Vol 26 No 5 June 2014

TAX INFORMATION *Bulletin*

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Inland Revenue
Te Tari Taake

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

YOUR OPPORTUNITY TO COMMENT

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

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

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

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

IN SUMMARY

Legislation and determinations (continued)

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INTERPRETATION STATEMENTS

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

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 14/02: INCOME TAX – FOREIGN TAX CREDITS – WHAT IS A TAX OF SUBSTANTIALLY THE SAME NATURE AS INCOME TAX IMPOSED UNDER S BB 1?

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

Scope of this statement

1. There are two circumstances where a taxpayer may be entitled to claim a foreign tax credit against their New Zealand income tax liability for foreign tax paid:
   - if the foreign tax is covered by a Double Taxation Agreement (DTA), a credit may be allowed under, and in accordance with, the terms of that DTA; or
   - if the foreign tax is not covered by a DTA, a foreign tax credit may be allowed directly under subparts LJ or LK.
2. A tax **is** covered by a DTA if the tax is expressly listed in the DTA as one of the taxes covered, or if the DTA applies to subsequently enacted taxes that are identical or substantially similar to one of the taxes expressly covered. If a credit is allowed under the DTA, the amount of that credit will be calculated under subpart LJ of the Act. If a credit is not available under the DTA, then there will be no foreign tax credit relief. A list of countries or territories that have DTAs with New Zealand can be found on Inland Revenue's website at **www.ird.govt.nz/international/residency/dta/**
3. A foreign tax is **not** covered by a DTA if:
   - New Zealand does not have a DTA with the foreign jurisdiction imposing the tax; or
   - there is a DTA between New Zealand and the foreign jurisdiction but the foreign tax is not a tax that the DTA applies to.
4. This Interpretation Statement only applies to taxes that are **not** covered by a DTA.

Introduction

5. If a taxpayer pays a foreign tax that is not covered by a DTA the taxpayer may be entitled to a tax credit under subpart LJ. One of the requirements for entitlement is that the foreign tax must be "income tax" as defined in s YA 2(5). This means the foreign tax must be:
   - a tax of substantially the same nature as income tax imposed under s BB 1, or
   - a tax of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT) or non-resident withholding tax (NRWT) and imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1.
6. This Interpretation Statement sets out the Commissioner's view of how s YA 2(5) should be interpreted and applied. It has three parts:
   - Part 1 – sets out the test of how s YA 2(5) should be interpreted and applied. It identifies the characteristics the Commissioner expects a foreign tax to have to be a tax of substantially the same nature as income tax imposed under s BB 1 or a tax of substantially the same nature as provisional tax, PAYE, RWT or NRWT.
   - Part 2 – contains the analysis that underpins the test. This part examines the relevant legislation and case law.
   - Part 3 – applies the test to three foreign taxes to illustrate how the Commissioner will apply s YA 2(5). The three foreign taxes are:
     - Solomon Islands PAYE;
     - United States of America Federal Insurance contributions; and
     - United Kingdom National Insurance contributions.

7. The interpretation of s YA 2(5) is considered in the context of a claim for a foreign tax credit under subpart LJ. However, the interpretation will also be relevant to other subparts of Part L, such as subpart LK (Tax credits relating to attributed controlled foreign company income). To this extent, the conclusions in this item regarding s YA 2(5) apply equally to all relevant subparts of Part L.

PART 1 – THE SECTION YA 2(5) TEST

8. To qualify for a foreign tax credit under subpart LJ, a taxpayer must have paid foreign income tax on a segment of foreign-sourced income. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". The meaning of "income tax" in this context is varied by s YA 2(5). Section YA 2(5)(a) extends the definition of income tax to include taxes that are of substantially the same nature as income tax imposed under s BB 1. Section YA 2(5)(b) further extends the definition of income tax to include taxes that are of substantially the same nature as provisional tax, PAYE, RWT or NRWT and are imposed as a collection mechanism for a foreign tax. Under s YA 2(5)(b), the foreign tax being collected must be of substantially the same nature as income tax imposed under s BB 1. Section YA 2(5) applies to taxes imposed by state or local government, in addition to centrally imposed taxes.

9. The ordinary meaning of "substantially the same nature" suggests that the qualities or characteristics of the foreign tax must be significantly or essentially like the qualities or characteristics of income tax imposed under s BB 1. In the case of s YA 2(5)(b), this means the tax imposed must be significantly or essentially like provisional tax, PAYE, RWT or NRWT and be imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

10. Case law suggests that "substantially the same" requires sameness in substance or effect but not necessarily in form. It means the foreign tax imposed must be "in the main, for the greatest part and in substance" the same as New Zealand income tax. This is the standard against which the foreign tax is to be judged. The Commissioner's view is that the comparison must be between the nature of the foreign tax imposed and the nature of income tax imposed under s BB 1. This means focusing on the amount of foreign tax that has been paid, including how it is calculated, and comparing it to the nature of New Zealand income tax.

11. The Commissioner's view is that the nature of New Zealand income tax is determined at a high level. It requires an understanding of the fundamental features of New Zealand income tax rather than the detail. For this purpose, the nature of New Zealand income tax has been defined in paragraph 12 below.

12. A foreign tax is likely to satisfy the requirements of s YA 2(5) if the following conditions are met:

The foreign tax must:

- be compulsory and enforceable by law;
- be imposed by, and payable to, a central, state, or local government;
- be intended for a public purpose (although it is generally irrelevant whether it is tagged for a specific public purpose);
- tax "income" as defined under the Act;
  - This condition will be satisfied even though there are minor differences between income taxed under s BB 1 and income taxed under the foreign tax.
- be calculated as a proportion of income;
  - The rate of the tax is not important.
  - Whether the tax is payable at a fixed rate or at graduated rates is not important.
  - This condition will still generally be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.
- be imposed on net income (gross income minus deductions) or taxable income (net income minus losses).
  - A taxing method designed to produce a reasonable approximation of actual net/taxable income may be acceptable.
  - Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.

The foreign tax must not be:

- a penalty;
- a payment of interest;
- a service charge or licence fee;
- a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).

The following factors are not determinative:

- Whether the tax rate is set by an annual taxing Act.
- Whether the tax is imposed under separate legislation from the principal taxing legislation.
- The name given to the tax.

Taxes that do not satisfy the s YA 2(5) test:

- The following are examples of taxes that are not of the same nature as income tax imposed under s BB 1. Accordingly, they do not satisfy the s YA 2(5) test:
  - Goods and services taxes and value added taxes.
  - Customs or import duties.
  - Insurance levies.
  - Gift taxes.
  - Property rates.
  - Asset taxes.
  - Wealth taxes.
  - Inheritance taxes and estate duties.
  - Excise taxes and duties.

13. The onus is on the taxpayer to demonstrate that the foreign tax is eligible for a foreign tax credit.

Foreign tax refunds

14. A person must make an adjustment if they receive a refund of foreign income tax.
15. If the person receives the refund before they have self-assessed, the amount of the foreign tax credit will be reduced by the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(2)).
16. If the person receives the refund after they have self-assessed, the person must pay to the Commissioner the lesser of the amount of the refund, or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(3)). In these circumstances, the date for payment is 30 days after the later of:
    - the date the person received the refund, or
    - the date of the notice of assessment in which the person used the credit (s LJ 7(4)).

PART 2 – ANALYSIS

17. This part of the Interpretation Statement provides the analysis that supports the test outlined in Part 1. This Part considers:
    - the legislative framework of subpart LJ;
    - the following key terms and phrases:
      - "tax";
      - "income tax imposed under section BB 1"; and
      - "of substantially the same nature"; and
    - case law that compares a foreign tax to income tax.

Legislative framework – subpart LJ

18. A New Zealand resident who derives foreign-sourced income that is subject to New Zealand income tax may be entitled to a tax credit for any foreign income tax paid on that income (ss LJ 1(2) and LJ 2(1)).
19. Subpart LJ sets out the process for claiming tax credits where foreign income tax has been paid. It does this in two steps. First, it provides the method for dividing foreign-sourced income into segments. It then allows a tax credit for foreign income tax paid on each segment of that foreign-sourced income (s LJ 1). No credit will be allowed for any unrecognised taxes specified in sch 27 (s LJ 1(2)(b) (there are currently none listed)).
20. Credits are calculated on the basis of income segments. A tax credit is available for foreign income tax paid on each segment of foreign-sourced income. (There are special rules for amounts derived from an attributing interest in a foreign investment fund – ss LJ 2(6) and (7).) Section LJ 4 defines "segment of foreign-sourced income" as follows:

    > 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.

21. The number of credits a taxpayer gets will depend on the number of foreign countries and the sources or the nature of the income derived (ss LJ 2(1) and LJ 4).
22. To attract a foreign tax credit, foreign income tax must have been paid on the segment of foreign-sourced income. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". "Income tax" is defined in s YA 1 to mean "… income tax imposed under section BB 1 (Imposition of income tax) except to the extent to which it has a different meaning under section YA 2 (Meaning of income tax varied)". Section YA 2(5) modifies the meaning of "income tax" when it is used in this context.

It provides:

Tax of other countries

(5) The term **income tax**, when specifically used in relation to tax of another country, whether imposed by a central, state, or local government,—

(a) means a tax of substantially the same nature as income tax imposed under section BB 1 (Imposition of income tax); and

(b) includes a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT), or non-resident withholding tax (NRWT).

23. Section LJ 5 explains how to calculate the amount of New Zealand income tax payable on each segment of foreign-sourced income. This calculation is necessary because the credit cannot be more than the amount of New Zealand income tax payable on that segment of foreign-sourced income (s LJ 2(2)).

24. Therefore, to qualify for a tax credit, a taxpayer must:

- be resident in New Zealand;
- have derived assessable income sourced from outside New Zealand; and
- have paid foreign tax on that income.

25. Further, the foreign tax paid must be a tax of substantially the same nature as income tax imposed under s BB 1. Alternatively, the foreign tax could be a tax that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, provided it is imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

26. The focus of the inquiry is on the nature of the foreign tax paid. In the Commissioner's view, s YA 2(5) requires a comparison between the nature of the foreign tax imposed on the amount of income, including how it is calculated, and the nature of income tax imposed under s BB 1. This means focusing on the characteristics of the foreign tax paid.

27. Certain taxes are not of substantially the same nature as "income tax imposed under s BB 1" for comparative purposes. "Ancillary tax" (defined in s YA 1 to include taxes such as fringe benefit tax, qualifying company election tax and withdrawal tax) is not included because it is not imposed on taxable income. Penalties and interest are also excluded from the definition of "income tax".

28. It is the meaning of the phrase "a tax of substantially the same nature as income tax" that is the subject of the following analysis. The effect of s YA 2(5)(b), and how it extends the meaning of income tax in s YA 2(5)(a), is also considered.

Meaning of "tax"

Introduction

29. To satisfy s YA 2(5), a taxpayer must prove that the foreign tax paid on a segment of foreign-sourced income is either a tax of substantially the same nature as income tax imposed under s BB 1 or a tax imposed as a collection mechanism for a foreign tax that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT.

30. The first step in this analysis is to establish that the foreign tax is a "tax" and not some other form of payment or charge. By definition, all "income tax" must first be a "tax". The paragraphs below discuss the meaning of the word "tax".

Legislation

31. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". Income tax in this context is varied by s YA 2(5)(a) to mean "**a tax** of substantially the same nature as income tax imposed under section BB 1". Section YA 2(5)(b) extends the meaning to include "**a tax**" that satisfies that subparagraph.

32. Section YA 1 defines "tax" as follows:

> **tax** means income tax, but in the provisions in which the term "income tax" has an extended or limited meaning, "tax" has a corresponding meaning

33. This definition is not helpful in determining what characteristics are necessary for a charge to be a "tax".

Ordinary meaning

34. "Tax" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011), to mean:

> Tax ▶ **n. 1** a compulsory contribution to state revenue, levied by the government on personal income and business profits or added to the cost of some goods, services, and transactions.

35. This definition is consistent with the case law discussed below.

Case Law

New Zealand

36. In *Case 37* (1967) 3 NZTBR 442, a taxpayer received an Indian army pension from the United Kingdom Government. Each year, an amount was deducted from the pension as "Indian Military Widows' and Orphans' Fund subscriptions". The taxpayer argued this deduction should be allowed as a credit because it was equivalent to New Zealand social security income

tax. The Taxation Board of Review (the board) applied the definition of "tax" from the Australian decision of *Leake v C of T* (1934) 36 WALR 66 (WASC) (discussed below at para [53]). At 447:

> The outstanding characteristic of a tax is, as Dwyer J. observed in *Leake's* case (*supra*), "that it is a compulsory contribution, imposed by the sovereign authority on, and required from, the general body of subjects or citizens, as distinguished from isolated levies on individuals".

37. The board held that no credit was permitted as the contribution was not a tax. The contribution was imposed by a private mutual insurance institution to provide pensions for widows and dependants. It was not imposed by the sovereign authority and required from the general body of citizens.

38. In *Haliburton & Ors v Broadcasting Commission* (CA 14-99, 15 July 1999), the Court of Appeal considered whether the public broadcasting fee contravened s 22 of the Constitution Act 1986. Section 22 states that it shall not be lawful for the Crown to levy a tax, except by or under an Act of Parliament. The appellants argued that the broadcasting fee was a tax and because it was imposed by the Broadcasting Commission it was not levied by or under an Act of Parliament.

39. The court said that a tax is:

- a compulsory contribution,
- to support government,
- made under state authority,
- made for a public purpose, and
- not a service charge or a licence fee.

40. The court assumed the public broadcasting fee was a tax within the meaning of s 22 and concluded that the fee was imposed by or under an Act of Parliament. (See also: *Carter Holt Harvey Ltd v North Shore City Council* [2006] 2 NZLR 787 (HC) and *Warnock v Director-General of Social Welfare* [2004] NZAR 274 (HC).)

Australia

41. Many of the key Australian decisions on whether a particular payment is a tax arise in the context of Australian constitutional law. While the constitutional context is quite different from the taxation context, the questions "what is a tax?" or "what is a law imposing taxation?" do not appear to have any special constitutional meaning that might limit their application. The inquiry is ultimately about the ordinary meaning of the word "tax".

Constitutional case law

42. In *R v Barger* (1908) 6 CLR 41 (HCA), the Australian High Court was asked to decide whether a particular excise tariff was a tax. The tariff was imposed only on those goods manufactured by companies that did not pay reasonable wages to their workers.

43. The court held that the tariff was a tax. Isaacs J, in a dissenting judgment, stated (at 99) that the true test of whether an Act is a taxing Act is:

> Is the money demanded as a contribution to revenue irrespective of any legality or illegality in the circumstances upon which the liability depends, or is it claimed as solely a penalty for an unlawful act or omission, other than non-payment of or incidental to a tax?
>
> It is not sufficient to say the effect is the same. It may even be the very purpose of the federal taxing authority to drive the taxed object out of existence; but as the power to tax includes the power "to embarrass or to destroy," neither the purpose nor the effect is an objection to the exercise of the power.

44. Despite Isaacs J's judgment being a dissenting one, *Barger* is considered authority for the proposition that a penalty cannot be a tax. (See also *FCT v Clyne* (1958) 100 CLR 246 (HCA) and *MacCormick v FCT* (1984) 158 CLR 622 (HCA).)

45. *Matthews v Chicory Marketing Board* (VIC) (1938) 60 CLR 263 (HCA) is considered the leading Australian authority on the meaning of "tax". The Australian High Court held that a levy, imposed on chicory producers at the rate of £1 for every ½ acre of chicory planted, was a tax. Latham CJ, in a minority judgment, set out what is now considered the "classic" definition of a tax, at 276:

> The levy is, in my opinion, plainly a tax. It is a compulsory exaction of money by a public authority for public purposes, enforceable by law, and is not a payment for services rendered.

46. The issue in *Air Caledonie International v Commonwealth of Australia* (1988) 165 CLR 462 (HCA) was whether a fee imposed for immigration clearance was a tax. The court's starting point was the definition of tax from *Chicory*. However, the court stated that *Chicory* should not be seen as providing an exhaustive definition of tax. For example, it might not be necessary for a tax to be a compulsory exaction of money, by a public authority, for a public purpose.

47. The court also considered the relationship between a tax and a fee for services. The court explained that a payment is unlikely to be a fee for services where it is compulsory and there is no discernible relationship with the value of what is acquired. The court then

went on to hold that the immigration clearance fee was a tax. This case has been referred to in several New Zealand decisions. (See for example, *Air New Zealand Ltd v Wellington International Airport Ltd* [2009] NZCA 259, [2009] 3 NZLR 713 and *Warnock*.)

48. In *Australian Tape Manufacturers Association v Commonwealth of Australia* (1993) 176 CLR 480 (HCA) the issue was whether a royalty imposed on blank tapes was a tax. The royalty was paid to a collecting society. The collecting society would then distribute the funds by way of a royalty to copyright owners. (This was an attempt by the Australian Government to deal with the widespread problem of unauthorised copying of sound recordings onto blank tapes.) The Australian High Court held the levy was a tax. It asserted that it is not essential to the concept of a tax that the exaction should be by a public authority. The court also decided the fact the levy was paid to a society rather than into the consolidated fund did not stop it from being for a public purpose. This is because Parliament has the power to authorise a statutory authority to levy a tax.

49. The issue in *Roy Morgan Research Pty Ltd v FCT & Anor* [2011] HCA 35, [2011] ATC ¶20,282 was whether a superannuation guarantee charge (SGC) was a tax. If an employer failed to provide all employees with a minimum level of superannuation, then any shortfall became the SGC. The SGC was to act as an incentive to employers to make superannuation contributions for their employees. The revenue raised by the SGC was paid into the consolidated revenue fund.

50. The court held that the SGC was a tax. The fact that the SGC was paid into the consolidated revenue fund established that the SGC was imposed for a public purpose.

General cases

51. In addition to the constitutional cases, there are also some general Australian cases that have considered the meaning of tax.

52. In *Morris Leventhal & Ors v David Jones Ltd* (1930) AC 259 (PC), the Privy Council was asked to determine whether a "bridge tax" was a land tax. The bridge tax was imposed on the unimproved value of land in Sydney and used to fund the building of the Sydney Harbour Bridge. The Privy Council held that a charge will be a tax even if it is imposed on a specified class of property or persons, and even if it is imposed for a specific purpose.

53. In *Leake v C of T*, the Supreme Court confirmed that a hospital fund contribution was a tax. This contribution was collected by the Commissioner of Taxation and paid into an account at the Treasury. Every person who earned income, salary or wages was required to pay it. The contributions collected were then used to fund public hospitals.

54. The Commissioner argued the levy was not a tax because it was raised for a special purpose: to support the hospital fund. It was not raised as part of the general revenue of the Crown.

