of such dividends derived from sources in the United Kingdom.

(3) For the purposes of paragraphs (1) and (2) of this Article, profits, income and capital gains derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources in that other State.

(4) Where, under the provisions of Article 10, profits on which an enterprise of a Contracting State has been charged to tax in that State are also included in the profits of an enterprise of the other Contracting State and the profits so included are profits which would have accrued to that enterprise of the other State if the conditions made or imposed between the two enterprises in their commercial or financial relations had been those which would have been made or imposed between independent enterprises, the amount included in the profits of both enterprises shall be treated for the purpose of this Article as income from a source in the other State of the enterprise of the first-mentioned State and relief shall be given accordingly under the provisions of paragraph (1) or paragraph (2) of this Article.

(5) Nothing in this Article shall entitle a person who is a resident of a Contracting State to credit against tax of that Contracting State of tax of the other Contracting State if the terms of the transactions giving rise to the profits on which the tax of the other State is payable are not such as might be expected in a bona fide commercial transaction and if they have as their main object, or one of their main objects, the obtaining of that credit.

COMMISSIONER'S OPERATIONAL POSITION ON FOREIGN TAX CREDITS FOR AMOUNTS WITHHELD FROM UNITED KINGDOM PENSIONS

The purpose of this item is to inform taxpayers of the operational position being adopted by the Commissioner in relation to this matter.

The Commissioner has released *QB 14/12: Income tax – Foreign tax credits for amounts withheld from United Kingdom pensions*.

This Question We've Been Asked (QWBA) confirms Inland Revenue's long-standing view that, in relation to a United Kingdom pension received by a New Zealand tax resident, New Zealand has the sole taxing rights under the Double Tax Agreement with the United Kingdom. This means that New Zealand tax residents cannot claim a foreign tax credit in New Zealand for any amounts withheld by their United Kingdom pension provider from their United Kingdom pension and that pension must be returned as income in New Zealand.

If you have previously claimed a tax credit for any tax withheld on your United Kingdom pension, we suggest you discuss the matter with your tax advisor, or us, and consider making a voluntary disclosure. If you are a tax resident of New Zealand and you receive (or about to receive) United Kingdom pension payments, to make sure you are not taxed further in the United Kingdom and to obtain a refund of amounts withheld in the United Kingdom in past years you should:

1. Complete the *Application for relief at source from United Kingdom income tax and claim to repayment of United Kingdom income tax* form New Zealand-Individual (**http://www.hmrc.gov.uk/cnr/nz_indiv.pdf**) which is on the HM Revenue & Customs (HRMC) website. You can either print the form directly from the website or save it to your computer as a PDF, then print it.
2. Send us your completed form and we will process and send the form to HMRC. They will issue a directive to your pension provider to stop the deductions in their system. The form also enables you to claim back amounts incorrectly withheld in the United Kingdom. The address to send your completed form to is:
   Inland Revenue
   PO Box 39010
   Wellington Mail Centre
   Lower Hutt 5045

   You can also contact us by Secure mail with the following details:
   Subject: Foreign Pension
   Account: All other
   Category: All other

For any general enquires or questions of a general nature you can email **Transactional.International@ird.govt.nz** (do not send any taxpayer or customer information to this email address).

The HMRC form New Zealand-Individual asks at Part B:

- Question 2: "On what date did you become resident in New Zealand?"
- Question 3: "From what date have you paid, or will you pay, tax in New Zealand on the income that you include in this claim? (*This may differ from the date you have given in answer to question 2.*)

  If you do not have to pay tax in New Zealand on this income please give the reason(s) on a separate sheet."

All taxpayers (to which this form applies) must fill in question 3 with the date you have paid or will pay tax in New Zealand on income included in this claim. For a transitional resident the pension is generally only taxable from the date when your transitional residency ends (or has ended) which is of course later than the date you become resident, so you need to enter that later date as the answer for this question. The later date will have no impact on the requirement on the United Kingdom to provide relief from taxation.