55. The court held that the contribution was a tax. The court confirmed that a charge can be a tax even if it is not called a tax. It identified the key distinguishing features of a tax:

- A tax is a compulsory contribution.
- A tax is imposed by the sovereign authority.
- A tax is imposed on, and required from, the general body of citizens.
- A tax can be distinguished from isolated levies on individuals.

56. The court also confirmed that particular fees, local assessments and tolls are not taxes. Furthermore, the court noted the charge did not need to be paid into the consolidated revenue fund for it to be a tax.

Canada

57. As with the Australian authorities, the leading Canadian cases on whether a particular payment is a tax have arisen in the context of constitutional challenges to the legality of particular charges. The leading authority in this area is *Lawson v Interior Tree Fruit and Vegetable Committee of Direction & The Attorney General of Canada* [1931] SCR 357. This case was referred to in the Australian cases of *Chicory* and *Roy Morgan*.

58. In *Lawson*, the Interior Tree Fruit and Vegetable Committee of Direction was given exclusive power to control and regulate the marketing of all tree fruit and vegetables under the Produce Marketing Act. The Committee imposed licence fees and levies to recover their costs. The Supreme Court held the fees charged were taxes. Duff J said that a charge is properly classified as a tax if four criteria are met:

- The charge is enforceable by law.
- The charge is imposed under authority of the legislature.
- The charge is levied by a public body.
- The charge is made for a public purpose.

59. On the issue of "public purpose", Duff J noted at 363:

> The levy is also made for a public purpose. When such compulsory, not to say dictatorial, powers are vested in such a body by the legislature, the purposes for which they are given are conclusively presumed to be public purposes.

60. So even though it was the Committee imposing the tax, it did so because it was empowered by the legislature. Therefore, the purpose of the tax is automatically considered to be for a public purpose.

61. The Supreme Court in *Eurig Estate (Re)* [1998] 2 SCR 565 applied *Lawson* when it held that Ontario's probate levy was a tax and not a fee. The court made the following distinction between a service fee and a tax, at 579:

> In determining whether that nexus exists, courts will not insist that fees correspond precisely to the cost of the relevant service. As long as a reasonable connection is shown between the cost of the service provided and the amount charged, that will suffice. The evidence in this appeal fails to disclose any correlation between the amount charged for grants of letters probate and the cost of providing that service. The Agreed Statement of Facts clearly shows that the procedures involved in granting letters probate do not vary with the value of the estate. Although the cost of granting letters probate bears no relation to the value of an estate, the probate levy varies directly with the value of the estate. The result is the absence of a nexus between the levy and the cost of the service, which indicates that the levy is a tax and not a fee.

(See also: the Privy Council decision in *Lower Mainland Dairy Products Sales Adjustment Committee v Crystal Dairy Limited* [1933] AC 168 (PC), and *Westbank First Nation v British Columbia Hydro and Power Authority* [1999] 3 SCR 134.)

Conclusion on meaning of "tax"

62. The ordinary meaning of tax is a compulsory contribution to government revenue, levied by the government on a person's income or business profits or added to the cost of goods, services or transactions.

63. More specifically, a tax is:
- a compulsory contribution or exaction (*Haliburton, Chicory, Leake*);
- imposed on and required from the general body of citizens (*Leake*);
- levied to support government (*Haliburton, Barger*);
  - but an impost need not be paid into the consolidated revenue fund for it to be a tax (*Leake, Eurig, Australian Tape Manufacturers*);
- levied for a public purpose (*Haliburton, Chicory, Lawson*);
  - there is some overlap between public purpose and State authority (*Australian Tape Manufacturers*);
  - if an impost is paid into the consolidated revenue fund then this will establish a public purpose (*Roy Morgan*);
- levied under government/Crown authority (*Haliburton, Chicory, Leake, Lawson*);
  - this might not be essential—as long as the body imposing the tax has been given the power to do so by Parliament (*Australian Tape Manufacturers, Lawson*);
  - includes being levied by a public body where that public body has been authorised by the government to levy the tax (*Lawson*);
- enforceable by law (*Chicory, Lawson*).

64. A charge may also be a tax even if it is:
- imposed on a specified class of property or persons (*Morris Leventhal*),
- imposed for a specific purpose (*Morris Leventhal*),
- not called a tax (*Leake*).

65. The following are not taxes:
- A service charge or licence fee (*Haliburton, Chicory*).
  - A tax can be distinguished from isolated levies on individuals (*Leake*).
  - A payment will not be a service charge where there is no correlation between the amount charged and the cost of providing the service (*Eurig*).
  - However, if a person has no choice whether to acquire the services or the amount of the charge has no discernible relationship with the value of what is acquired, then it may be a tax (*Air Caledonie*).
- A payment imposed as a penalty (*Barger*).

66. In conclusion, a foreign charge that bears all the features at para [63] above will be a "tax" for the purposes of s YA 2(5). A foreign charge that bears some of these features may also be a "tax". If the foreign charge is a service charge or a licence fee or if it is imposed as a penalty, then it will not be a "tax".

67. As well as being a "tax", the foreign charge paid must be of substantially the same nature as income tax imposed under s BB 1 or of substantially the same nature as provisional tax, PAYE, RWT or NRWT and be a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1. This factor is considered next.

Meaning of "income tax imposed under section BB 1"

Introduction

68. Section YA 2(5)(a) requires that the foreign tax must be of substantially the same nature as income tax imposed under s BB 1. Section YA 2(5)(b) extends the meaning of foreign tax to include a tax that is of substantially the same nature as provisional tax, PAYE, RWT, or NRWT provided it is imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1. The following paragraphs will consider what is meant by "income tax imposed under section BB 1". The item will then consider how the phrase "of substantially the same nature" modifies the s BB 1 definition of "income tax", at paras [83]–[108].

Legislation

69. There is no exhaustive definition of income tax in the Act. However, s YA 1 provides a broad definition of income tax. Section YA 1 states:

> **Income tax** means income tax imposed under section BB 1 (Imposition of income tax) except to the extent to which it has a different meaning under section YA 2 (Meaning of income tax varied)

70. Section BB 1 is the key charging provision in the Act. It provides that:

> **BB 1 Imposition of income tax**
>
> Income tax is imposed on taxable income, at the rate or rates of tax fixed by an annual taxing Act, and is payable to the Crown under this Act and the Tax Administration Act 1994.

71. Section BB 1 therefore identifies three key characteristics of income tax:
    - Income tax is imposed on taxable income.
    - Income tax is imposed at the rate or rates of tax fixed by an annual taxing Act.
    - Income tax is payable to the Crown.

Imposed on taxable income

72. Section BB 1 "imposes" income tax on "taxable income". "Impose" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) to mean:

> **Impose ▶ v. 1** force to be accepted, done, or complied with.

73. This shows that income tax is a compulsory payment.

74. "Taxable income" is defined in s YA 1 to mean: "taxable income for a tax year calculated under section BC 5 (Taxable income)". Section BC 5 states:

> **BC 5 Taxable income**
>
> A person's **taxable income** for a tax year is determined by subtracting any available tax loss that the person has from their net income under Part I (Treatment of tax losses).

75. The requirement that income tax be imposed on taxable income suggests a tax that taxes gross income will not fall within the definition of income tax. Income tax must be imposed on taxable income (gross income less deductions and losses).

76. It could be argued that PAYE is essentially a tax on gross income as no deductions are generally allowed because of the employment limitation (s DA 2(4)). Similar arguments could be made for RWT and NRWT in some circumstances. However, s YA 2(5)(b) expressly includes as "income tax" a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as provisional tax, PAYE, RWT, or NRWT.

77. The tax must also tax "income". Part C of the Act defines income. Section CA 1 states that an amount is "income" if it is income under a provision in Part C or if it is income under ordinary concepts.

78. The Act taxes income from both labour (eg salary and wages) and capital investment (eg dividends and interest).

Rate or rates fixed by an annual taxing Act

79. Section BB 1 provides that income tax is imposed on taxable income "at the rate or rates of tax fixed by an annual taxing Act".

80. The use of the words "rate or rates" indicates that income tax can be imposed at different rates depending on the entity or person being taxed (eg corporate tax rate or personal tax rate). The words also allow income tax to be imposed at a flat rate or at graduated rates.

Payable to the Crown

81. Section BB 1 states that income tax is payable to the Crown. In the New Zealand context, the Crown is the New Zealand government. If a tax is paid to a private company or organisation, for example, then it will not be income tax imposed under s BB 1.

Conclusion on the meaning of "income tax imposed under section BB 1"

82. Section BB 1 identifies the following characteristics of New Zealand income tax:
    - Income tax is compulsory.
    - Income tax is imposed on taxable income, not gross income.
    - Income tax only taxes "income" as defined in Part C.
    - Income tax can be imposed at either a flat or graduated rate.

- Income tax can be imposed at different rates depending on the person or entity being taxed.
- The rate of income tax is fixed by an Act on an annual basis.
- Income tax is payable to the Crown.

Section YA 2(5): Meaning of "of substantially the same nature"

Introduction

83. Having determined the characteristics of income tax imposed under s BB 1, the following paragraphs consider how s YA 2(5) modifies the s BB 1 definition of income tax.

Legislation

84. Section YA 1 defines "income tax" to mean income tax imposed under s BB 1, except to the extent to which it has a different meaning under s YA 2. This means that, in certain circumstances, s YA 2 modifies the definition of "income tax" in s BB 1. Of relevance in the current context is s YA 2(5), which modifies the s BB 1 definition of "income tax" when that phrase is used in relation to "tax of another country".

Imposed by a central, state or local government

85. Section YA 2(5) applies where the tax has been imposed by a central, state or local government. This therefore modifies the definition of income tax under s BB 1, which requires that income tax be "payable to the Crown". When the term "income tax" is used in relation to tax of another country, it includes taxes imposed by a central, state or local government.

Of substantially the same nature

86. Section YA 2(5)(a) extends the concept of income tax to a foreign tax of "substantially the same nature" as income tax imposed under s BB 1. Section YA 2(5)(b) also extends the concept of income tax to a foreign tax that is of "substantially the same nature" as provisional tax, PAYE, RWT or NRWT, provided the tax is imposed as a collection mechanism for the foreign tax. The Commissioner considers that the reference to "the foreign tax" in s YA 2(5)(b) refers back to the tax described in s YA 2(5)(a). This means that under s YA 2(5)(b) the foreign tax being collected by one of the listed collection mechanism taxes (that is of substantially the same nature as provisional tax, PAYE, RWT or NRWT) must itself be a tax of "substantially the same nature" as income tax imposed under s BB 1.

87. It is therefore important to understand what is meant by "of substantially the same nature". This is the standard against which the foreign tax must be judged.

Ordinary meaning

Of substantially the same nature

88. As the phrase "of substantially the same nature" does not appear to have any specific legal or technical meaning, it is useful to consider the ordinary meaning.

89. The terms "substantially", "same" and "nature" are relevantly defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011), to mean:

> **Substantially ▸ adv. 1** to a great or significant extent. **2.** for the most part; essentially.
>
> **Same ▸ adj. 1** identical; unchanged.
>
> **Nature ▸ 2** the basic or inherent features, qualities, or characteristics

90. Combining these definitions, "of substantially the same nature as income tax imposed under section BB 1" means that the qualities or characteristics of the foreign tax must be significantly or essentially like the qualities or characteristics of income tax imposed under s BB 1. In the case of s YA 2(5)(b), this means that a tax imposed as a collection mechanism for the foreign tax must be significantly or essentially like provisional tax, PAYE, RWT or NRWT.

Case Law

Of substantially the same nature

91. There are only two New Zealand cases that consider the application of s YA 2(5).

92. In *Case 37* (discussed above at para [36]), a taxpayer received an Indian army pension from the United Kingdom Government. Each year, an amount was deducted from the pension as "Indian Military Widows' and Orphans' Fund subscriptions". The taxpayer argued this deduction should be allowed as a credit under s 170 of the Land and Income Tax Act 1954 (the s YA 2(5)(a) equivalent), as this deduction was substantially of the same nature as New Zealand social security income tax. (The earlier Acts phrased the test "substantially of the same nature" rather than "of substantially the same nature".) At the relevant time, New Zealand social security income tax fell within the definition of income tax in s 170.

93. The board held that the Fund did not "bear any comparable relationship with this country's social security scheme". The main reason for this finding appears to be that New Zealand social security benefits were paid out of the consolidated revenue account from money appropriated by Parliament. By contrast, the Fund was a private mutual insurance institution that existed solely for the provision of pensions for widows and orphans.

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94. The board also had regard to other differences between the Fund and New Zealand social security. At 447:

> Counsel for the respondent, in comparing the New Zealand social security scheme with the Fund to which the appellant contributed, referred to various points of distinction, among them being: that whereas, in this country, benefits might become payable to a person who was neither a taxpayer nor a dependant of a taxpayer, the rules of the Fund expressly provided for contributions and payments to be made by a limited class of persons and for pensions to be paid to beneficiaries claiming through those persons; that the obligation of a contributor to the Fund to make payments thereto was a continuing one from which he was not relieved even if he was not in receipt of pay (R 8); and that the rules of the Fund provided for subscriptions to be refunded under certain circumstances (R 13). A study of the Rules of the Fund discloses many more differences between them and the provisions of the New Zealand social security legislation.

95. The board considered whether the contribution was a tax, in the general sense of the word, by looking to the ordinary meaning and case law, including the Australian decision in *Leake*. The board concluded that the contribution to the Fund was not a tax because it was a private institution that existed for the provision of pensions to a restricted class of persons.

96. *Case F11* (1983) 6 NZTC 59,613 also considers the meaning of "substantially of the same nature as income tax" in s 293 of the Income Tax Act 1976 (the s YA 2(5) equivalent). In *Case F11*, the taxpayer had spent a year working in the United Kingdom. During that time, she paid United Kingdom income tax and made national insurance (NI) contributions. Both were compulsory payments deducted at source. The taxpayer was granted a tax credit for United Kingdom income tax, but not for the NI contributions. The issue for the authority was whether the NI contributions were substantially of the same nature as New Zealand income tax.

97. The taxpayer argued that NI was just another way of collecting income tax. New Zealand imposes a single tax to fund both general and social security services. The United Kingdom imposes a separate tax to fund social security services. The taxpayer submitted that to regard one method of collection as income tax and not the other was semantics and not in the interests of justice.

98. The authority found for the Commissioner. Judge Barber held the taxpayer had not discharged the onus of proof. However, he noted the taxpayer would not have been able to in any event, as the nature of NI was far narrower than the nature of income tax. (Although he did acknowledge that the issue was not argued before him in any detail.) Therefore, *Case F11* is authority for the proposition that NI is not "substantially of the same nature as income tax". (NI is considered in more detail in example 3, at para [214] below.)

Substantially the same

99. The meaning of "substantially the same" was considered by the Employment Court in *National Distribution Union Inc v General Distributors Ltd* [2007] ERNZ 120 (EmpC). While the context was quite different, the Employment Court had to determine the ordinary meaning of the phrase "substantially the same". On this basis, the analysis is potentially useful.

100. Section 59B of the Employment Relations Act 2000 states that it is not a breach of the duty of good faith for an employer to pass on to a non-union employee a term that is the same or substantially the same as a term in the collective employment agreement, unless the employer does so with the intention and effect of undermining the collective agreement.

101. The Union argued that the employer, General Distributors, passed on a pay rise term that was substantially the same as a pay rise term in the collective agreement with the intention and effect of undermining the collective agreement. It was accepted that the pay rise was not exactly the same, so the question for the court was whether the pay rise was "substantially the same".

102. The court accepted that "substantially the same" requires sameness in substance or effect but not necessarily in form. In the current context, this might mean that a foreign tax is still a tax of "substantially the same" nature as income tax under s BB 1 if it taxes an amount also taxed under the Act, but in a different way or using a different method. The taxing effect is the same, but the form or method of taxing is different.

103. The Employment Court also said:

> [97] Mr Langton addressed judicial interpretations of the word substantially, and referred us to the 2005 Supplement to *Words and Phrases Legally Defined* and, in relation to the phrase in Australia "including a child who is being wholly or substantially maintained by a person". The text notes:
>
> > In the present context the word "substantially" appears in contrast to the word "wholly" but forms a phrase with it. If "substantially" bore the meaning … something more than merely incidental, there would have been no need at all for the word "wholly" to have appeared. It is

> the word "wholly" that gives context here to the word "substantially". In the context, … the word means something less than "wholly" but more than merely "insubstantial" or "insignificant" and is appropriately paraphrased by the word "in the main" or "as to the greater part".
>
> [98] So, Mr Langton submitted, "in the main", "for the greatest part" and "in substance", the wage increases agreed with non-union employees must be the same to come within the definition of "substantially the same" in s 59B(1).
>
> …
>
> [102] Mr Langton accepted that whether the terms were "substantially the same" depends on how the Court interprets that phrase. Counsel submitted that the Legislature must have intended it to be something more than "similar" and more than "substantially similar", otherwise it would have used these words or phrases. GDL says that the word "same" has been deliberately qualified by the adjective "substantially".
>
> [103] On the issue of what amounts to substantial sameness, we prefer Mr Langton's submissions to Mr Fleming's. It is common ground that the wage increases given to the non-union employees were not the same and the issue is whether they were substantially the same. It seems to us that the more appropriate adjectives to describe a comparison of the collective and individual wage increases would be similar or even substantially similar. But, as Mr Langton emphasised, Parliament has stipulated for the higher or more precise standard of sameness, whether on its own or, as is in issue here, qualified by the adjective "substantial". That connotes a higher degree of identity than the plaintiff contends for and the evidence exhibits.

104. The court decided that "substantially the same" must mean more than "substantially similar". It is a higher and more precise standard.

105. Applying this decision to s YA 2(5)(a), when comparing a foreign tax to New Zealand income tax it is the substance or effect of the tax that must be examined, not the form of the tax. The substance or effect of the tax must be "in the main, for the greatest part and in substance" the same as New Zealand income tax. This analysis would be the same for s YA 2(5)(b). When comparing a tax imposed as a collection mechanism for the foreign tax, the substance or effect of the tax must be "in the main, for the greatest part and in substance" like provisional tax, PAYE, RWT or NRWT.

Conclusion on the meaning of "substantially the same nature"

106. When the term "income tax" is used in relation to a foreign tax, its meaning is modified by s YA 2(5) in the following way:
    - Income tax may be imposed by a central, state or local government; and
    - Income tax means:
      - a tax that is of substantially the same nature as income tax imposed under s BB 1; or
      - a tax imposed as a collection mechanism for the foreign tax that is of substantially the same nature as provisional tax, PAYE, RWT and NRWT, provided the foreign tax being collected is of substantially the same nature as income tax imposed under s BB 1.