Additionally, you will need to give details of your transitional residency stating the reason you won't be paying tax on a separate sheet and attach it to the form. For example:

a) That you arrived in New Zealand on [Day, Month, Year] (same date as question 2) and are eligible for a "temporary tax exemption on foreign income" for new migrants and returning New Zealanders (often referred to as transitional residency); and

b) That you are not required to pay tax on foreign income in New Zealand for 4 calendar years, (up to 49 months) for the dates from [Day, Month, Year] (same date as question 2) to [Day, Month, Year] (same date as question 3).

If you are in doubt please contact us at the above address before you send us any application for double taxation relief. Also, if as a result of incorrectly filling in the HMRC form you have been treated as electing out of the transitional residence rules you should contact us.

If you have claimed a foreign tax credit in prior tax returns, you should ensure going forward that you no longer claim any foreign tax credits from your United Kingdom pension income in your New Zealand tax return. Taxpayers making pre-audit voluntary disclosures will not be subject to shortfall penalties.

If you make a voluntary disclosure because you have claimed these tax credits in the past you will only be required to make a disclosure to amend your returns to remove the foreign tax credit in relation to the 2013 (1 April 2012 – 31 March 2013) and/or 2014 (1 April 2013 – 31 March 2014) tax years.

We are aware that the HMRC will provide refunds for periods earlier than the 2013 tax year if applicable (provided it is not in respect of tax periods greater than 6 years old). The concessionary treatment for voluntary disclosures outlined in this item only applies if the taxpayer has not received refunds from HMRC in respect of periods earlier than the 2013 tax year.

If an earlier refund has been or is going to be obtained by HMRC, the Commissioner will assess the taxpayer for those earlier periods, as opposed to simply the 2013 year onwards. Taxpayers who receive (or have received) earlier period refunds in this way must advise the Commissioner accordingly when they are received. Although this will result in reassessments for those earlier periods no penalties or use of money interest will be imposed in relation to those earlier periods.

The due date for payment of the increased liability for New Zealand tax will be deferred to allow you to receive the refund from the United Kingdom. This means that we will not be expecting any money from you until you have received the refund from the United Kingdom. No late payment penalties will be applied on your New Zealand tax liability provided you pay the increased amount of tax on or before the new due date (some use of money interest may apply for the 2013 tax year onwards). Foreign exchange differences (and use of money interest if applicable) may result in you having to pay additional amounts to Inland Revenue to meet your tax liability which is over and above the refund received from HMRC.

In a limited number of cases, the pension may not have been taxed in either the United Kingdom or New Zealand. In those cases the concessionary approach outlined in this item does not apply and we suggest that taxpayers in that situation who wish to make a voluntary disclosure contact us to discuss further.

If interest is charged for the 2013 tax year onwards it is possible to apply in writing for a remission of any use of money interest imposed if you consider that any of the grounds in Standard Practice Statement *SPS 05/10: Remission of penalties and interest* are satisfied, for instance if you consider that you have relied on incorrect advice from Inland Revenue in taking your tax position.

If you have difficulty paying any of the New Zealand tax outstanding (over and above the refund from the United Kingdom) you should contact us. It may be possible to enter into an instalment arrangement or apply for relief from the outstanding tax if recovery would place you in hardship.

For information on instalment arrangements or relief from outstanding tax see the guide *Debt options (IR 582)*. For further information see Standard Practice Statement *SPS 11/01: Instalment arrangements for payment of tax* or Standard Practice Statement *SPS 06/02: Writing off outstanding tax*.

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.

COURT HAD JURISDICTION TO CURE FAILURE TO FILE A NOTICE OF PURSUIT OF CLAIM

Case	Kin San Cheang v Commissioner of Inland Revenue
Decision date	3 October 2014
Act(s)	District Court Rules 2009
Keywords	Notice of pursuit of claim, extension of time, technical non-compliance, irregularity, nullity, jurisdiction, strike out

Summary

The failure to file and serve a notice of pursuit of claim ("NPC") was a procedural irregularity and did not nullify the proceeding. The Court had jurisdiction to cure that irregularity, hear the strike-out application and enter judgment and did so in this case because there was no prejudice to the appellant.

Impact of decision

The District Court Rules 2009 ("the Rules") have since been replaced by the District Court Rules 2014 (under which there is no requirement to serve and file an NPC). Therefore, the precedential value of the decision is limited.

However, Moore J did say that this judgment should not be read as authorising the late filing of any application where r 1.18.2A is engaged. The circumstances encountered in this case that permit such a course will be relatively rare.

Facts

Mr Cheang was sued in the District Court by the Commissioner of Inland Revenue ("the Commissioner") for $301,767.86. This amount arose from default assessments issued for the 2004 and 2005 income tax years.

The relevant procedure under the Rules is provided for in r 2.17: the Commissioner was to file a notice of claim, Mr Cheang a notice of response and both parties to file information capsules, following which the Commissioner was to file an NPC. However, the Commissioner did not file the NPC, but filed only an application to strike out Mr Cheang's defence. The Rules state that failure to file an NPC within time means the proceedings are at an end (r 2.17.4). Mr Cheang therefore argued the Court had no jurisdiction to entertain the Commissioner's strike-out application.

Judge Harrison in the District Court heard the strike-out application and determined that the Commissioner's failure to file the NPC was not fatal to the application because it was clear the proceeding did not go out of all existence following the failure. Since the Rules allow for the Court to extend the time for filing an NPC even after the deadline in r. 2.17 has expired (r 1.18.2/1.18.2A), the proceeding maintained sufficient existence for the Court to rule on the strike out application.

Mr Cheang appealed to the High Court.

Decision

Moore J determined that the Court did have jurisdiction to hear the strike-out application.

Moore J first examined the purpose of r 2.17 and the effect of r 1.18.2/1.18.2A. Recognising the Rules provide for the NPC to be served on the defendant first rather than filed, he held the primary intention of the NPC is to notify the defendant the plaintiff intends to proceed. He accepted this purpose was achieved when the Commissioner filed the strike-out application and therefore the substance of the Rules was met.

Both parties acknowledged that r 1.18.2 allowed the Court to extend the time to file the NPC. However, Mr Cheang argued that the rule only operated to extend the proceeding when the time was in fact extended: if the Commissioner had applied for an extension, the Court would have had jurisdiction to hear the strike-out application but not otherwise.

Moore J rejected that argument for the reason that it would render r 1.18.2A of no effect, the proceeding would come to an end and could not be revived. He accepted

the proceeding maintained a level of existence sufficient to support an extension of time application and this was supported by the fact the Rules envisaged that application to be made on notice involving the other party (which would not be the case if the proceeding had ended).

However, Moore J did not accept that just because the proceeding could support an extension of time application, it could support a strike-out application.

Rather, His Honour decided the appeal on the fact that the failure to file the NPC amounted to technical non-compliance with the Rules and that r 1.10 provides that non-compliance with the Rules is to be treated a matter of irregularity rather than a nullity. Since the Court has discretion as to how the irregularity is treated, the Court has the ability to cure the failure to file the NPC.

In deciding to exercise that discretion in favour of the Commissioner, Moore J recognised there was no prejudice to Mr Cheang, since the only effect of enforcing strict compliance would be to make the Commissioner start the claim again. Further, since the purpose of the NPC is to inform the defendant that the plaintiff intends to continue with the claim and since that purpose in this case was satisfied by the strike-out application, Mr Cheang was in no doubt the Commissioner would pursue the claim. Moore J also noted Mr Cheang had no defence to the claim, given he could not contest the correctness of the Commissioner's assessment in the District Court.