107. The ordinary meaning of "substantially the same nature as income tax imposed under s BB 1" suggests that the qualities or characteristics of the foreign tax must be significantly or essentially like income tax imposed under s BB 1. In the case of s YA 2(5)(b), this means the tax imposed as a collection mechanism for the foreign tax must be significantly or essentially like provisional tax, PAYE, RWT or NRWT.

108. The case law also identified some features of a tax that could be compared when trying to determine whether a foreign tax is of substantially the same nature as New Zealand income tax. *Case 37* was decided at a time when income tax was divided into two parts, income tax and social security income tax. Consequently, some of the features of income tax in that case are different to the current New Zealand income tax legislation. However, the decision is still useful as it shows how a New Zealand court has approached the "substantially of the same nature" test when comparing a foreign tax to a New Zealand tax (in that case, social security income tax). In *Case 37*, the fact that the Fund was a private institution that existed for the provision of pensions to a restricted class of persons meant that it was not substantially of the same nature as New Zealand social security income tax. New Zealand social security income tax provided benefits from the consolidated revenue account to a wider class of persons.

109. The decision in *National Distribution Union* suggests that "substantially the same" requires sameness in substance or effect but not necessarily in form. Applied in the current context, this could mean that a foreign tax is still "substantially the same" if it taxes amounts taxed under the Act, but does so in a different way. The case also notes that "substantially the same" is a higher, more stringent test than "substantially similar". The foreign tax must be "in the main, for the greatest part and in substance" of the same nature as New Zealand income tax. This analysis would apply equally to s YA 2(5)(b).

Case law comparing foreign taxes to income tax

110. As there is limited New Zealand case law that considers whether a foreign tax is of "substantially the same nature" as income tax imposed under s BB 1, it is useful to refer to cases from other areas of law and from other jurisdictions. The following cases are examples of where the courts have had to decide whether a particular charge is an "income tax" or is sufficiently similar to a particular income tax.

111. It is important to note that all these cases apply a different standard of comparison to the standard set out in s YA 2(5) of "substantially the same". However, the decisions are useful as they show how the courts have approached the task of comparing taxes.

New Zealand

112. The New Zealand courts have not directly considered the meaning of "income tax" in a taxation context. However, there are three cases that have considered whether New Zealand social security contributions, unemployment relief tax and national security tax could be considered income taxes for the purposes of paying out annuities under a will. Care needs to be taken when applying decisions in different contexts. However, the Australian courts have applied two of the cases in determining whether to grant a foreign tax exemption under the Australian equivalent of s YA 2(5) (although the Australian section is worded differently). See, for example, *Case R68* 84 ATC 482 and *Case S52* 85 ATC 388. The focus in these cases is the ordinary meaning of income tax. Therefore, the New Zealand cases are potentially relevant.

113. *In re Richards (Deceased), Richards v Richards* [1935] NZLR 909 (SC) concerned a testator who granted an annuity "to be paid clear and free from all deductions whatsoever and free of all duties and taxes". The issue was whether the annuity should be paid free of the unemployment relief tax, ie whether the estate should provide additional funds to meet the unemployment relief tax (the precursor to the social security contribution).

114. Northcroft J held that the reference "to be paid clear and free from all deductions whatsoever and free of all duties and taxes" was wide enough to include income tax. Northcroft J further held that the unemployment relief tax was "of the character of income tax" as it was calculated by reference to the income of the taxpayer and assessed in the same way as income tax. Therefore, the annuity should be paid free of the unemployment relief tax.

115. *Re Hirst, Public Trustee v Hirst* [1941] 3 All ER 466 (Ch) is a United Kingdom High Court decision. However, because the issue was whether the New Zealand social security contribution (SSC) was an income tax, it has been grouped with the New Zealand cases.

116. In *Hirst*, an English testator left annuities to two New Zealand relatives. The annuities were to be paid "clear of all deductions whatsoever …" including "… income tax at the current rate deductible at source or payable in New Zealand". The issue was whether the New Zealand SSC was an income tax and whether the annuities were to be paid free of that tax.

117. The court held that the SSC could not properly be described as income tax. It was a separate tax (from income tax) imposed by separate legislation. This meant it could not be income tax. In reaching this decision the court was influenced by the language of the Social Security Act 1938. That Act stated that the SSC should be administered "as if it were income tax". According to Morton J, this indicated the contribution was not an income tax.

118. Despite concluding the SSC was not an income tax, the court nevertheless found it sufficiently resembled income tax in the way it was assessed, collected and recovered. For this reason it was decided the annuities should be paid free of the SSC.

119. The same issue came before the New Zealand Court of Appeal in *In Re Paterson (Deceased), Rennick v Guardian Trust and Executors Co of NZ Ltd* [1944] NZLR 104 (CA). Applying *Hirst*, the court held that New Zealand SSC and national security tax were not income taxes. However, they were of the character of income tax so the annuity in question should be paid free of these taxes.

120. Myers CJ concluded that only income tax imposed under the Land and Income Tax Act 1923 could be considered income tax. He observed that a tax might be a tax on income, but that will not be enough to make it an income tax as that term is ordinarily understood.

121. Myers CJ agreed with Northcroft J in *Richards* that the SSC, while not an income tax, was of the character of income tax. It was calculated by reference to the income of the taxpayer and was a charge on that income. However, it could not properly be described as income tax.

122. *Hirst* and *Paterson* are authority for the view that if a tax is separate from the main income tax and imposed under a separate Act from the main income tax Act, then it will not be an income tax. This is the case even

if the tax is assessed and collected in the same way as the main income tax. However, it is noted that these cases were considering whether a tax **was** income tax, not whether the tax was of **substantially the same nature as** income tax. In the Commissioner's opinion, whether a tax is contained within the income tax Act of a foreign country is not a helpful question in determining whether a foreign tax is sufficiently like New Zealand income tax. It is the nature and characteristics of the tax imposed that are relevant.

Australia

General case law

123. The facts in *de Romero v Read* (1932) 48 CLR 649 (HCA) were that, under a deed of separation, Mr R agreed to pay his wife a clear annual sum "free from all State income tax".

124. Evatt J, in his dissenting judgment, considered whether the unemployment relief tax (a social security tax) was included in the expression "all State income tax". (The other judges did not have to decide this question.)

125. Evatt J held that the unemployment relief tax was an income tax. He noted a charge could still be a tax even if it was paid into a special fund and used for a special purpose. He also held that it is the subject matter and essence of the charge that will determine whether it is an income tax, not the label it is given. At 675:

> It is true that the tax in question is not called "income" tax but "unemployment relief" tax. But in essence it is an additional income tax assessed in accordance with the *Income Tax (Management) Act* itself. The subject matter of the tax, so far as it affects the present case, is "net assessable income", which means the gross income after excluding all income exempt from tax and after making the allowed deductions. By sec. 18 of the *Prevention and Relief of Unemployment Act*, "net assessable income" is to be assessed in like manner as taxable income under the *Income Tax (Management) Act 1928*, the principal Act. Sec. 22 brings into play the machinery of income tax assessment, including sec. 83 itself.

126. So the fact that the tax was not called an income tax did not prevent it from being an additional income tax.

Tax exemption cases

127. Australia currently operates a foreign income tax offset regime. For income periods prior to 30 June 2008, a foreign tax credit regime applied. Prior to 1 July 1987, Australia had an exemption system.

128. The Commissioner considers that, whether the relief is allowed as an offset, an exemption or a credit, the underlying principles that determine which taxes are creditable should not change. However, it is arguable that under the exemption system the courts applied a tougher standard than they would with tax credits or offsets. This is because under the exemption system *all* income subject to foreign tax was exempt from Australian income tax. Under an offset or credit system, an offset or credit is only allowed for foreign income tax paid up to the amount of Australian tax payable on that income.

129. In *Case 20* (1957) 7 CTBR (NS) 91, an Australian-resident professor worked in the United States of America (United States) for just under a year. During this period, Federal insurance (FICA) contributions were deducted from his salary. No other United States income taxes were deducted. The taxpayer claimed an exemption for his United States income on the basis that the FICA contributions were an income tax for the purposes of s 23(q) of the Income Tax Assessment Act 1936–1955. Section 23(q) only required that the foreign tax be "an income tax". (This is not the same as the s YA 2(5) test, which requires the foreign tax to be a tax "of substantially the same nature as income tax imposed under section BB 1".)

130. The Commissioner denied the claim and the board was asked to decide whether the FICA contributions were an income tax.

131. There was no consensus between the three members on this issue and as a result the taxpayer's claim was disallowed. After considering the authorities, (*Hirst*, *Paterson*, *Morris Leventhal* and *de Romero*, among others), the Chairman concluded that FICA was an income tax. It was levied, collected and paid on the income of every individual. The fact that the tax was used for a specific purpose did not prevent it from being regarded as income tax.

132. The second board member decided the case involved a conflict of laws. On this basis, the taxpayer was required to prove the differences between English law and United States law by expert evidence. As no expert evidence had been produced, the taxpayer's claim failed.

133. The third board member held that FICA contributions were not payments of income tax and concluded that "payments to such a fund are in my view entirely foreign to the concept of the term 'income tax'".

134. Given the different approaches and conclusions of the board members, no definite conclusions can be drawn from this case.

135. In *Case 112* (1958) 7 CTBR (NS) 733, a New Zealand-resident taxpayer owned a patent. He granted the manufacturing and selling rights to the patent to an Australian company. The taxpayer was required

to visit Australia twice a year to provide services to the company. The taxpayer was paid a fee for these visits. While the fee was not assessable income for New Zealand tax purposes, it was subject to the New Zealand social security contribution. On this basis, the taxpayer argued that the fee was taxed in New Zealand and should therefore be exempt from tax in Australia.

136. The board held that the contribution was not a tax. It applied *Hirst* and *Paterson* and concluded that it was a separate tax imposed by separate legislation.

137. In *Case R68* 84 ATC 482, an Australian resident taxpayer had worked for a year in Saudi Arabia. The Commissioner included the Saudi Arabian salary in the taxpayer's assessable income for that tax year. The taxpayer claimed the salary should be exempt from Australian income tax because it had been taxed in Saudi Arabia.

138. The taxpayer was not required to pay Saudi Arabian income tax, but he did have Saudi Arabian social insurance (SSI) contributions deducted from his salary. The contributions went into a special bank account (not the consolidated revenue fund) to provide compensation for industrial injuries, occupational diseases, disability, old age and death.

139. The issue was whether the SSI was an income tax. The board started with the definition of tax from *Leake*, but noted that this definition would need to be supplemented by the requirement that the tax should relate to income. The board decided that the SSI was not an income tax. In fact, the board doubted whether the SSI was a tax at all.

140. The fact that the SSI was only imposed on a segment of the population (wage-earning men), it was imposed for a specific purpose, and it was paid into a special bank account and not the consolidated revenue fund, led the board to conclude that it was not an income tax.

141. In *Case S52* 85 ATC 388, an Australian-resident taxpayer had taken up a short-term university appointment in the United States. The taxpayer was not required to pay federal income tax, but he was required to make FICA contributions. The taxpayer claimed that his United States salary should be exempt from Australian tax because the salary had been subject to income tax in the United States. The issue for the board was whether the FICA contributions were an income tax. This was the same issue considered in *Case 20* above. The board held that even though FICA was not a tax under United States revenue law, it was income tax for the purposes of s 23(q) (the exemption provision):

> 12. Applied to the present case, I have concluded that FICA constitutes "income tax" for purposes of sec. 23(q). The obligation to make the payment is part of the US Internal Revenue Code, it is paid by the employee "in addition to other taxes" (sec. 3101), is stated to be tax to be struck as a percentage of wages (up to the limit imposed by statute). In practice, a proportion of salary is withheld for FICA out of each and every instalment of salary. It follows that even though the tax is limited to only part of [sic] salary, none the less it is deemed to be a tax on the whole of the amount.

142. This case distinguishes *Hirst* and *Paterson* on two grounds. The first was that the New Zealand Social Security legislation was not part of the Income Tax Acts. However, it is arguable that neither is FICA. FICA is imposed under the Federal Insurance Contribution Act and codified at Title 26, Subtitle C, Chapter 1 of the United States Code.

143. The second ground for distinguishing *Hirst* and *Paterson* was their different context. *Hirst* and *Paterson* concerned the interpretation of wills. However, the board decided to follow the *de Romero* and *Morris Leventhal* cases where the context was also quite different: a separation agreement and a contractual dispute.

144. The board also incorrectly refers to the decision in *Case 20* as reaching an identical decision on identical facts. As explained above, in *Case 20* the taxpayer lost because the board failed to reach a unanimous view on whether FICA contributions were an income tax. In the current case the taxpayer won. The decisions were clearly not identical.

145. In *Case U52* 87 ATC 347, an Australian-resident taxpayer was entitled to a pension from the Yugoslav Government. Before he immigrated to Australia, he divorced his wife and became liable to pay her maintenance. He arranged to have his pension paid to her to satisfy the maintenance obligations.

146. The pension was subject to a deduction known as a "self-contribution" to the Self Managing Interest Community of Pension and Invalid Insurance of the Workers of Croatia at Split (SIZMIORH"). The taxpayer argued that the pension should be excluded from his taxable income as it was subject to tax in Yugoslavia. The issue for the tribunal was whether this contribution was a tax.

147. The tribunal held that the contribution was not a tax. The tribunal reviewed the nature of the SIZMIORH, which was understood to be a co-operative organisation that helped to finance the collective needs of the community and its members. The tribunal likened the contribution to the Saudi Arabian SSI

considered in *Case R68*, and concluded that a levy by a co-operative organisation would not have the character of a tax, even though that co-operative was formed within the context of the legal organisation of the State.

United Kingdom

148. To qualify for the United Kingdom unilateral tax credit, the foreign tax must be paid under the law of the foreign territory, calculated by reference to the income arising in the foreign territory, and must correspond to United Kingdom tax (s 9(1) of the Taxation (International and Other Provisions) Act 2010). "Corresponds to United Kingdom tax" appears to be a lower standard of comparison than the s YA 2(5) test of "substantially the same".

Tax credit case

149. In *Yates (HMIT) v GCA International (formerly Gaffney Cline & Associates Ltd)* [1991] BTC 107 (Ch), the taxpayer company entered into a service contract worth £209,300 with a Venezuelan company. Venezuela levied a tax of 25% on 90% of the total contract value. The taxpayer claimed tax credit relief. The Revenue argued that the Venezuelan tax did not correspond to income or corporation tax because a tax on 90% of gross receipts was a turnover tax.

150. The court held that the Venezuelan tax did correspond to United Kingdom income tax or corporation tax. In fact, a translation of the law showed it was called "income tax". The court noted that the intention of the Venezuelan tax code was to charge tax on net profits. It therefore served the same function as an income tax. It was not a turnover tax.

General cases

151. In the case of *In Re Reckitt; Reckitt v Reckitt* [1932] 2 Ch 144 (CA), a testator gave £200,000 to his trustees to invest and to pay his widow an annual sum of £5,000 for life "free of income tax". The issue for the Court of Appeal was whether that amount was also to be paid free of super-tax or sur-tax.

152. The Court of Appeal held that the sur-tax was an income tax and the annuity should be paid free of sur-tax as well as income tax. The court said at 151:

> ... super-tax or sur-tax is in essence an additional income tax, and, as there is no indication to restrict the words to income tax as known for so many years, it must follow that freedom is given to the widow in respect of both income tax, as we know it, and the additional income tax which has now been given the name of sur-tax.

153. In reaching this decision, the court did not attempt to define "income tax" as a separate concept; instead it contrasted the sur-tax with income tax. The court noted there were differences between the two taxes. For example, the taxpayer initiated payment of the sur-tax, whereas the Revenue assessed income tax. The frequency and method of collection of sur-tax was also different. However, the court concluded that the sur-tax was in essence an additional income tax.

154. *Reckitt* is therefore authority for the view that a tax can be assessed and collected in a different way from income tax, yet might still be an income tax.

Canada

Foreign Tax Credit Cases

155. The following cases concern the application of the Canadian foreign tax credit rules. Section 126 of the Income Tax Act 1985 provides a foreign tax credit for an income or profits tax paid in foreign jurisdictions.

156. In *Kempe v The Queen* [2001] 1 CTC 2060 (TCC), the court was asked to decide whether a German church tax was eligible for a foreign tax deduction. Some, but not all German churches were entitled to collect German church tax. The churches used the tax to fulfil their ecclesiastical duties. The tax was payable by all members of a church. The tax was charged at 8% on income tax or wages tax.

157. The German tax authorities administered the church tax. Proceeds collected by the authorities were then paid over to the respective churches, after a collection fee had been deducted. The church tax had a legal basis in the Constitution and was levied on the basis of German Federal State law.

158. The court held that the church tax was a tax. It cited *Lawson* as authority for the proposition that a tax is a levy, enforceable by law, imposed under authority of a legislature, imposed by a public body and levied for a public purpose. The church tax was enforceable against the appellant and imposed under authority of the German legislature. The tax was also compulsory. At 10:

> As to the compulsory nature of this tax, the ability to avoid the tax by giving up citizenship or church membership does not make it any the less a tax. The imposition of church tax is, I conclude, a compulsory obligation.

159. The court also held that the church tax was an income tax. This was because the tax is generally based on the income or wages tax. The court noted that the tax's designated destination (presumably to fund the church activities) did not change its characteristic as a tax on income or wages.

160. It is the Commissioner's view that German church tax would not satisfy the s YA 2(5) test. This is because the tax is in the nature of a service charge collected by the government and then distributed to the particular church that the taxpayer attends. The tax is payable by all members of the congregation and the proceeds go to fund the activities of the church. If a person leaves the church, their obligation to pay the tax ends. The church tax also fails to satisfy the "public purpose" requirement. The church tax is not intended for a public purpose—it is intended for the benefit of the German taxpayer's own church.

161. *Yates v Her Majesty the Queen* 2001 DTC 761 (TCC) concerned a taxpayer's claim for a foreign tax credit for United Kingdom NI contributions. The taxpayer was a dual United Kingdom/Canadian citizen. He had sought, but been refused, a foreign tax credit for Class 3 United Kingdom NI contributions. He had voluntarily applied to pay the contributions to maintain his United Kingdom pension.

162. The court, in applying *Lawson*, held that the NI contributions were not compulsory and therefore they did not amount to a tax. The court also noted that the contributions were not calculated as a percentage of income earned, as no income was being earned in the United Kingdom.

163. In *Nadeau v The Queen* 2004 TCC 433, 2007 DTC 1670, the taxpayer was a United States citizen and resident of Canada, employed as a teacher in Maine. The taxpayer had sought, but been refused, a foreign tax credit for premiums paid to the United States of Maine Retirement System (MSRS). The MSRS is a retirement system for Maine public servants and teachers. The MSRS contributions were intended to provide the public servants and teachers with pension, sickness, disability and death benefits.