Accordingly, under r 1.10, Moore J held that the Court had jurisdiction to hear and determine the strike-out application and enter judgment in favour of the Commissioner.

JUDICIAL REVIEW OF DECISION TO REMOVE TAX AGENT FROM LIST OF APPROVED TAX AGENTS

Case	Accountants First Limited v Commissioner of Inland Revenue
Decision date	6 October 2014
Act(s)	Tax Administration Act 1994
Keywords	Judicial review, removal of tax agent status

Summary

Commissioner of Inland Revenue ("the Commissioner") fully complied with her obligations under s 34B(9) of the Tax Administration Act 1994 ("TAA") to give the tax agent reasons for any proposed decision to remove the tax agent from the list of approved tax agents.

Impact of decision

A decision-maker does not need to conduct a consultation as required by s 34B(9)(b) of the TAA, provided:

1. the tax agent is fully and fairly aware of the basis on which the decision-maker is considering removing him or her from the list of tax agents; and
2. the decision maker fully and fairly takes into account any submissions made by the tax agent before deciding whether or not to remove the tax agent from the list of approved tax agents.

Facts

Accountants First Ltd ("Accountants First") was incorporated on 3 October 2005. Its sole director is Mr Kamal. He, his wife and the Imran Kamal Trustee Company Ltd are the shareholders of Accountants First. Soon after it was incorporated, Accountants First was granted approved tax agent status by the Commissioner under s 34B(4) and (5) of the TAA.

In February 2001, the Commissioner commenced an investigation into the tax affairs of Accountants First and Mr Kamal. The investigation revealed that between March and July 2006, Accountants First claimed input tax credits in respect of fictitious tax invoices for three goods and services tax periods, resulting in Accountants First evading tax amounting to $55,735.50.

On 18 December 2012, Mr Kamal pleaded guilty to six charges of tax evasion under the TAA. On 15 February 2013, Mr Kamal was sentenced to three months' home detention and 150 hours of community work. On the same day, Accountants First was convicted and discharged in relation to charges laid under the same provisions of the TAA.

Mr Kamal sought name suppression in the District Court because of concerns about Mrs Kamal's health. While his original application was dismissed, Mr Kamal successfully appealed that decision to the High Court. However, the High Court later revoked name suppression because Mr Kamal's evidence "proved to be very questionable".

Following the conclusion of the prosecution against Accountants First and Mr Kamal, officers of the Commissioner commenced a process to determine if Accountants First's tax agent status should be revoked. This process involved two decisions.

First decision

In May 2013, the Commissioner sent the shareholders of Accountants First letters advising that their company's tax agent status was being reviewed. The letters explained this was because of Mr Kamal's convictions and the duty of the

Commissioner to protect the integrity of the tax system. The Commissioner sought a response within 30 days.

In June, the Commissioner received a submission from Accountants First's barrister at the time, Mr Coleman, explaining why the company's tax status should not be revoked (June submission).

After a meeting between officers of the Commissioner, Mr Kamal and Mr Coleman in August 2013, the Department sent letters to Accountants First's shareholders advising that a decision had been made to remove the company from the list of approved tax agents.

In October 2013, Accountants First filed judicial review proceedings and an application for interim relief. The application claimed that in making her decision, the Commissioner was unreasonable and/or failed to take into account relevant considerations and/or took into account irrelevant considerations.

Second decision

In December 2013, an officer of the Commissioner realised that the officer who had made the decision to revoke Accountants First's tax agency status did not have delegated authority from the Commissioner to make that decision.

In a letter to Accountants First's new barrister, Mr Weaver, Crown Law outlined the situation and explained that the decision made in September was not valid. It was also explained that a new decision-maker, with appropriate delegation, would consider whether Accountants First should be removed from the list of approved tax agents because of Mr Kamal's criminal convictions.

The matter was then given to a senior officer of the Commissioner who had the appropriate delegated authority. In an affidavit to the court, the senior officer swore that she carefully considered all matters on the file, including the June submission from Accountants First and the minutes of the meeting in August 2013.

In February 2014, the senior officer made the decision to remove Accountants First from the list of approved tax agents. In March 2014, the Department sent a letter to the shareholders of Accountants First notifying them of the decision and the reasons for the decision. Accountants First filed an application for judicial review on 20 March 2014 pleading two breaches of s 34B(9) of the TAA.

Decision

Reasons for proposing to remove tax agent status

The Court identified the Commissioner's clear and unequivocal duty imposed by s 34B(9) of the TAA to give a tax agent reasons for any proposed decision to remove the tax agent from the list of approved tax agents.

Collins J was satisfied that the Commissioner complied with her obligations under s 34B(9) of the TAA when she explained in May 2013 the reasons why she was considering removing Accountants First from the list of approved tax agents and when Accountants First was given the opportunity to make submissions, which it did in June and August 2013.

Mr Weaver argued that the Commissioner was obliged to again state her reasons for proposing to remove Accountants First when the second decision to consider removal was made.

His Honour stated that even if there was a further obligation on the Commissioner, this was complied with when Crown Law sent its letter restating those reasons in December 2013.

Consultation

The Court explained that s 34B(9) of the TAA also places a clear and unequivocal duty upon the Commissioner to consider arguments against the proposed decision that were advanced by the tax agent. Collins J considered whether the Commissioner had a duty to again consult with Accountants First when Ms Young made the second decision to remove it as an approved tax agent.

After considering relevant decisions, Collins J concluded that a duty to consult further only arises if the information relied upon by the decision-maker has materially changed.

His Honour found that the senior officer's decision to remove Accountants First from the list of approved taxpayers was based on the same key factors that Accountants First addressed in its original June submissions. The other matters that were referred to by the senior officer when reaching her decision were ancillary matters of no consequence. Furthermore, the Court pointed out that the fact the first decision-maker lacked authorisation did not invalidate the steps taken under s34B(9) of the TAA before the first decision was made.

The Court concluded that this reflects the realities of how administrative decisions have to be made in large organisations such as Inland Revenue. Everyday issues are consulted upon at one level and then escalated up the organisation to senior officers who are delegated with the responsibility to make decisions in the name of the Commissioner.

The court found that the Commissioner fully complied with her obligations under s 34B(9) of the TAA and therefore dismissed the application for judicial review.

JUDICIAL REVIEW OF DECISION NOT TO RECALCULATE

Case	Peebles & Bradbury & Anors v Attorney-General & Commissioner of Inland Revenue
Decision date	24 October 2014
Act(s)	Tax Administration Act 1994, Income Tax Act 1994
Keywords	Judicial review, collections, s 6/6A powers, Trinity scheme

Summary

This was a judicial review by Trinity investors asserting that following a tax challenge, the subsequent collection/recovery of tax is a new phase and there is a duty on the Commissioner of Inland Revenue ("the Commissioner") to recalculate the amount owing. The High Court rejected that there was any such duty and noted the Commissioner is entitled to collect the amount fixed in the challenge proceedings.

Impact of decision

The taxpayer is obliged to pay on completion of the challenge procedure and if the taxpayer does not pay, the Commissioner is obliged to collect unless it is impracticable to do so. The High Court did not consider there is any intervening duty to reconsider the amount of the taxpayer's liability if proceedings to collect are required.

Facts

Mr Peebles and Mr Bradbury ("the plaintiffs") were investors in the Trinity tax avoidance scheme and were unsuccessful in their tax challenges against the Commissioner in the High Court, the Court of Appeal and Supreme Court.

The Supreme Court judgment, *Ben Nevis Forestry Ventures Ltd & Ors v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289, was issued in December 2008 and since then the plaintiffs have not paid the amount they were assessed or any additional amount that has accrued over that time.