164. The court dismissed the taxpayer's appeal and held the MSRS contributions were not a tax. The court was attempting to determine whether the foreign tax paid was an income or profits taxes under s 126(7). The court decided that the MSRS contribution was not a tax and stopped the inquiry there. The court applied *Lawson* and *Eurig* and held that the MSRS contributions were not collected to raise revenue for the common good. They were intended to provide a limited class of persons—Maine public servants and teachers—with various benefits. On this basis, the contributions were not a foreign tax for tax credit purposes.

Conclusion on the case law comparing taxes to income tax

New Zealand case law

165. The court in *Richards* held that unemployment relief tax was of the character of income tax because it was calculated by reference to the taxpayer's income and assessed in the same way as income tax.

166. *Paterson* noted that while a tax may have the character of income tax, this will actually not be enough to make it income tax. *Paterson* is authority for the proposition that income tax has a "well-understood meaning" and unless a tax satisfies that meaning, it will not be income tax.

167. Whether a tax is separate from the main income tax or imposed under a separate Act from the main income tax Act are not questions that are helpful in determining whether a foreign tax is sufficiently like New Zealand income tax (see para [122] above). It is the characteristics of the tax in question that are relevant.

Summary of Australian case law

168. The court in *de Romero* held that it is the subject matter and essence of the impost that will determine whether it is an income tax, not the label it is given.

169. The cases have identified the following characteristics of an income tax:

- Just because the charge is paid into a special account (and not the consolidated revenue account) and used for a special purpose does not mean it is not an income tax (*de Romero*).
- Payment into the consolidated revenue account may indicate that the charge is an income tax (*Case R68*). However, if the amount is paid into a private account, then it would be highly unlikely to be an income tax.
- It is not always necessary for an impost to be called a tax for it to be one (*Case R68*).
- Funds used for a specific purpose and to benefit a restricted class of persons might not be an income tax (*Cases R68* and *S52*).
- A levy by a co-operative organisation does not have the character of a tax, even if the co-operative is formed within the context of the legal organisation of the State (*Case U52*).

170. There is some uncertainty surrounding FICA taxes. *Case S52* held that they were an income tax and *Case 20* found they were not.

Summary of United Kingdom Case Law

171. *Yates (HMIT)* considered the title of the tax to be relevant. It also held that a tax would correspond to United Kingdom income tax if it serves the same function as United Kingdom income tax, even if it does not tax in the same way.

172. *Reckitt* concluded that a sur-tax was an income tax because it was like income tax, even though it was assessed and collected in a different way.

Summary of Canadian Case Law

173. Class 3 United Kingdom NI contributions were not a tax as the contributions were not compulsory. The contributions were also not calculated as a percentage of income earned, as no income was being earned in the United Kingdom (*Yates*).

174. The court in *Kempe* held that German church tax was an income tax. The tax was an income tax as it was based on the income or wages tax. However, it is the Commissioner's opinion that German church tax would not satisfy the test in s YA 2(5) because the tax is in the nature of a service charge. It would also fail to satisfy the "public purpose" requirement.

175. *Nadeau* is authority for the view that something will be a tax if it is collected for a public purpose (the common good). In this case, the MSRS contributions were not a tax as they were collected to provide a limited class of persons with benefits (or in the case of a death benefit, a benefit to persons associated with those persons).

PART 3 – EXAMPLES

Introduction

176. The following examples are included to assist in explaining the application of the law.

177. The following facts have been assumed:

- The person is a New Zealand tax resident.
- The person is subject to tax in both countries.
- The person has paid the foreign tax.
- The income mentioned in the example is the only income of that person for that tax year.
- All the other requirements of subpart LJ are satisfied.

178. The onus is on the taxpayer to demonstrate that the foreign tax is eligible for a tax credit under s YA 2(5).

Example 1 – Solomon Islands PAYE

Facts

179. Jake spent the 2011–12 New Zealand tax year working as a diving instructor in the Solomon Islands for a local dive company called "Big Blue".

180. During his time in the Solomon Islands, Jake had Solomon Islands PAYE deducted from his salary by Big Blue under the PAYE system. The PAYE was then remitted to the Solomon Islands Inland Revenue Division.

181. Jake returned to New Zealand at the end of the 2011–12 New Zealand tax year and prepared his New Zealand tax return for the period that he was in the Solomon Islands. He seeks a tax credit under subpart LJ for Solomon Islands PAYE. Is Jake entitled to a foreign tax credit?

Application of the s YA 2(5) Test

182. As Jake has paid Solomon Islands PAYE, the tax falls to be considered under s YA 2(5)(b). Section YA 2(5)(b) requires a two-part inquiry. Is Solomon Islands PAYE of substantially the same nature as New Zealand PAYE? And if so, is it imposed as a collection mechanism for a foreign tax that is of substantially the same nature as income tax imposed under s BB 1?

183. Solomon Islands PAYE is of substantially the same nature as New Zealand PAYE. Solomon Islands PAYE is withheld from employment income by the employer and remitted to the Solomon Islands Inland Revenue in the same way that New Zealand PAYE is withheld and remitted.

184. Solomon Islands PAYE is also imposed as a collection mechanism for Solomon Islands Income Tax. Whether Solomon Islands income tax is a tax of substantially the same nature as income tax imposed under s BB 1 is considered below.

Relevant factors	
Compulsory and enforceable by law.	The Solomon Islands government imposes income tax on taxpayers under the Solomon Islands Income Tax Act ([Cap 123] Consolidated to 14 November 2012). Payment is compulsory and enforceable by law.

Imposed by, and payable to, a central, state or local government.	Solomon Islands income tax is imposed by the Solomon Islands government and administered and collected by the Inland Revenue Division (IRD).
Intended for a public purpose (although it is irrelevant whether it is tagged for a specific public purpose).	The revenue that IRD collects is for a public purpose as it enables the government to stimulate development and provide vital social services throughout the Solomon Islands. (Solomon Islands Inland Revenue Division website: **www.ird.gov.sb** accessed on 3 March 2014.)
The foreign tax must tax "income" as defined under the Act. • Some minor variations will be acceptable.	The Solomon Islands Income Tax Act identifies income that is subject to tax. This includes: • gains or profits from employment (s 3(1)(a)(ii)). • Section 5(a) confirms that "gains or profits" includes amounts from wages or salaries. • Section 36A states that an employer shall deduct tax from an employee's gross employment income, as prescribed in the Tax Deduction Rules 2005 (Solomon Islands).
Calculated as a proportion of income. • The rate of the tax is not important. • Whether the tax is payable at a fixed rate or at graduated rates is not important. • This condition might still be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.	Solomon Islands income tax is calculated as a proportion of income. Individuals are entitled to an exemption for their first $15,080 earned. The balance of any income is then subject to income tax at graduating rates.
Imposed on taxable or net income. • A taxing formula designed to produce a reasonable approximation of actual taxable/net income may be acceptable. • Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.	Solomon Islands income tax is imposed on "chargeable income", which is a similar concept to "taxable income" under the New Zealand Act. Income tax for employees is collected under the Solomon Islands PAYE system.
Not a penalty.	Solomon Islands income tax is not a penalty.
Not a service charge or licence fee.	Solomon Islands income tax is not a service charge or a licence fee.
Not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).	Solomon Islands income tax is not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors). There is no connection between payment of income tax and any specific benefit.

Conclusion

185. Jake is entitled to a foreign tax credit for Solomon Islands PAYE. Solomon Islands PAYE satisfies the test in s YA 2(5)(b) as it is a tax of substantially the same nature as New Zealand PAYE and it is imposed as a collection mechanism for a tax (Solomon Islands income tax) that is of substantially the same nature as New Zealand income tax.

186. Solomon Islands income tax is compulsory, imposed by central government and intended for a public purpose. It taxes employment income in substantially the same way that the New Zealand Act does, and it is calculated as a proportion of income.

187. Solomon Islands income tax is imposed on chargeable income, which correlates to the

New Zealand concept of "taxable income". It is not a penalty, service charge, licence fee or a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).

188. Jake's foreign tax credit cannot be more than the amount of New Zealand income tax payable on his Solomon Islands employment income.

Example 2 – United States of America Federal Insurance Contributions

Facts

189. Tim spent the 2011–12 New Zealand tax year working for an IT company in the United States. During this time, FICA contributions were deducted from Tim's salary. Tim has noted that social security and unemployment taxes are specifically excluded from the Double Taxation Relief (United States of America) Order 1983 at Art 2(3)(b). Tim would like to know whether it is possible to get a foreign tax credit for FICA contributions.

What is FICA?

190. Under the United States Federal Insurance Contribution Act (as codified at Title 26, Subtitle C, Chapter 21 of the United States Code (USC)) employees and employers are required to make payments to the Federal government to fund social security benefits. These payments are known as FICA contributions or taxes.

191. FICA consists of two taxes. The first tax is for old-age, survivors and disability insurance (OASDI) (also referred to as the Social Security tax). It provides retirement benefits, survivor benefits (where an insured worker dies and leaves a spouse/child) and disability benefits.

192. The second tax is known as Medicare. Medicare is used to fund hospital insurance for the elderly, younger people with disabilities, and people with end-stage renal disease.

193. FICA taxes are payroll taxes. For the 2012 tax year, FICA was imposed on employees at the rate of 5.65%. This consists of 4.2% OASDI and 1.45% Medicare. OASDI was imposed on wages up to $110,100. There is no limit on wages subject to Medicare.

194. An employer is required to deduct FICA from employees' gross wages. This amount, coupled with the employer contribution, is then remitted to the Internal Revenue Service along with income tax. An employer who fails to make the required payments or fails to pay on time will be liable for a penalty.

195. For completeness, it is noted that employer FICA contributions would not satisfy the test in s YA 2(5). This is because they are not imposed on the employer's taxable or net income.

Who is FICA imposed on?

196. FICA taxes are imposed on the wages of all employees. Employers are also required to make contributions. Both the employer and employee contributions are compulsory.

Eligibility and benefits

OASDI

197. The amount an employee pays throughout their working life is indirectly tied to the OASDI benefit that they receive on retirement. To receive most benefits, a person must be "fully insured". This means the person must have worked long enough and put enough money into the system. This is tracked using credits.

198. A person receives one credit for each quarter year they work. To be eligible for retirement benefits a person needs 40 credits (meaning they need to have worked for at least 10 years). They also need to earn a certain amount of money each quarter to get a credit for that quarter. The minimum age to qualify for a retirement benefit depends on when a person was born. Those born after 1960 qualify for a retirement benefit when they reach 67.

199. The amount of the monthly benefit paid depends on the person's earnings during their working life and the age at which they retire. People who earned more will get more back. However, the system is weighted so that low income workers will receive a higher percentage of their former wages than high income earners.

200. A person can qualify for a disability benefit with fewer credits. To be entitled to a disability benefit a person must have:

- a medical condition that meets the definition of "disability" in the social security legislation; and
- worked long enough and recently enough to be covered (this will vary depending on the age of the person).

201. If a person who is covered by OASDI dies, their surviving spouse/children can receive a survivor benefit.

202. The United States Supreme Court, in *Flemming v Nestor* (1960) 363 US 603 (SC), held that entitlement to social security benefits is not a legally binding contractual right. Congress can change the rules regarding eligibility and has done so many times. The rules can be made more generous or more restrictive and benefits that are granted can be withdrawn. The FICA legislation specifically reserves the right of Congress to "alter, amend or repeal" any of the social security and Medicare provisions.

Medicare

203. People aged 65 and over are entitled to receive Medicare benefits if they:

- receive a social security benefit;
- have worked long enough to be eligible for a social security benefit;
- would be entitled to a social security benefit based on their spouse's work record and their spouse is aged at least 62; or
- have worked long enough in a federal, state or local government job to be insured for Medicare.

204. People aged under 65 who receive disability benefits or who have end-stage renal disease may also qualify for Medicare.

205. As with OASDI, Congress has reserved the right to "alter, amend or repeal" any of the Medicare provisions.

Trust Funds

206. FICA taxes are collected by the United States Internal Revenue Service (IRS) and paid into the United States Treasury General Fund. They are then appropriated to three separate funds: the Federal Hospital Insurance Trust Fund, the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. Amounts held in these funds are not held for any particular individual. Likewise, employer contributions are not held in trust for any particular employee. The US social security system is a pay as you go scheme, under which current employer and employee contributions are used to fund the payment of retirement benefits to the current recipients of retirement benefits.

207. The analysis below combines employee Medicare and OASDI contributions. They are two separate taxes. However, as the same factors apply to each tax, they are considered together. Employer contributions are not considered.

Application of the s YA 2(5) Test

Relevant factors	
Compulsory and enforceable by law.	FICA is compulsory and enforceable by law.
Imposed by, and payable to, a central, state or local government.	FICA is imposed under the Federal Insurance Contribution Act. FICA is collected by the IRS and paid into the United States Treasury General Fund.
Intended for a public purpose (although it is irrelevant whether it is tagged for a specific public purpose).	FICA is intended for a public purpose. FICA is used to provide benefits to insured people. The employee contribution is connected with a benefit. With OASDI, the amount an employee pays throughout their working life is indirectly tied to the OASDI benefit they receive on retirement. With Medicare, an employee also needs to have paid Medicare for at least 10 years prior to reaching retirement age. This may mean that there is a private element to the contribution.
The foreign tax must tax "income" as defined under the Act. • Some minor variations will be acceptable.	FICA taxes employment income in substantially the same way that the New Zealand Act taxes employment income.
Calculated as a proportion of income. • The rate of the tax is not important. • Whether the tax is payable at a fixed rate or at graduated rates is not important. • This condition might still be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.	FICA is calculated as a percentage of an employee's gross income.

Imposed on taxable or net income. • A taxing formula designed to produce a reasonable approximation of actual net/taxable income may be acceptable. • Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.	Because they are payroll taxes, OASDI and Medicare contributions are imposed on an employee's gross income. They are imposed in a similar way to New Zealand PAYE.
Not a penalty.	FICA is not a penalty.
Not a service charge or licence fee.	FICA is not a service charge or licence fee.
Not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).	FICA is essentially a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors). The employee contribution is linked to a benefit entitlement. Without making contributions the employee will not be eligible to receive the relevant benefits. How much the employee pays in will broadly correlate to what they ultimately receive. One of the main arguments for claiming that FICA is a tax, and not a contribution to a fund or scheme, is that under FICA an employee does not have an enforceable contractual right to receive a benefit. The United States Congress has the power to change eligibility requirements or even to repeal the benefit. However, the same could be said for most government-run social insurance schemes. There is always the risk that the government will not have enough funds to pay out benefits. However, these potential risks do not detract from the essential characteristic of the payments, which are payments made to secure entitlement to future benefits.

Conclusion on FICA

208. Tim is not entitled to a foreign tax credit for his FICA contributions as FICA does not satisfy the test in s YA 2(5)(a). FICA is not a tax of substantially the same nature as New Zealand income tax imposed under s BB 1. FICA contributions also do not satisfy s YA 2(5)(b). While they are deducted from employment income in much the same way as New Zealand PAYE, they are not a collection mechanism for a separate tax that is of substantially the same nature as income tax imposed under s BB 1.

209. Employee FICA contributions do satisfy certain elements of the test. They are compulsory and imposed by central (Federal) government. They are calculated as a proportion of the employee's income. They are imposed on gross income in much the same way as the New Zealand Act imposes income tax on employee income—via a PAYE system. Further, employee FICA contributions are not penalties, service charges or licence fees.

210. It is also arguable that FICA contributions are intended for a public purpose, ie to pay benefits to eligible recipients. However, it is also the case that the payments are made for a private purpose, ie to secure eligibility to a potential private benefit.

211. Employee FICA contributions fail the s YA 2(5) test as they can be characterised as a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors). By making the payment into the fund, the employee becomes entitled to receive benefits to which they would not otherwise have been entitled. The benefits are not available to all citizens, only those citizens that are fully insured. The United States Supreme Court in *Flemming v Nestor* held that this entitlement is not a legally binding contractual right. However, the Commissioner considers that as the payment is linked to a future benefit (whether that benefit is ever realised or not), then it has the features of a payment into a fund or scheme.

212. As employee FICA contributions are likely to have a private as well as a public benefit, and because they have the characteristics of a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors), the Commissioner considers that employee FICA contributions do not satisfy the requirements of s YA 2(5).

213. Br Pub 09/02: Federal Insurance Contributions Act (FICA) – Fringe benefit tax liability, *Tax Information Bulletin*, Vol 21, No 4 (June 2009): 2 looked at whether employer FICA contributions are subject to fringe benefit tax. The Public Ruling was mainly concerned with whether employer FICA contributions gave rise to a fringe benefit. However, it touched briefly on employee FICA contributions and noted that *Flemming v Nestor* establishes that a person who makes payments under FICA does not acquire a right to a benefit analogous to a property right as a consequence. As mentioned above, this Interpretation Statement accepts that the employee FICA contributions do not result in an enforceable right. However, the essential characteristic of the payment is a payment made to secure an entitlement to a future benefit. Only people that make contributions are entitled to benefit. This can be compared to a general income tax where payers do not receive any benefit as a consequence of being a taxpayer. Subject to the eligibility requirements of government benefits (such as social security, unemployment, etc), the same benefits are available to all citizens whether they are required to pay, or have paid, income tax.

Example 3 – United Kingdom National Insurance Contributions

Facts

214. Melanie spent the 2011–12 New Zealand tax year working as a pharmacist in London. Melanie's only income for this tax year is employment income from her job in London. United Kingdom income tax and Class 1 Employee National Insurance (NI) contributions have been deducted via the United Kingdom PAYE system from this income.

215. Melanie returned to New Zealand at the end of the tax year. She notes that she is able to claim a foreign tax credit for United Kingdom income tax under the Double Taxation Relief (United Kingdom) Order 1984 (the DTA). However the DTA does not mention NI contributions. Melanie would like to know whether she is able to claim a foreign tax credit under subpart LJ for United Kingdom NI contributions. Are United Kingdom NI contributions of substantially the same nature as income tax imposed under s BB 1?

What is National Insurance?

216. United Kingdom NI is a scheme where employees, employers and the self-employed make contributions towards the cost of certain state benefits. The scheme is administered by Her Majesty's Revenue and Customs (HMRC) and contributions are collected by HMRC through the PAYE system along with income tax.

217. NI contributions are mandatory contributions paid by employees and employers on earnings and by employers on certain benefits in kind provided to employees. The self-employed are also required to make NI contributions—partly by a fixed weekly or monthly payment and partly on a percentage of net profits above a certain threshold. Individuals may also make voluntary NI contributions. A person is required to make NI contributions if they are:

- an employee or self-employed,
- aged 16 years or over (although Class 1 and Class 2 employee contributions are not payable by a person over the state pension age), and
- their earnings are at a prescribed level.