In December 2013, the Commissioner issued recovery proceedings ("the proceedings") to obtain summary judgment against the plaintiffs for sums she disputes are owed.

The plaintiffs, in turn, sought judicial review against the Commissioner for refusing to discontinue the recovery proceedings against them.

The judicial review was premised on the argument that, notwithstanding the Supreme Court's determination of their tax challenge, the Commissioner should have recalculated the tax due under a different provision of the Income Tax Act 1994. The plaintiffs argued that the Commissioner has a duty not to seek to recover more tax than is properly payable and that the Commissioner failed to have regard to that duty, therefore she made an error of law when she decided to commence/continue with the proceedings.

The Commissioner opposed the plaintiffs' application on the following grounds:

1. the decision to commence or continue proceedings to recover tax is not amenable to review;
2. she is not subject to any duty to the plaintiffs in the nature alleged; and
3. if a ground of review was established, the Court ought to decline relief on the basis that the plaintiffs' application is another attempt to avoid or delay meeting their obligations.

Decision

Is a decision to commence and/or continue with recovery proceedings amenable to judicial review?

Peters J considered the Commissioner's submissions on this issue, namely that the Court should not generally review a decision as to the conduct of litigation made by the Commissioner in discharging her duties in the care and management of taxes.

While there were several authorities in support of the Commissioner's submissions, her Honour made reference to *Raynel v Commissioner of Inland Revenue* (2004) 21 NZTC 18,583 (HC), where Randerson J stated Courts would be slow to intervene with such decisions but left open the possibility that the Court may intervene in such a decision if the Court is satisfied that the Commissioner had made a material error of law.

Accordingly, Peters J felt it was necessary to consider whether or not the Commissioner has a duty not to seek to collect more tax than is properly payable, even if there are assessments for greater amounts.

Does the Commissioner have a duty not to seek to collect more tax than is properly payable, even if there are assessments for greater amounts?

The plaintiffs argued that the collections phase is a new phase within which the Commissioner is required to review the position. Further, the Commissioner has a duty for collection purposes to recalculate the amount payable to ensure that she is not seeking to recover more than is actually payable prior to initiating recovery action.

The Commissioner argued that she is not subject to a duty to recalculate the amount of tax she is seeking to collect, and that the amount she was seeking was the correct amount, as confirmed by the Supreme Court judgment.

Peters J agreed that the Commissioner is not subject to a duty to recalculate the amount of tax before deciding to commence and/or continue with recovery proceedings if that taxpayer defaults in their obligation to pay and proceedings to collect are required.

Her Honour further noted that the Commissioner is entitled to seek the sum due from a taxpayer, which is fixed on the outcome of the challenge procedure. If the taxpayer does not pay the amount owed, then the Commissioner is obliged to collect unless it is impracticable to do so.

Given the High Court's findings on this issue, it was not necessary for her Honour to consider the other grounds argued. Accordingly, the plaintiffs' application for judicial review was dismissed.

TAXPAYER DID NOT HAVE A PERMANENT PLACE OF ABODE IN NEW ZEALAND

Case	Michael William Diamond v Commissioner of Inland Revenue
Decision date	15 August 2014
Act(s)	Income Tax Act 1994, Income Tax Act 2004
Keywords	Permanent place of abode, resident in New Zealand

Summary

This was an appeal by Mr Diamond against the Taxation Review Authority ("TRA") finding that he had a permanent place of abode in New Zealand and therefore was a resident in New Zealand for tax purposes for the years in dispute. The High Court on appeal found for the taxpayer and determined that he was not a resident.

Impact of decision

This decision is the most recent authority dealing with the issues of residency and permanent place of abode. The Commissioner of Inland Revenue ("the Commissioner") has appealed the decision. The Commissioner's view on the correct application of the permanent place of abode test is as set out in IS 14/01.