218. Employers are also required to make NI contributions.

Classes of NI contributions

219. There are six different classes of NI contributions. These are summarised as follows:

- Class 1 NI contributions are paid by employers and employees. The employee contribution is deducted from the employee's gross wages by the employer. The employer then adds an employer contribution and submits the amount to HMRC along with income tax.
- Class 1A NI contributions are paid by employers on the value of benefits in kind provided to their employees.
- Class 1B NI contributions are payable whenever an employer enters into a PAYE settlement agreement for tax. Class 1B contributions are payable only by employers.
- Class 2 NI contributions are fixed weekly amounts paid by the self-employed. While the amount is calculated weekly, it is typically paid monthly

or quarterly. Payments are due regardless of trading profits or losses (although those with low earnings can apply for an exemption).

- Class 3 NI contributions are voluntary payments paid by a person wishing to fill a gap in their contribution record. The gap may have arisen because the person was not working or because their earnings were too low. This allows a person to preserve their entitlement to certain state benefits. Class 3 NI contributions are paid at a flat rate.
- Class 4 NI contributions are paid by the self-employed as a proportion of their net profits. The amount due is calculated with income tax at the end of the year.

Benefit entitlements

220. A person's entitlement to contributory state benefits (and the amount of those benefits) depends on the class of NI contribution paid:

- Class 1 NI contributions (paid by employees and employers) provide the employee with an entitlement to all contributory benefits. The Class 1 employer NI contributions do not provide the employee with an entitlement to contributory benefits. Entitlement is determined solely by the amount paid by the employee. (For employee contributions, contributory benefits are determined only by NI contributions below something called the "Upper Accrual Point".)
- Classes 1A and 1B NI contributions (paid by employers) do not count towards any contributory benefits.
- Class 2 NI contributions (paid by the self-employed) provide an entitlement to the state pension and bereavement benefits only.
- Class 3 NI contributions (voluntary) count towards state pension and bereavement benefits only.
- Class 4 NI contributions (paid by the self-employed) do not count towards any contributory benefits. This is because the self-employed qualify for benefits by paying Class 2 NI contributions.

221. In addition, entitlement to a contributory benefit depends on how long a person has paid in NI contributions. There are different calculations for each of the different classes and for each of the different benefits.

The National Insurance Fund

222. The National Insurance scheme is administered by HMRC. HMRC collects the NI contributions through the PAYE system. The NI contributions go into the National Insurance Fund (NIF). The NIF is separate from the Consolidated Fund.

Application of the s YA 2(5) Test

Relevant factors	
Compulsory and enforceable by law.	It is compulsory for a person to make NI contributions if they are: • an employee (Class 1) or self-employed (Class 2 and Class 4), • aged between 16 and state pension age, and • their earnings are at a prescribed level. Employers are also required to make NI contributions (Classes 1, 1A and 1B). Class 3 NI contributions are voluntary.
Imposed by, and payable to, a central, state or local government.	NI contributions are imposed by central government. NI contributions are collected and administered by HMRC. A proportion of NI contributions are used to fund the National Health Service (NHS). The remainder of the NI contributions are then paid by HMRC into the NIF. The NIF is separate from the Consolidated Fund.
Intended for a public purpose (although it is irrelevant whether it is tagged for a specific public purpose).	A proportion of all NI contributions are used to help fund the NHS. A proportion is also used to fund non-contributory benefits. Use of the NHS and access to non-contributory benefits are available to everyone. There is no eligibility requirement. On this basis, the NI contributions are being used for a public purpose. However, a proportion of NI contributions are also used to fund contributory benefits. This is not a public purpose. In this instance, NI contributions are used to fund a private benefit.

The foreign tax must tax "income" as defined under the Act. • Some minor variations will be acceptable.	Class 1 employee NI contributions tax employment income. The New Zealand Act also taxes and collects employment income substantially the same way. Class 1 employer NI contributions and Classes 1A and 1B NI contributions do not tax income (of the employer). Class 2 NI contributions are a flat fee and not a tax on income/profits. They are payable regardless of income/profits. Class 3 NI contributions are voluntary and paid at a flat rate unrelated to income. Class 4 NI contributions tax net profits of the self-employed. The "income" that is taxed is the type of income that is taxed under the Act.
Calculated as a proportion of income. • The rate of the tax is not important. • Whether the tax is payable at a fixed rate or at graduated rates is not important. • This condition might still be satisfied even if the tax is not payable until a minimum income threshold is reached, or if the applicable income is capped at a certain threshold.	Class 1 employee NI contributions are calculated as a proportion of income. Class 1 employer NI contributions are calculated on the basis of the employee's income and not the employer's. This means Class 1 employer contributions are not calculated as a proportion of income of the employer. Classes 1A and 1B NI contributions are also not calculated as a proportion of income. They are paid by the employer. Class 2 NI contributions are not calculated as a proportion of income. Class 2 NI contributions are calculated at a flat rate of £2.65 per week. Class 3 NI contributions are voluntary and usually made because the person is not earning any income. They are imposed at a flat rate and therefore not calculated as a proportion of income. Class 4 NI contributions are calculated as a proportion of the self-employed person's profits.

Imposed on taxable or net income. • A taxing formula designed to produce a reasonable approximation of actual net/taxable income may be acceptable. • Where a tax is imposed as a collection mechanism for income tax and is of substantially the same nature as provisional tax, PAYE, RWT or NRWT, then the requirement that the tax be imposed on taxable or net income does not need to be satisfied.	Class 1 employee NI contributions are imposed on gross income and deducted from employees' wages by the employer. In this way, they could be characterised as a collection mechanism for the NI contributions of the same nature as New Zealand PAYE and so would satisfy this requirement. Class 1 employer NI contributions and Classes 1A and 1B are not imposed on the employer's income. Class 2 NI contributions are imposed as a flat fee. They are payable regardless of profits or losses. Class 3 NI contributions are a voluntary payment paid at a flat rate unrelated to income. Class 4 NI contributions are calculated on net profits. Net profit is broadly the same as "taxable income". Therefore, Class 4 NI contributions would satisfy this requirement.
Not a penalty.	NI contributions are not a penalty.
Not a service charge or licence fee.	NI contributions are not a service charge or licence fee.
Not a payment into a fund or scheme where the entitlement to the benefit is limited to those who contribute (or persons associated with contributors).	Class 1 employee NI contributions and Classes 2 and 3 NI contributions are effectively payments into a fund or scheme where the entitlement to the benefit is limited to those who contribute. There are deemed contributions for certain people who do not contribute. For example, a spouse who does not work because of parental responsibilities is entitled to deemed contributions. The benefit of the payment is linked via a person's NI contributions account to contributions made. Class 4 NI contributions and employer contributions (Classes 1, 1A and 1B) can also be classed as payments into a fund or scheme where the entitlement to the benefit is limited to those who contribute. The only difference with these classes of NI contributions is that the contributor does not personally stand to benefit as a consequence of payment.

Conclusion on NI contributions

223. Melanie is not entitled to a foreign tax credit, as United Kingdom NI contributions do not satisfy the test in s YA 2(5). United Kingdom NI contributions are not a tax of substantially the same nature as New Zealand income tax imposed under s BB 1. They are also not a tax of substantially the same nature as PAYE. While they are collected in much the same way via the PAYE system, they are not a collection mechanism for a separate foreign tax that is of substantially the same nature as income tax imposed under s BB 1.

224. All NI contributions have the characteristics of a payment into a scheme or fund where the entitlement to the benefit is limited to those who contribute. Most NI contributions are connected with an entitlement to a specific benefit, for example, the state pension. Consequently, United Kingdom NI contributions do not satisfy the test in s YA 2(5).

225. *Case F11* is the only New Zealand authority to consider whether NI contributions are substantially of the same nature as New Zealand income tax (this was the phrase used in s 293 of the Income Tax Act 1976, applicable at the time). The Taxation Review Authority held that the taxpayer had failed to discharge the burden of proof to show that NI contributions were substantially of the same nature as New Zealand income tax. However, Judge Barber stated that it would not be possible to discharge the burden of proof in any event as the nature of NI contributions seemed to be far narrower than the nature of income tax. (Although he acknowledged that the point was not argued before him in any detail.) The findings in this case are consistent with the view taken in this Interpretation Statement.

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APPENDIX – LEGISLATION

Income Tax Act 2007

1. Section BB 1 provides:

BB 1 Imposition of income tax

Income tax is imposed on taxable income, at the rate or rates of tax fixed by an annual taxing Act, and is payable to the Crown under this Act and the Tax Administration Act 1994.

1. Sections LJ 1–LJ 5 provide:

LJ 1 What this subpart does

When tax credits allowed

(1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for foreign income tax paid in relation to a segment of that income.

Limited application of rules

(2) The rules in this subpart apply only when—

(a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and

(b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.

When treated as assessable income (Repealed)

(3) Repealed.

Source of dividends

(4) If a company is not resident in New Zealand, and for the purposes of a law of another territory in relation to which a double tax agreement has been made is resident in that territory, and the law imposes foreign tax, a dividend paid by the company is treated as being derived from a source in that other territory for the purposes of the double tax agreement.

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.

Relationship with section YD 5

(6) Section YD 5 (Apportionment of income derived partly in New Zealand) applies to determine how an amount is apportioned to sources outside New Zealand.

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.

Limitation on amount of credit

(2) The amount of the person's credit in subsection (1) must not be more than the amount of New Zealand tax payable by the person in relation to the segment calculated under section LJ 5(2), modified as necessary under section LJ 5(4).

Amount adjusted

(3) The amount of the person's credit in subsection (1) may be reduced or increased if either section LJ 6 or LJ 7 applies.

When person both resident in New Zealand and another country

(4) A person described in section LJ 1(2)(a) who has, because they are a citizen or resident of, or are domiciled in, a foreign country, paid foreign income tax on their assessable income, has a credit under subsection (1). However, the amount of the credit is limited to the amount of foreign income tax that would have been paid in the foreign country if the person were treated as not a citizen or resident of, or domiciled in, that foreign country.

Multi-rate PIEs and their investors

(5) For a multi-rate PIE and an investor in a multi-rate PIE, the amount of a tax credit is limited to the extent allowed under subpart HM (Portfolio investment entities).

When subsection (7) applies

(6) Subsection (7) applies to a person who derives an amount from an attributing interest in a FIF when the amount is treated as not being income under section EX 59(2) (Codes: comparative value method, deemed rate of return method, fair dividend rate method, and cost method).

Tax credit

(7) The person has a tax credit under this subpart for foreign income tax paid on or withheld in relation to the amount. The calculation of the maximum amount of the tax credit is made under section LJ 5(2), modified so that the item **segment** in the formula is the amount of FIF income from the attributing interest that the person derives in the period referred to in section EX 59(2).

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.

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.

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:

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

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—

$$(\text{person's net income} - \text{losses}) \times \text{tax rate}$$

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).

2. Section YA 1 defines "income tax", "tax" and "taxable income" to mean:

income tax means income tax imposed under section BB 1 (Imposition of income tax) except to the extent to which it has a different meaning under section YA 2 (Meaning of income tax varied)

tax means income tax, but in the provisions in which the term "income tax" has an extended or limited meaning, "tax" has a corresponding meaning

taxable income means taxable income for a tax year calculated under section BC 5 (Taxable income)

3. Section YA 2 provides:

YA 2 Meaning of income tax varied

DTA and time bar provisions: ancillary tax

(1) The term **income tax** includes ancillary tax in—

(a) section BB 3(2) (Overriding effect of certain matters):

(b) section BH 1 (Double tax agreements):

(c) sections 107A to 108B of the Tax Administration Act 1994.

DTA provisions: tax recovery agreements

(2) The term **income tax** includes a tax that is prescribed in a tax recovery agreement made under Part 10A of the Tax Administration Act 1994 in—

(a) section BB 3(2):

(b) section BH 1.

General tax avoidance provisions: ancillary tax

(3) The term **income tax** includes ancillary tax, but not excluded ancillary tax, in—

(a) section BB 3(1):

(b) sections BG 1 (Tax avoidance) and GA 1 (Commissioner's power to adjust):

(c) the definition of **tax avoidance**.

Modified application of section GA 1

(4) When section GA 1 is applied in the case of an ancillary tax,—

(a) the words "taxable income" in section GA 1(2) are treated as replaced by the words "liability to the ancillary tax"; and

(b) the following paragraph is treated as added to section GA 1(5): "(e) an amount subject to the ancillary tax".

Tax of other countries

(5) The term **income tax**, when specifically used in relation to tax of another country, whether imposed by a central, state, or local government,—

(a) means a tax of substantially the same nature as income tax imposed under section BB 1 (Imposition of income tax); and

(b) includes a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT), or non-resident withholding tax (NRWT).

UFTC rules (Repealed)

(6) (Repealed)

FDP, imputation, and BETA rules

(7) The term **income tax**, in relation to tax that has been paid by a person, includes provisional tax in—

(a) the FDP rules:

(b) the imputation rules:

(c) subpart OE (Branch equivalent tax accounts (BETA)).

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR 715)*. You can download this publication free from our website at **www.ird.govt.nz**

PRODUCT RULING BR PRD 14/03: BANK OF NEW ZEALAND

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Bank of New Zealand (BNZ).

Taxation Laws

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

This Ruling applies in respect of:

a) ss BG 1, CC 7, EW 15, EW 31, GA 1, RE 1 to RE 6, RE 10, RF 1, RF 2, RF 3 and RF 4; and

b) ss 86F and 86I of the Stamp and Cheque Duties Act 1971 (SCDA).

The Arrangement to which this Ruling applies

The Arrangement is a product (TotalMoney) that BNZ offers to its customers. These customers may only be individuals, companies or trusts.

TotalMoney involves the creation of new types of accounts that must be in a group of accounts, and the facility to elect to group up to 10 of these new types of accounts (potentially increasing to 25 during 2014) into one or more groups to either "pool" or "offset" the account balances.

"Pooling" involves the aggregation of account credit balances to determine the tiered interest rate that will apply to the calculation and crediting of interest to each account balance. "Offsetting" involves the aggregation of account balances to calculate the amount of interest debited to a lending facility account balance.

The Arrangement is set out in the documents listed below, copies of which were received by the Taxpayer Rulings Unit, Inland Revenue, on 13 December 2013:

- Terms and Conditions for your Bank of New Zealand TotalMoney Account for Personal and Sole Trader Customers;
- Terms and Conditions for your Bank of New Zealand TotalMoney Account for Companies and Trusts;
- Bank of New Zealand Home Loan Facility Master Agreement;
- Bank of New Zealand Facility Master Agreement;
- Letter of Advice – TotalMoney Home Loan;
- Letter of Advice – TotalMoney Business Term Loan; and
- Confirmation of New Terms and Conditions (for customers converting to TotalMoney).

Further details of the Arrangement are set out in paragraphs 1 to 30 below.

1. TotalMoney is a package of accounts and loans that BNZ offers to its customers. These customers may only be individuals, companies or trusts.
2. Customers, in general, have a range of accounts with BNZ, including transaction accounts, savings accounts and various loan accounts. Loan accounts may only be table, non-table, tailored, principal and interest, interest only, fixed or floating home loan accounts, or business loan accounts.
3. Interest under a TotalMoney loan account cannot be capitalised, for example, because of a "mortgage holiday". TotalMoney allows customers to group or aggregate these accounts to either "pool" or "offset" the account balances.

Primary features of TotalMoney

4. The primary features of TotalMoney are the "pooling" and "offsetting" features. These features operate in the manner described below.

   Pooling

   a) The pooling aspect of TotalMoney can operate when several transaction accounts with credit balances exist. Interest on these credit balance accounts is calculated and paid based on the cumulative credit balance of all transaction accounts in the group that are nominated for the pooling feature. Interest-bearing accounts usually attract interest based on interest rate brackets that apply to the balance of each relevant individual account.

b) The cumulative credit balance is calculated so BNZ can ascertain the relevant interest rate tier applicable to the relevant accounts. The separate funds are not actually transferred to one account before the interest is calculated. BNZ calculates interest at the applicable interest rate tier that applies to the accumulated balance.

Offsetting

a) With the offset feature of TotalMoney, interest on a lending facility or facilities within the group is calculated and paid by the customer on the difference between the lending facility balances and the credit balances of transaction accounts in the group that are nominated for the offset feature. Under the terms and conditions agreed between BNZ and its customers for TotalMoney, BNZ pays no interest on the credit balances that are "offset" against the lending facility.

b) The "offsetting" is only to calculate the balance of the lending facility or facilities on which interest is payable or, where the credit balances nominated for the "offset" feature exceed the balance of the lending facility, the balance of the credit balances on which interest is receivable. There is no actual transfer of funds, no set-off or netting of funds together in an account, and no transfer of any interest in or entitlement to funds.

5. Every transaction account in a TotalMoney group must be selected to either "pool" or "offset". That is, customers can choose whether some or all of their transaction accounts with credit balances are "pooled" (in which case BNZ will pay interest to those accounts) or "offset" against the product lending facility. By default, all accounts will be set to the "offset" feature unless changed to "pooled" (by the customer or BNZ on the customer's instructions), except where the customer has no loan account (in which case the customer's TotalMoney accounts will automatically "pool").

6. TotalMoney does not provide a facility for existing accounts. TotalMoney involves the creation of a new type of account. To participate in TotalMoney, a customer must open specific TotalMoney accounts that are particular to the TotalMoney product. Customers may convert an existing non-TotalMoney transaction or savings account that they have with BNZ to a new TotalMoney account. However, the customer must agree that the existing terms and conditions applying to those accounts cease to apply and are replaced by the TotalMoney Terms and Conditions.

7. For TotalMoney accounts, the customer can select either to "offset" or "pool" (and to change between) at any time and for any period.

Pooling – further detail

8. BNZ has a contractual obligation to pay interest to each transaction account with a credit balance participating in the pooling feature, based on the applicable interest rate tier applying to the total cumulative balance of all accounts being "pooled". Following usual business practice, BNZ makes a separate determination for withholding tax on each interest payment made to each account.

9. The benefit of the "pooling" feature for customers is that they can earn more interest by combining smaller balances and reaching higher interest-rate tiers and still maintain their money in separate accounts for separate purposes. The customer may consider this an advantageous way to manage their money.

10. Account owners have full deposit and withdrawal access to their transaction accounts. Overdraft facilities may be available for these accounts. However, any overdraft balance is ignored for "pooling" purposes. BNZ charges debit interest on the overdrawn balance of any account. The overdrawn balance does not reduce the "pooled" balance of the credit balance accounts when BNZ is calculating interest for those accounts.