The Commissioner notes that the Court made some *obiter* comments about the operation of the day-count rules in s OE1. The Commissioner's view on the operation of those rules is as set out in IS 14/01.

Facts

Mr Diamond ("the appellant") is a former New Zealand soldier who worked as a security contractor in Papua New Guinea and Iraq during the tax years in question (the tax years ending 31 March 2004 to 2007 inclusive). During those years, the appellant did not pay income tax on his foreign earnings.

The Commissioner assessed the disputant as a New Zealand resident under s OE 1(1) of the Income Tax Act 1994 and Income Tax Act 2004 ("ITAs") on the basis that he had a permanent place of abode in New Zealand. The appellant challenged this assessment, submitting he had been (and remained) a non-resident from the date he left New Zealand (July 2003).

In 2013, the TRA held that the appellant had a permanent place of abode in New Zealand under s OE 1(1) of the ITAs and therefore was a resident in New Zealand for tax purposes for the tax years ending 31 March 2004 to 31 March 2007. The TRA also found that the appellant had adopted an unacceptable tax position. The appellant appealed that decision to the High Court.

Decision

Clifford J stated that the TRA's approach to the issue relied on a two-stage test drawn from *Case Q55* (1993) 15 NZTC 5,313:

- firstly, whether the appellant had an available dwelling in New Zealand in the relevant tax years; and
- secondly, a consideration of the appellant's other connections with New Zealand.

However, Clifford J considered *Case Q55* to be authority only for the proposition that a person's permanent place of abode in New Zealand will not cease to have that character merely because that dwelling is rented out whilst the person is outside New Zealand. Clifford J considered *Case Q55* proceeded from the factual matrix of that case, in that:

- the taxpayer and his wife had lived in the dwelling prior to their departure;
- their absence was always intended to be temporary;
- the taxpayer and his wife had always intended to return to New Zealand and to resume residing in their home here after their absence; and
- they retained a wide range of connections with New Zealand during their absence.

It was in that context that Judge Barber found in *Case Q55* that despite the dwelling not being available while the taxpayer was overseas (because it was rented out), it nonetheless remained the taxpayer's permanent place of abode. Clifford J held that *Case Q55* is not authority for the approach taken by the Commissioner or the TRA.

Clifford J then considered whether there was any other basis upon which the property might be considered the appellant's permanent place of abode in New Zealand. In doing so, his Honour looked to determine the correct interpretation of s OE 1(1) of the ITAs.

First, Clifford J considered the ordinary meaning of the words *permanent, abode, place, in,* and then the phrase as a whole; and found that the ordinary meaning of "to have a permanent place of abode in New Zealand" is "to have a home in New Zealand". Given that the appellant had never lived at the property, and only rented it out to others, Clifford J found that the Property is not, in the ordinary sense of the meaning of those words, a permanent place of abode the appellant has in New Zealand.

Clifford J then proceeded to examine the purpose behind the provision, and in doing so considered the section's legislative history. He noted the "permanent place of abode" test had replaced the previous "home" test. However, he could not identify any alteration in meaning which would support the Commissioner's approach.

At [75] Clifford J acknowledged that the appellant did have other, and ongoing, personal connections with New Zealand. However, he considered that in the absence of the property having any of the characteristics of a permanent place of abode, those connections did not alter his conclusion.

The Court allowed the appeal, concluding there is no basis for the proposition that the appellant had a permanent place of abode in New Zealand so as to make him resident for tax purposes.

On the issue of penalties, Clifford J stated at [76] that due to the outcome he did not need to consider whether the appellant had adopted an unacceptable tax position, but noted that had it been necessary, he would have found in the appellant's favour.

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 and Strategy

Policy 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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The TIB index is also available online at **www.ird.govt.nz/aboutir/newsletters/tib/** (scroll down to the bottom of the page). The website has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you would prefer to get the TIB from our website, please email us at **tibdatabase@ird.govt.nz** and we will take you off our mailing list.

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New Zealand Government