Offsetting – further detail

11. Where one loan account is in the group, the interest payable on the loan account is calculated on the balance of the loan account less the credit balances of accounts set to the "offset" feature. This will be the case as a matter of law (in terms of TotalMoney documentation) and as a matter of practice (in terms of BNZ's computer system). There is no actual set-off, netting, or transfer of funds, or transfer of any interest in or entitlement to funds. "Offsetting" occurs before debit or credit interest is calculated.

12. For example, in the case of a loan account that would otherwise be the same as a standard variable rate table home loan facility over 20 years with a "minimum payment", there will be no provision for the amount of interest saved under "offsetting" to reduce the "minimum payment". The effect of "offsetting" is the same as a decrease in the floating interest rate and a decision not to reduce the amount of the "minimum payment". In either case, the term of the loan is reduced because the principal portion of the payment is effectively increased. In the case of a non-table

loan, interest payments will be reduced by "offsetting", principal repayments will not change, and the loan term will not reduce.

13. Where there is more than one loan account in the group, the loan accounts in the group are given a default priority, namely, the oldest loan account in the group will receive the highest priority. However, the customer may elect two or more of those loan accounts to be prioritised for "offsetting" purposes. The loan account with the highest priority will receive the benefit of "offsetting" first. It is only where the credit balances of transaction accounts set to offset exceed the balance of that highest priority loan account that the next highest priority loan account balance is offset, and so on.
14. If the total credit balances of the transaction accounts set to "offset" are greater than the total debit balance of the loan accounts, credit interest will be applied to the difference and paid on a prorated basis to the credit balance accounts (essentially in line with the "pooling" feature of TotalMoney).
15. BNZ calculates interest daily. If, during a month, BNZ has both an entitlement to receive interest (that is, the balance of participating loan accounts exceeds the balance of all transaction accounts set to the offset feature) and, at another point in the month, BNZ has an obligation to pay interest (that is, the balance of transaction accounts set to offset exceeds the balance of the relevant loan accounts), then the two interest payments are made and are not set-off.
16. The "offsetting" feature of TotalMoney essentially offers the same benefits to customers as those offered by a revolving credit loan (such as BNZ's "Rapid Repay" product) in terms of lower interest costs and a shorter time to repay the loan. However, this feature overcomes a primary perceived disadvantage of a revolving credit loan because it allows customers to retain separate account balances (which customers may prefer when managing their finances).
17. Where a customer has a TotalMoney loan account, this account must be grouped with at least one TotalMoney transaction account.
18. No arrangement must exist between the customers who have grouped their accounts that provides for the loan account owner(s) to make a payment(s) to the transaction account owner(s) in consideration for the transaction account owner(s) electing the "offset" feature of TotalMoney.

Business purposes

19. When TotalMoney was established, customers were contractually prohibited from using TotalMoney for business purposes. BNZ has now removed the prohibition on the business use of TotalMoney. BNZ extended the availability of TotalMoney to business customers to give them the same tools for managing their financial affairs as it gives to personal customers.
20. Under the terms and conditions applicable to TotalMoney, customers are able to use TotalMoney accounts for business purposes, which means that customers are able to group business and non-business product accounts. This means that a sole trader, for example, is able to group their business and non-business accounts.

Terms and Conditions for the TotalMoney home loan products

21. Each of BNZ's home loans is explained in a collection of documents. These documents include primarily a Home Loan Facility Master Agreement (which is a standard form master document that contains generic provisions that apply to all BNZ home loan facilities) and a Letter of Advice for Home Loans (which contains particular and specific provisions for the home loan facility being made available to the customer and overrides the Loan Facility Master Agreement in case of any inconsistencies). The Letter of Advice is produced from a computer system that contains a master list of possible provisions that can apply to BNZ's home loans. Under this system, the provisions applicable to a particular home loan are selected, collated and produced in a document.
22. The TotalMoney product home loans are also documented in a Home Loan Facility Master Agreement and Letter of Advice for Home Loans. Customers may also enter into another Letter of Advice if they want to be able to redraw amounts that they have repaid under a fixed home loan at a later stage. The Home Loan Facility Master Agreement is the standard document that applies to all BNZ home loans. The Letter of Advice for Home Loans has only minor differences from the Letter of Advice for other loans, primarily relating to branding (that is, the name BNZ has given to this particular form of home loan) and the interest calculation for the variable rate components of the home loan (to account for the "offset" feature of TotalMoney).
23. Table loans provide for regular payments and a set date when the loan will be paid off. Most payments

early in the loan term comprise interest, while most of the payments later in the term comprise repayments of the principal. Non-table loans have two separate repayments, one of interest and one of principal. Customers repay the same amount of principal each time and interest is charged separately.

24. The documentation for a TotalMoney standard variable rate table home loan facility over 20 years will largely be the same as that for current BNZ home loan facilities that are standard variable rate table home loans over 20 years. The only differences are: branding (the name on the Letter of Advice), the interest calculation (which provides for the effect of the "offset") and, in relation to table loans, the provision stating that where the loan has the benefit of the "offset" to reduce the interest cost, the "minimum payment" specified for the loan will not decrease because of any interest savings but instead the loan term will reduce. Under a non-table loan, any interest saving (whether as a result of a reduction in the applicable interest rate because of a general decrease in interest rates or because of the offset feature) would result in either a reduction of the interest repayment or a reduction in the loan term (if the original repayment amount is maintained despite the interest saving). In relation to a TotalMoney product home loan that is a table home loan, a reduction is only allowed in the loan term.

Terms and conditions for TotalMoney business loan products

25. Each of BNZ's business loans is also documented under a collection of documents. These include primarily the Loan Facility Master Agreement (a standard form "Master" document that contains primarily generic provisions that apply to BNZ's business loan facilities) and a Business Term Loan Letter of Advice (which contains particular and specific provisions for the loan facility that is being made available to a TotalMoney business customer and overrides the Loan Facility Master Agreement in case of any inconsistencies).

26. Any variations between the different versions of the Business Term Loan Letter of Advice and the Loan Facility Master Agreement primarily relate to branding (the name given by BNZ to this particular form of loan) and the interest calculation for the variable rate components of a business loan (to account for the "offset" feature of the product). Apart from these differences, the provisions are the standard provisions that apply to BNZ's other business loans; for example: table, non-table, tailored, interest only, and so on.

Groups

27. TotalMoney is based on a group of participating accounts. Groups can comprise only one of the following categories:
    a) Natural persons:
        i) The accounts of an individual, or the individual and joint accounts of married, de facto, and civil union couples, and any of their children may be combined as part of one group of accounts.
        ii) For example, the various accounts of one natural person, Jane, or the various accounts (individual or joint) of Jane and her husband, John, and their child, Joe. The group is not limited to residents of New Zealand, although the group may not include both residents and non-residents.
    b) One company or one trust:
        i) Multiple accounts of one company (including a qualifying company or look through company) or one trust may be combined as a group of accounts. Only one entity can be in a group at any time.
        ii) Accounts of different entities (including the entity and any related individual) cannot be pooled or offset.

28. Accounts may only be included in one group. An individual may have accounts in three groups, through membership in one as an individual customer, the second as a joint customer and in the third as a sole trader. A group may not include more than one sole trader's accounts.

29. A customer may be a resident or non-resident of New Zealand for tax purposes. However, where a group of accounts consists of accounts owned by more than one legal person, BNZ will obtain representations from the owners of those accounts that they do not have different tax residence status. That is, where more than one legal person is participating in a group of accounts, either all persons must be residents of New Zealand for tax purposes or all persons must be non-residents of New Zealand for tax purposes.

BNZ's objectives

30. BNZ's objectives in providing TotalMoney are to:
    a) increase its market share, particularly for home loans and transaction-type accounts;
    b) increase the proportion of its home loans that are charged variable interest rates;

c) increase customer satisfaction and customer retention; and

d) improve its brand awareness and be seen as a market leader.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

a) All interest rates related to the TotalMoney product are arm's length market interest rates.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the condition stated above, the Taxation Laws apply to the Applicant and the Arrangement as follows:

Financial arrangements rules

a) When a credit balance of a transaction account and a debit balance of a loan account are "offset", there is no amount of consideration paid or payable because of that "offset" for the calculation of income and expenditure under ss EW 15 and EW 31 of the "financial arrangements rules" (as defined in s EW 1(2)).

Resident Withholding Tax (RWT), Non-Resident Withholding Tax (NRWT) and Approved Issuer Levy (AIL)

b) Under the "pooling" feature of TotalMoney:

i) RWT (as defined in s YA 1) and NRWT (as defined in s YA 1) must be deducted by BNZ from the interest credited to the participating transaction accounts in a group in accordance with the RWT rules (as defined in ss RE 1(1) and YA 1) and the NRWT rules (as defined in ss RF 1(1) and YA 1);

ii) For an account that is a "registered security" (as defined in s 86F of the SCDA), "approved issuer levy" (as defined in s 86F of the SCDA) may be paid by an "approved issuer" (as defined in s 86F of the SCDA) for the interest credited to that account pursuant to s 86I of the SCDA.

c) Under the "offsetting" feature of TotalMoney:

i) There is no payment of or entitlement to "interest" (as defined in s YA 1) for the credit balances of participating transaction accounts in a group, and no obligation to deduct RWT or NRWT or to pay AIL, except to the extent that the combined credit balance of those accounts exceeds the combined debit balance of the lending facility accounts.

ii) To the extent that interest is credited to participating transaction accounts in a group:

- RWT (as defined in s YA 1) and NRWT (as defined in s YA 1) must be deducted by BNZ from the interest credited to the participating transaction accounts in a group in accordance with the RWT rules (as defined in ss RE 1(1) and YA 1) and the NRWT rules (as defined in ss RF 1(1) and YA 1);
- For an account that is a "registered security" (as defined in s 86F of the SCDA), "approved issuer levy" (as defined in s 86F of the SCDA) may be paid by an "approved issuer" (as defined in s 86F of the SCDA) for the interest credited to that account pursuant to ss 86F and 86I of the SCDA.

Section CC 7

d) No income arises under s CC 7 for BNZ or its customers in relation to the Arrangement.

Section BG 1

e) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2014 and ending on 31 March 2018.

This Ruling is signed by me on the 31st day of March 2014.

Bill Acton
Investigations Manager, Investigations and Advice

PRODUCT RULING BR PRD 14/04: SCALES CONSOLIDATED TAX GROUP

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by:

- The Scales Consolidated Tax Group
- Scales Corporation Ltd.

Taxation Laws

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

This Ruling applies in respect of s CD 22 and s BG 1.

This Ruling does not consider or rule on the tax effects set out in paragraph 60.

The Arrangement to which this Ruling applies

The Arrangement is an intra-group restructure of the Scales Consolidated Tax Group (Scales Group). The Arrangement involves a transfer of certain property-owning companies to a new holding company, George H Investments Ltd (GHI). Scales Corporation Ltd (SCL) will then distribute the shares in GHI, along with surplus cash, to its shareholders in an off-market share repurchase and cancellation (so that GHI is a sister company to the existing holding company).

Further details of the Arrangement are set out in the paragraphs below.

1. SCL has identified property assets and shares that are considered surplus to the ongoing requirements of the Scales Group. The Arrangement has the following three purposes:
   - The Arrangement will be undertaken to allow the capital represented by these surplus property assets and shares to be returned to current SCL shareholders. The assets identified are various land and buildings and a 10.3% shareholding in Turners & Growers Ltd (T&G).
   - The Arrangement will be undertaken because the Scales Group considers that the risk of ownership of these surplus property assets and shares could complicate a possible initial public offering (IPO).
   - The Arrangement will be undertaken because separating the core operating divisions of the Scales Group from other property and investment interests (not required in the operating divisions) will enable SCL to focus on the growth and development of the core operating divisions while GHI focuses on managing its property and other investments. The Scales Group considers this will maximise value, with any proceeds from asset realisations by GHI and GHI's newly acquired subsidiaries expected to be returned to shareholders as the relevant assets are realised.

Current Scales Group structure

2. Figure 1 in the Appendix sets out the current structure of the Scales Group.
3. All of the wholly-owned New Zealand companies, in Figure 1 in Appendix 1, are members of the Scales Group, except for Scales Property Development Ltd (SPDL) and Cashreal Properties Ltd (in liquidation). However, SPDL is wholly owned by Scales Holdings Ltd (SHL), which is a member of the Scales Group.

Summary of Arrangement

4. The following will occur before the distribution of GHI shares by SCL to its shareholders:
   - Some of the assets (being real property) that are surplus to the ongoing requirements of the Scales Group have been, or will be, sold to third parties. These sales are expected to raise about $9.3 million. Two further properties will be sold to other Scales Group companies.
   - Several options have been entered into to enable members of the Scales Group to acquire properties from GHI's newly acquired subsidiaries (for a fixed price based on their market value), until 31 December 2015.
   - GHI will purchase:
     - various intra-group loans; and
     - the shares in Tiger Ventures Ltd (TVL), SPDL, Silverstream Industrial Park Ltd (SIPL), and Whakatu Property Management Ltd (WPML).
   - The proceeds from the above transactions will be paid between Scales Group members as dividends or loan repayments.
   - There will be a 2 to 1 share split of all SCL shares issued (currently 39,864,002 shares).
5. The above share split will be followed by an off-market pro rata repurchase and cancellation of 50% of SCL's shares on issue in exchange for cash consideration (27 cents per share and $10.8 million in total) and one share in GHI for each SCL share (the demerger). The cash paid to shareholders will be sourced from the sales of the surplus properties.
6. The restructuring referred to above and how the demerger will occur are explained in more detail in paragraphs 7 to 57.

Pre demerger restructuring

George H Investments Ltd

7. GHI was incorporated on 5 December 2013. GHI will be part of the Scales Group from that date (although it may leave the Scales Group on an IPO). SCL will hold 100% of the shares in GHI until the demerger.
8. SCL will capitalise GHI with up to $52.6 million of new capital. SCL will fund the capitalisation of GHI by issuing GHI with assignable promissory notes for the amount of the capital. The capital may be less than $52.6 million, with GHI obtaining external debt funding to cover the difference, if it should be necessary to reduce the value of GHI so the total distribution to shareholders, on the share repurchase and cancellation, does not exceed the available subscribed capital of SCL. In this event, SCL expects to repay its borrowings (being working capital facilities provided by a third-party bank) by an equivalent amount. The Scales Group does not expect GHI's external debt funding, used to reduce the value of GHI, will exceed $4 million.

Whakatu Property Management Ltd

9. WPML owns land in Hawke's Bay (the Whakatu Industrial Park), one lot of which it is planning to subdivide into seven sections during 2014. WPML expects to apply for resource consent, to subdivide this land, in April 2014 and to complete this subdivision by December 2014.
10. WPML's parent entity Whakatu Coldstores Ltd (WCS) uses part of the Whakatu Industrial Park as part of its cold store business (lot 3). WPML will sell lot 3 to WCS at its market value (about $2.1 million) before the demerger. Title in that land will transfer to WCS in 2014 immediately on the completion of the subdivision. WCS will fund this purchase from its available working capital, including (as necessary) its bank working capital facility.
11. Until 31 December 2015, WCS will hold an option to acquire a second lot in the Whakatu Industrial Park (lot 12) from WPML for $370,000 (which is the market value of this lot). The option ensures WCS can acquire this land if it becomes required for its business before 31 December 2015.
12. WPML sold three further sections (Wool Scours) to a third party in December 2013 for a total of $2.2 million. The sale proceeds are being held in a trust account until title to these sections is issued.
13. The balance of the land in Whakatu Industrial Park is considered surplus to the Scales Group ownership requirements and will be retained in WPML when that entity is sold to GHI. The value of this land is expected to be about $9.6 million.
14. WPML has already sold a property in Dunedin to a third party. The property is leased to a Scales Group entity, Meateor Foods Ltd, for use in its business activities. This land was sold at market value ($1.7 million).
15. The above transactions and land holdings of WPML are summarised in the following table:

	Value ($m)	**Status**
WCS lot 3	2.1	To be sold
Meateor, Dunedin	1.7	Sold
Wool Scours	2.2	Sold
Residual land	9.6	Holding

16. WPML's parent entity, WCS, has an outstanding intercompany balance with WPML for about $5.5 million. After the above transactions, WCS will repay this amount to WPML. This outstanding intercompany balance is money lent after WPML and WCS were both part of the Scales Group. Further, WPML and WCS will remain in the Scales Group when WCS repays this loan to WPML.
17. The funds received from these land sales (about $4.3 million), along with the funds received from WCS (about $5.5 million, being repayment of the intercompany loan), plus some accumulated gains of about $0.5 million will be paid as a dividend (about $10.3 million), to WCS, before the demerger.

Scales Property Development Ltd

18. SPDL owns land in Hawke's Bay (Groome Place), part of which a Scales Group entity, Mr Apple Ltd, uses as part of its business activities.
19. In 2014, SPDL is planning to subdivide lot 5 Groome Place into five sections. SPDL expects to apply for resource consent, to subdivide this land, in March 2014. SPDL expects that the subdivision will be complete by December 2014. Until 31 December 2015, Mr Apple Ltd will lease two of these sections from SPDL on market terms. During this period, Mr Apple Ltd will also have an option to acquire either or both of these sections for $760,000 and $635,000 (the respective current market values of each section).
20. SPDL will retain the land SPDL owns when the entity is sold to GHI. This residual land's value will be about $5.2 million.

21. The above land holdings, by SPDL, are summarised in the following table:

	Value ($m)	Status
Residual land	5.2	Holding

Silverstream Industrial Park Ltd

22. SIPL owns industrial land and buildings in Mosgiel (Silverstream Industrial Park).

23. This land is considered surplus to the Scales Group's requirements. SIPL has subdivided and sold a portion of this land to a third party for $5.4 million. The settlement proceeds were temporarily advanced to another Scales Group entity, Polarcold Stores Ltd (PCL), which will repay them to SIPL.

24. The balance of the land in Silverstream Industrial Park will be retained by SIPL and held for future sale. This residual land's value will be about $12.5 million.

25. PCL owns a piece of bare land in Hornby, Christchurch (Canada Crescent), that is considered surplus to the Scales Group's requirements. SIPL will purchase this land before the demerger at the land's current market value (about $2.3 million). Until 31 December 2015, PCL will hold an option to reacquire this land from SIPL for $2.3 million (which is the market value of this land). This option ensures PCL can reacquire this land if it becomes required for its business before 31 December 2015.

26. The above transactions and land holdings by SIPL are summarised in the following table:

	Value ($m)	Status
Mosgiel	5.4	Sold
Canada Crescent	2.3	To be purchased
Residual land (excluding above)	12.5	Holding

27. The net funds received from the above transactions (about $3.1 million), plus some accumulated gains of about $0.4 million, will be paid as a dividend (about $3.5 million), to PCL before the demerger.

Tiger Ventures Ltd

28. TVL is a wholly-owned subsidiary of SCL. TVL was incorporated for the purpose of purchasing shares in Turners and Growers Ltd (T&G). TVL owns a 10.3% shareholding in T&G. These shares are the only asset TVL holds. TVL funded the purchase of shares in T&G through a loan from SCL. This loan is TVL's only liability.

29. The market value of TVL's shares in T&G (based on T&G's NZX trading price) is now less than the amount of the loan SCL advanced to TVL to fund the purchase. However, the combined shareholding may have an additional strategic value (which is difficult to value). As explained in paragraph 30, the consideration for the transfer of this loan, from SCL to GHI, will be the face value of the loan (the amount owing, which is about $22.9 million).

George H Investments Ltd purchases shares in various companies, and loans, from members of the Scales Group

30. Following the above transactions, GHI will acquire the following assets from the Scales Group:
    - In relation to TVL:
      - the shares in TVL, from SCL, for $1; and
      - a loan TVL owes to SCL, from SCL, for the amount owing of about $22.9 million.
    - In relation to SPDL:
      - the shares in SPDL, from SHL, for about $0.5 million; and
      - a loan SPDL owes to WCS, from WCS, for the amount owing of about $4.9 million.
    - In relation to SIPL:
      - the shares in SIPL, from PCL, for about $0.2 million; and
      - a loan SIPL owes to PCL, from PCL, for the amount owing of about $13.3 million.
    - In relation to WPML:
      - the shares in WPML, from WCS, for about $8.7 million.

31. All of the above loans are interest free, repayable on demand, and in New Zealand currency. Further, after the sale of the above loans to GHI, their terms will not change and these loans will remain fully repayable. No portion of these loans will be remitted either before or after GHI acquires these loans.

32. GHI will fund the above purchases by assigning the promissory notes SCL issued to it (up to $52.6 million in total). The recipients of these notes will use them to fund their transactions under the Arrangement (together with funds raised from selling properties to third parties and available working capital). The promissory notes are all finally paid or distributed to SCL under the Arrangement, at which point they will be cancelled (because SCL will be both the holder and the issuer of the notes).

Cash used to pay further dividends and repay another intra-group loan

33. After the above transactions, the Scales Group will pay further dividends and repay another intra-group loan with the cash received from the above transactions and the previous dividends (as detailed above).

Whakatu Coldstores Ltd

34. WCS will pay a dividend to PCL of approximately $16.3 million funded by the dividend received from WPML ($10.3 million), the sale of WPML shares ($8.7 million) and the SPDL loan ($4.9 million).

Polarcold Stores Ltd

35. PCL has a loan liability to SCL of $32.8 million as the result of various advances. PCL will repay this loan and pay a dividend of $2.8 million to SHL, a total of $35.6 million, which the above transactions will fund.

36. PCL (the borrower) and SCL (the lender) have been in the Scales Group for the whole term of the above loan. PCL and SCL will remain in the Scales Group when PCL repays this loan to SCL.

Scales Holdings Ltd

37. SHL will pay a dividend to its parent SCL of about $3.3 million funded by the sale of SPDL shares ($0.5 million) and the dividend from PCL ($2.8 million).

38. Figure 2 in the Appendix summarises the funding flows under the Arrangement.

Scales Corporation Ltd undertakes a demerger of the GHI group

39. SCL will then undertake the demerger of the new GHI group, from SCL, as explained below.

40. Before the return of capital, under the demerger, SCL will carry out a 2 to 1 share split of all SCL shares issued (currently 39,864,002 shares).

41. The demerger of the GHI group will then occur by way of a mandatory pro-rata buy back and cancellation by SCL of 50% of its shares. The shares will be cancelled wholly and not in part.

42. For every one SCL share cancelled, SCL shareholders will receive one GHI share (estimated value $1.36) and $0.27 cash (being solely the proceeds of the sale of assets identified as surplus to the Scales Group's requirements under the Arrangement).

43. The share repurchase and cancellation will allow capital represented by assets identified as surplus to requirements to be returned to SCL shareholders ahead of a possible IPO of SCL. If an IPO occurs, its primary purpose will be to allow existing shareholders access to an easily accessible market to increase the transferability of their shares. No plans exist to issue new shares if an IPO does not proceed. Any such potential share issue is not part of the Arrangement.

44. The return of capital is not intended to be a substitute for, or to replace, the payment of a dividend.

45. The total cash payment to SCL's shareholders on the share repurchase will be about $10.9 million and the total value of the GHI shares will be not more than $52.7 million.

46. Initially, SCL's and GHI's shares will be stapled. No decision has been made about when the shares might be de-stapled, except that if an IPO occurs, a de-stapling would occur at that point.

Structure of the Scales Group after Arrangement

47. Figure 3 in the Appendix shows the structure of the Scales Group after the Arrangement.

Available subscribed capital of Scales Corporation Ltd

48. The available subscribed capital of SCL was $63.6 million as at 31 March 2013 (at a minimum) and will be maintained at least at that level until the demerger.

Dividend history of Scales Corporation Ltd

49. Previous dividends SCL paid are shown in the following table:

Date	Amount of dividend ($)
December 2007	1,885,637
December 2008	2,157,025
November 2009	3,370,352
June 2013	8,107,668

50. Dividends were not paid between 2010 and 2012 because of financial pressure in this period. Instead profit was used to retire debt.

51. The Scales Group was sold to its current ownership group on 21 July 2011. Since then the group's financial position has improved such that the group could pay its first dividend since 2009 in June 2013.

52. The Scales Group does not have a formal dividend policy. However the Scales Group intends to pay the following dividends:

- a final dividend for the 2013 calendar year of $8 million; and
- a further dividend in the following year subject to the financial position of the Scales Group.

53. The company has historically maintained and is committed to re-establishing consistent dividend payments in the future.

Retained earnings balances of Scales Corporation Ltd and the Scales Group

54. The balances of retained earnings for SCL, SPDL and the Scales Group are set in paragraphs 55 to 57.

55. The balance of retained earnings of SCL are shown in the following table (brackets indicate negative balances):

Date	Level of retained earnings ($)
30 June 2009	(29,446,704)
30 June 2010	(23,168,048)
30 June 2011	(18,553,390)
31 December 2011	(22,988,518)
31 December 2012	(34,179,727)

56. The balance of the retained earnings of SPDL is shown in the following table (brackets indicate negative balances):

Date	Level of retained earnings ($)
30 June 2010	0
30 June 2011	(6)
31 December 2011	141,631
31 December 2012	(386,308)

57. The balance of the retained earnings of the Scales Group (on a consolidated basis) is shown in the following table:

Date	Level of retained earnings ($)
30 June 2009	53,065,421
30 June 2010	50,752,877
30 June 2011	66,604,876
31 December 2011	59,993,342 (restated)
31 December 2012	71,022,206

Subsequent plans after the demerger

58. Initially, none of the companies will leave the Scales Group.

59. GHI and GHI's subsidiaries (after the demerger) will progressively dispose of their assets to optimise value for the GHI shareholders. GHI's subsidiaries will repay the loans owed to GHI as funds are available and then be liquidated or amalgamated. These post-demerger transactions are not part of the Arrangement.

Tax effects of the Arrangement

60. The Applicants consider that the tax effects of the Arrangement are as follows:

a) All shares being transferred under the Arrangement are held on capital account by the transferors. They will also be held on capital account by the transferees. No income will arise, from the transfer of these shares, under s CA 1.

b) In relation to the subdivision of Whakatu Industrial Park into seven sections by WPML:

- The land (Whakatu Industrial Park Land) was purchased in 1995 and was not acquired for the purpose of disposal.
- The land is held on capital account and no income will arise, under s CA 1, from the sale of this land.
- Section CB 12 does not apply to the disposal of any of this land, because the land has been held for more than 10 years.
- Section CB 13 does not apply to the disposal of any of this land, because the subdivision of land will not involve significant expenditure.

c) In relation to the sale, of lot 3 Whakatu Industrial Park, by WPML to WCS:

- The sale price will be at market value.
- WPML will derive depreciation recovery income, of about $188,000, from the sale under subpart EE. This income will be excluded income under ss FM 8 and CX 60.
- WCS will be treated as having acquired the property on the date it was acquired by WPML for its cost to WPML and to have been allowed deductions of the depreciation loss that WPML has been allowed for the property under s FM 15.
- The expected sale price of $2.054 million will generate an associated party capital gain of $1.020 million. Under s CD 44(10B), this amount will not be included in WPML's capital gain amount for the purposes of the "available capital distribution" formula in s CD 44.
- Any income derived from the sale of lot 3 to WCS would be excluded income to WPML under ss FM 8 and CX 60.

d) In relation to the sale of the three sections (referred to in the Arrangement as the Wool Scours) by WPML, to unrelated parties, WPML will derive depreciation recovery income, of about $10,000, under subpart EE. This land is held on capital account, and no other income will arise from the sale of this land.

e) In relation to the sale of the Meateor, Dunedin, site by WPML to a third party:
   - The sale is complete and settlement occurred on 31 October 2013.
   - This land was held on capital account and no income arose under s CA 1.
   - WPML derived depreciation recovery income of about $180,000 under subpart EE.

f) In relation to the land, held by SPDL, at Groome Place, Hawke's Bay:
   - This land was acquired in June 2011 (from Mr Apple Ltd and WCS).
   - This land is held on revenue account, because SPDL carried on a business of property development when this land was acquired (and the land has been held for less than 10 years). Therefore, income will arise under s CA 1 for SIPL from any sale of this land.
   - The sale proceeds of any of this land in the future will be income under s CB 10(1).
   - Mr Apple Ltd has options, which will expire on 31 December 2015, to acquire either or both of two sections. If these options are exercised, the amount SPDL receives will be income under s CB 10(1).

g) In relation to the sale of the land and buildings in Mosgiel (Silverstream Industrial Park) by SIPL to third parties:
   - This land was acquired in August 2008.
   - This land is held on revenue account because SIPL was associated with a property developer when the land was acquired. Therefore, income will arise under s CA 1 for SIPL from any sale of this land.
   - The gain on sale of this land will be about $500,000. This gain on sale will be taxable under s CB 10(2).
   - SIPL will derive depreciation recovery income of about $80,000 under subpart EE.

h) In relation to the sale of land at Canada Crescent, Christchurch, by PCL to SIPL:
   - The sale price will be at market value.
   - This land is, and will continue to be, held on capital account. Therefore, any sale proceeds will not be income under s CA 1.
   - There are no buildings or other depreciable property. Therefore, PCL will not derive any depreciation recovery income on the disposal of this land under subpart EE.
   - PCL will have an option, which will expire on 31 December 2015, to buy back the land for $2.3 million (which is its market value).

i) The loans GHI will purchase are excepted financial arrangements for the lenders under s EW 5(10). Therefore, on the purchase of the loans by GHI, the lenders are not required to calculate a base price adjustment under s EW 29. The borrowers remain liable under those loans, so are not required to calculate a base price adjustment under s EW 29.

j) The sale of shares (in SIPL, WPML, TVL and SPDL) to GHI is on capital account. Therefore, no income arises from the disposal of those shares under s CA 1. If any income were to arise, then that income would be excluded income under ss FM 8 and CX 60.

k) SCL's shareholders will be treated as disposing of their shares when SCL repurchases them under its pro rata buy back and cancellation. Consequently, any shareholder who hold their SCL shares on revenue account will derive net income from the repurchase equal to the difference between the repurchase proceeds they receive and the cost of the shares that are repurchased from them.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) All SCL shares cancelled as part of the Arrangement will be ordinary shares of the same class issued by SCL, and the shares will each be cancelled in whole, not in part.

b) A "market value circumstance" (as defined in s YA 1) will not exist at the time of the share cancellation.

c) The aggregate of the amount payable, plus the market value of the GHI shares distributable, by SCL to its shareholders on account of the share cancellation will be less than the available subscribed capital of SCL.

d) The aggregate of the amount payable, plus the verifiable market value of the GHI shares distributable by SCL to its shareholders on account of the share cancellation will be at least 15% of the market value of all ordinary shares SCL issues at the time of the share cancellation being notified to SCL's shareholders.

e) SCL will continue to pay dividends after the capital reduction provided the financial performance of the Scales Group allows this.

f) All transactions in the Arrangement will be for market value and on arm's length terms with the possible exception of the purchase, by GHI, of the loan owned by TVL to SCL. In particular, any amount paid for or allocated to the sale of depreciable property under the Arrangement is equal to the market value of that depreciable property on the date of sale.

g) All of the companies in the Scales Group and SPDL are solvent, both in terms of their liquidity and balance sheet, except for TVL, which may be insolvent.

h) No material tax effects arise from the Arrangement other than those described in paragraph 60.

i) The Scales Group and SPDL will file its tax returns materially in accordance with the tax effects described in paragraph 60.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the conditions stated above and the qualification set out under "Taxation Laws", the Taxation Laws apply to the Arrangement as follows:

a) The entire amount distributed to SCL shareholders upon the pro-rata buy-back and cancellation of shares by SCL under the Arrangement is excluded from being a "dividend" (as defined in subpart CD) by s CD 22 of the Income Tax Act 2007.

b) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 January 2014 and ending on 31 December 2015.

This Ruling is signed by me on the 31st day of March 2014.

Dinesh Gupta
Director (Taxpayer Rulings)

APPENDIX: DIAGRAMS OF SCALES GROUP AND FLOW OF FUNDS UNDER THE ARRANGEMENT

Figure 1: Existing Scales Group structure

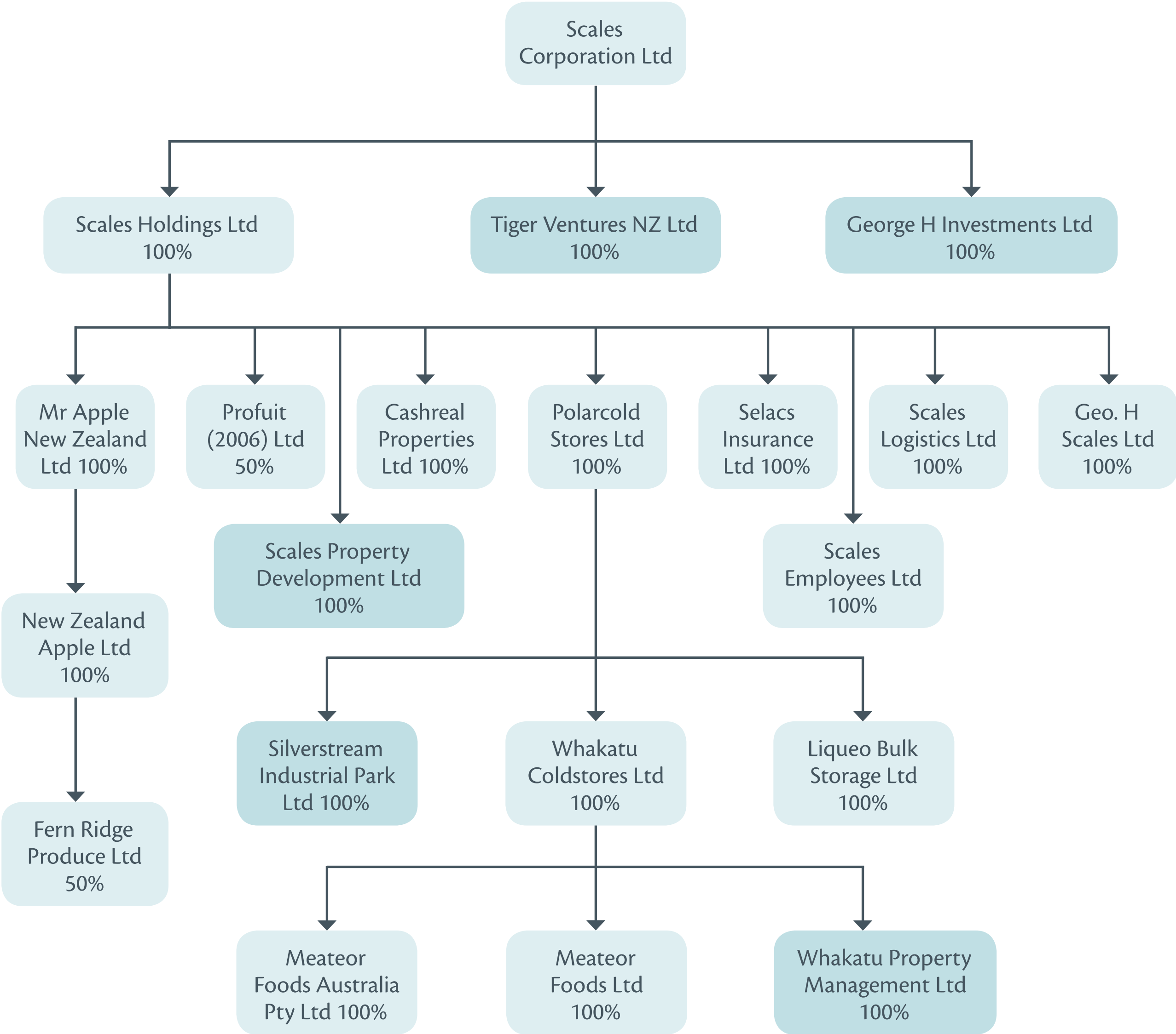


Figure 2: Flow of funds under the Arrangement (the numbers in **bold** indicate the order in which the transactions occur)

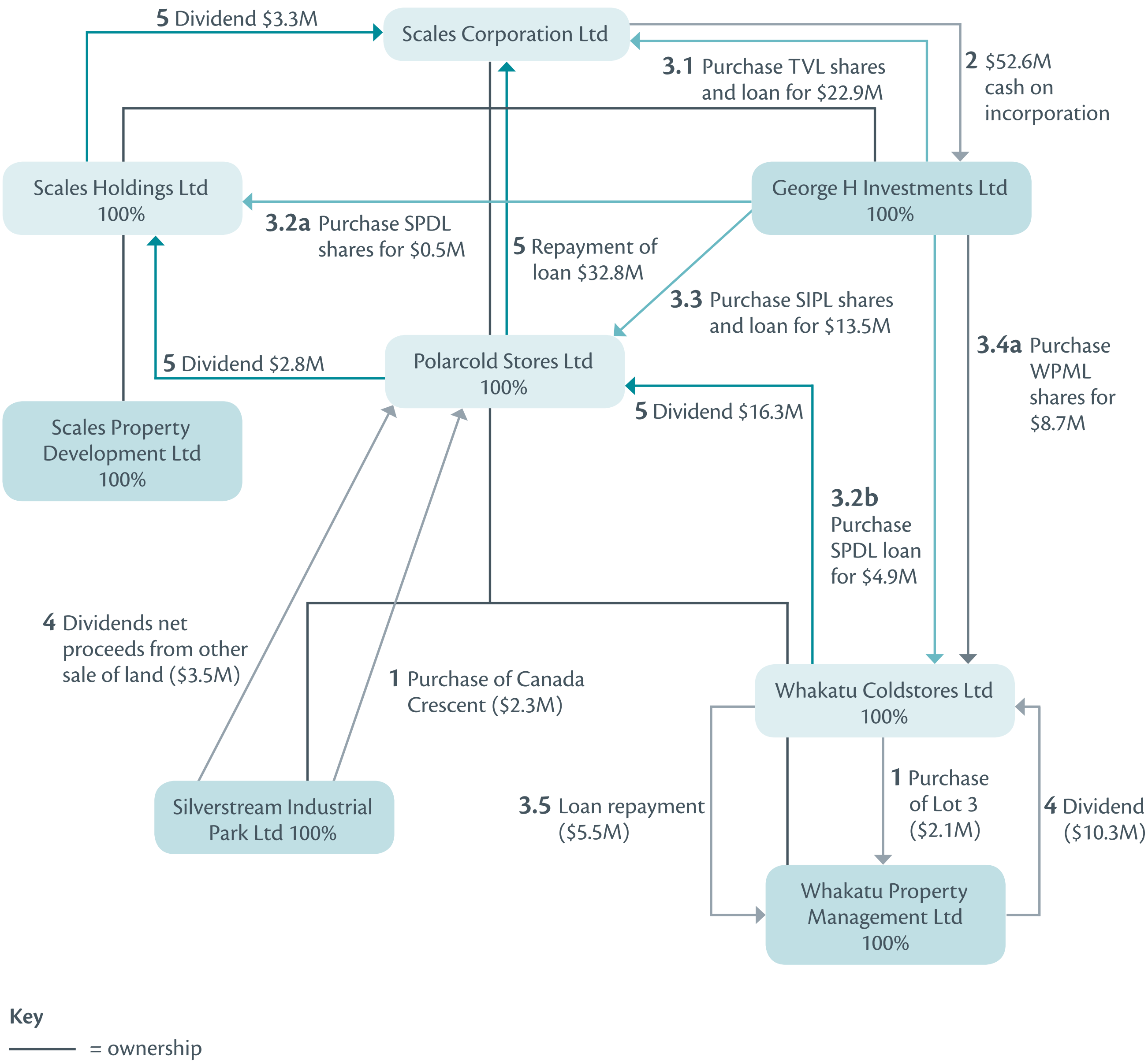
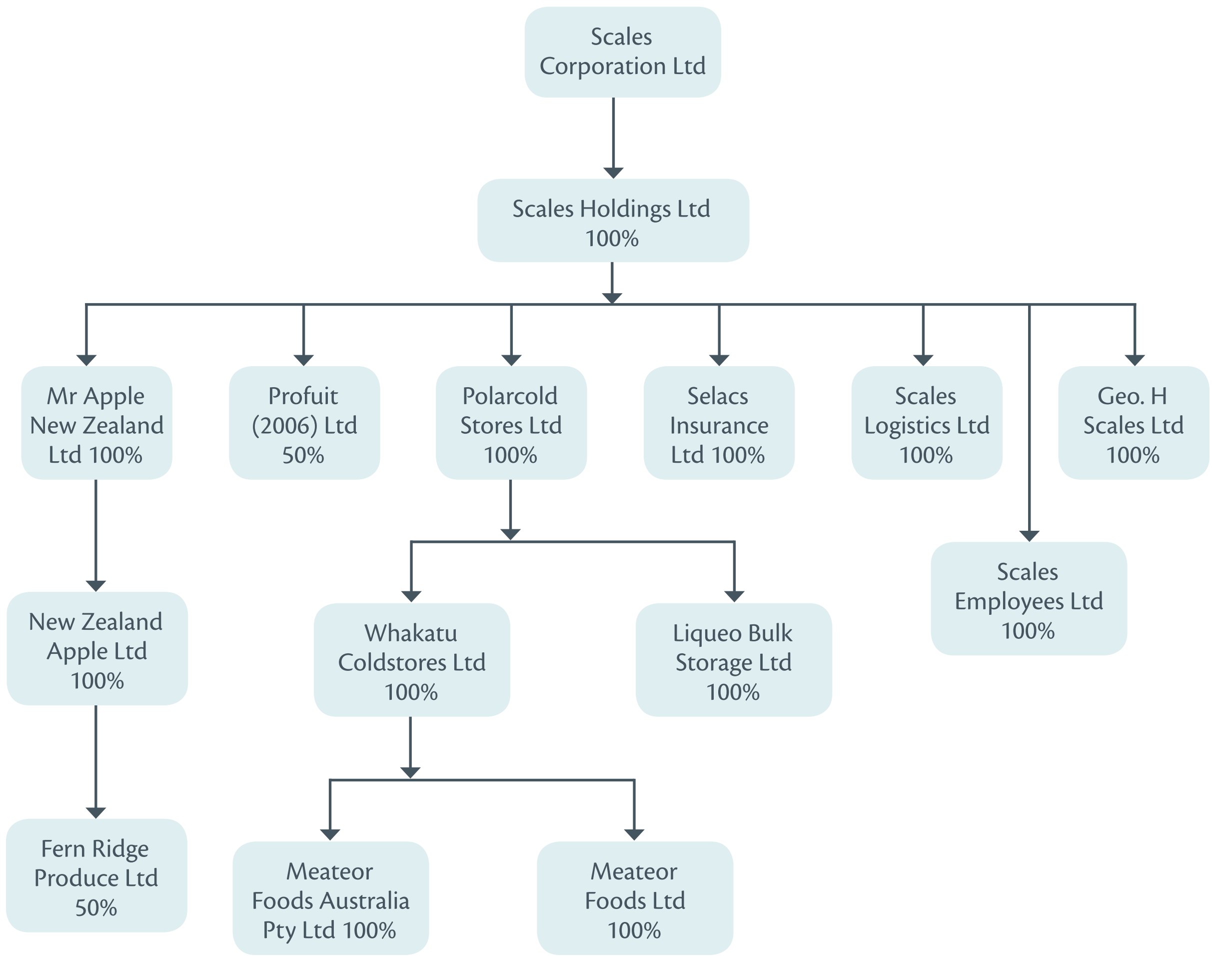
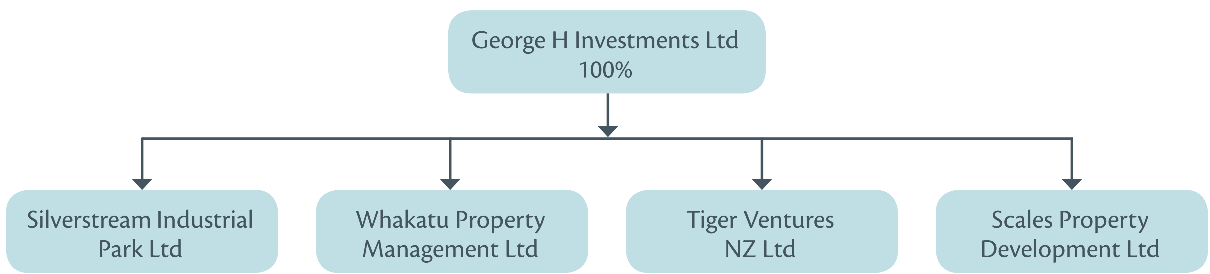


Figure 3: Scales Group and GHI (and subsidiaries) structure after the Arrangement

SCALES CORPORATION LIMITED COMPANY STRUCTURE



PROPERTYCO COMPANY STRUCTURE



LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

SPECIAL DETERMINATION S26: VALUATION OF SHARES ISSUED BY BANK FOLLOWING A TRIGGER EVENT

This determination may be cited as Special Determination S26: Valuation of Shares issued by Bank following a Trigger Event.

1. Explanation (which does not form part of the determination)

1. This determination relates to a funding transaction involving the issue of Notes by Bank to Issuer. The Notes will contain a conversion mechanism, in order to allow them to be recognised as Additional Tier 1 or Tier 2 capital for the purposes of the Reserve Bank of New Zealand (RBNZ) frameworks relating to the capital adequacy of banks.
2. Bank and Issuer will enter into a Deed Poll, which will set out the steps that will occur in the event that a Trigger Event occurs, requiring conversion of the Notes.
3. If a Trigger Event occurs, the relevant number of Notes may be immediately and irrevocably converted into ordinary shares in Bank.
4. The Arrangement is the subject of private ruling BR Prv 14/15 issued on 15 April 2014, and is fully described in that ruling.
5. The share subscriptions provided for in the Deed Poll are each a financial arrangement (as defined in s EW 3) and an "agreement for the sale and purchase or property or services" (as defined in s YA 1). The Notes and the share subscriptions are, together, a wider financial arrangement.

2. Reference

This determination is made under s 90AC(1)(i) of the Tax Administration Act 1994.

3. Scope of determination

1. This determination applies to a funding transaction involving the issue of Notes by Bank to Issuer. Bank and Issuer will enter into a Deed Poll, which will set out the steps that will occur in the event that a Trigger Event occurs, requiring conversion of the Notes into shares in Bank.
2. If a Trigger Event occurs, the relevant number of Notes may be immediately and irrevocably converted into shares in the Bank. In summary, the steps for the conversion of the Notes will be as follows:
   a) Each Note (subject to conversion) will become immediately due and payable and Bank will be required to repay the Face Value of the Note and, in the case of Tier 2 Notes, all accrued but unpaid interest on the relevant series of Tier 2 Notes, to Issuer.
   b) Under the terms of the Deed Poll, Issuer will be required to pay a sum to Bank equal to the face value of each Note converted and, in the case of Tier 2 Notes, all accrued but unpaid interest on the relevant series of Tier 2 Notes, to subscribe for ordinary shares in Bank.
   c) The number of ordinary shares in Bank to be subscribed for will be calculated in accordance with a formula set out in the Deed Poll.
3. This determination applies in the situation that shares are issued by Bank to Issuer following a Trigger Event, and the net tangible assets of Bank are positive immediately prior to the conversion of Notes into ordinary shares in Bank (such that the "NTA" item in the "Value per Share" formula as set out in the Deed Poll is not deemed to be NZ$1,000,000) to determine the value of the shares for the purposes of the financial arrangement rules.

4. Principle

1. The share subscriptions and the Notes are, together, a financial arrangement (as defined in s EW 3). The subscription for shares in Bank by Issuer contained in the Deed Poll is an "agreement for the sale and purchase of property and services" (as defined in s YA 1), as they are conditional agreements to acquire property.
2. The share subscriptions are not a "short-term agreement for sale and purchase" (as defined in s YA 1), as settlement will not occur within 93 days of the Deed Poll being entered into. As such, they are not excepted financial arrangements under s EW 5.
3. For the purposes of determining the consideration paid or payable under the financial arrangements rules, the value of the shares issued by Bank must be established under s EW 32. None of subs (3) to (5) apply to the share subscriptions.

4. Under s EW 32(6), the Commissioner is required to determine the value of the property. Both Bank and Issuer are required to use this amount.

5. Interpretation

In this determination, unless the context otherwise requires:

"Bank" means the bank issuing the Notes.

"Issuer" means a sister company of Bank.

"Trigger Event" has the meaning set out in the Deed Poll, as described in private ruling BR Prv 14/15, issued on 15 April 2014.

"Notes" means the Notes issued to Issuer as described in private ruling BR Prv 14/15, issued on 15 April 2014.

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

6. Method

1. The Arrangement does not involve the advancement or deferral of consideration.
2. For the purposes of s EW 32(6), the value of the shares issued by Bank is equal to the amount paid for those shares by Issuer where the net tangible assets of Bank are positive immediately prior to the conversion of Notes into ordinary shares in Bank (and not deemed to be NZ$1,000,000 in the "Value per Share" formula as set out in the Deed Poll).

7. Example

This example illustrates the application of the method set out in this determination.

> Following a Trigger Event, Notes with a face value of $100 are to be converted to ordinary shares in Bank. Bank immediately repays the face value of the Notes and, if the Notes are Tier 2 Notes, all accrued but unpaid interest on the relevant series of Tier 2 Notes, to Issuer.
>
> Issuer pays an amount equal to the face value of the Notes and, if the Notes are Tier 2 Notes, all accrued but unpaid interest on the relevant series of Tier 2 Notes, to Bank to subscribe for ordinary shares in Bank. Bank issues the number of shares to Issuer calculated in accordance with the formula set out in the Deed Poll. The value of the shares, for the purposes of s EW 32, is $100 plus, in the case of Tier 2 Notes, the amount of interest paid by Bank to Issuer upon conversion.

This Determination is signed by me on the 15th day of April 2014.

Fiona Heiford
Manager (Taxpayer Rulings)

DETERMINATION DEP87: DEPRECIATION RATE FOR TABLET COMPUTERS AND ELECTRONIC MEDIA STORAGE DEVICES (INCLUDING SMARTPHONES AND MP3 PLAYERS AND SIMILAR DEVICES)

This determination may be cited as "Determination DEP87: Tablet computers and electronic media storage devices (including smartphones and MP3 players and similar devices)".

1. Application

This determination applies to taxpayers who own items of depreciable property of the kind listed in the tables below.

This determination applies for the 2013–14 and subsequent income years.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994 I set in this determination the economic rate to apply to the kind of items of depreciable property listed in the table below by:

- adding into the "Computers" asset category, the new asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Tablet computers and electronic media storage devices (including smartphones, MP3 players and similar devices)	3	67	67

- adding into the "Leisure" industry category, the new asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
MP3 and similar devices, such as iPods and the like	3	67	67

- deleting from the "Office Equipment and Furniture" asset category, the asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Telephone (mobile)	3	67	67

- adding into the "Office Equipment and Furniture" asset category, the new asset class, estimated useful life, and general diminishing value and straight-line depreciation rates listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Mobile telephones, including smartphones	3	67	67

Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed by me on the 28th day of April 2014.

Sharyn Rea
LTS Manager, Technical Standards

GENERAL DEPRECIATION DETERMINATION DEP88: PET GROOMING AND CLEANING EQUIPMENT

Note to Determination DEP88

The Commissioner has set general depreciation rates for pet grooming and cleaning equipment by adding a new asset category of "Pet grooming and cleaning equipment". The new asset category applies only to services provided for the grooming and cleaning of domestic animals (including horses).

As the determination shows, the pet grooming and cleaning equipment consists of a number of components that have different useful lives. To date we have identified:

- Pet washers (portable);
- Pet dryer units (portable);
- Pet/animal vacuum clipper units;
- Pet/animal clippers.

An asset category default rate is also set, to provide for other equipment used for pet grooming and cleaning not listed above.

DETERMINATION DEP88: TAX DEPRECIATION RATES GENERAL DETERMINATION NUMBER 88

1. Application

This determination applies to taxpayers who own depreciable property of the kind listed in the table below.

This determination applies from the 2014 and subsequent income years.

2. Determination

Pursuant to section 91AAG of the Tax Administration Act 1994 the general determination will apply to the kind of items of depreciable property listed in the table below by:

- adding a new "Pet grooming and cleaning equipment" asset category, new asset classes, estimated useful lives, and diminishing value and straight line depreciation rates as listed below:

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Pet washers (portable)	8	25	17.5
Pet dryer units (portable)	5	40	30
Pet/animal vacuum clipper units	5	40	30
Pet/animal clippers	5	40	30
Pet grooming and cleaning equipment (default class)	8	25	17.5

3. Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed by me on the 7th day of May 2014.

Sharyn Rea
LTS Manager, Technical Standards

CPI ADJUSTMENT 14/01 FOR DETERMINATION DET 09/02: STANDARD-COST HOUSEHOLD SERVICE FOR CHILDCARE PROVIDERS

In accordance with the provisions of Determination DET 09/02, as published in *Tax Information Bulletin* Vol 21, No 4 (June 2009), Inland Revenue advises that, for the 2014 income year:

a) the variable standard-cost component will increase from $3.37 per hour per child to $3.42 per hour per child; and

b) the administration and record-keeping fixed standard-cost component will increase from $329 per annum to $334 per annum, for a full 52 weeks of childcare services provided.

The above amounts have been adjusted in accordance with the annual movement of the Consumers Price Index for the 12 months to March 2014, which showed an increase of 1.5%. For childcare providers who have a standard 31 March balance date, the new amounts apply for the period from 1 April 2013 to 31 March 2014.

CPI ADJUSTMENT 14/02 FOR DETERMINATION DET 05/03: STANDARD-COST HOUSEHOLD SERVICE FOR BOARDING SERVICE PROVIDERS

In accordance with the provisions of Determination DET 05/03, as published in *Tax Information Bulletin* Vol 17, No 10 (December 2005), Inland Revenue advises that the weekly standard-cost component for the 2014 income year, is retrospectively adjusted as follows:

a) The weekly standard-cost for one to two boarders will increase from $250 each to $254 each.

b) The weekly standard-cost for third and subsequent number of boarders will increase from $204 each to $208 each.

The above amounts have been adjusted in accordance with the annual movement of the Consumers Price Index for the 12 months to March 2014, which showed an increase of 1.5%. For boarding service providers who have a standard 31 March balance date, the new amounts apply for the period from 1 April 2013 to 31 March 2014.

NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK DETERMINATION 2014

This determination may be cited as "The National Average Market Values of Specified Livestock Determination, 2014".

This determination is made in terms of section EC 15 of the Income Tax Act 2007 and shall apply to specified livestock on hand at the end of the 2013–2014 income year.

For the purposes of section EC 15 of the Income Tax Act 2007 the national average market values of specified livestock, for the 2013–2014 income year, are as set out in the following table.

National average market values of specified livestock

Type of livestock	Classes of livestock	Average market value per head $
Sheep	Ewe hoggets	94.00
	Ram and wether hoggets	90.00
	Two-tooth ewes	131.00
	Mixed-age ewes (rising three-year and four-year old ewes)	118.00
	Rising five-year and older ewes	101.00
	Mixed-age wethers	79.00
	Breeding rams	257.00
Beef cattle	*Beef breeds and beef crosses:*	
	Rising one-year heifers	506.00
	Rising two-year heifers	799.00
	Mixed-age cows	986.00
	Rising one-year steers and bulls	614.00
	Rising two-year steers and bulls	933.00
	Rising three-year and older steers and bulls	1145.00
	Breeding bulls	2031.00
Dairy cattle	*Friesian and related breeds:*	
	Rising one-year heifers	946.00
	Rising two-year heifers	1616.00
	Mixed-age cows	1963.00
	Rising one-year steers and bulls	442.00
	Rising two-year steers and bulls	780.00
	Rising three-year and older steers and bulls	1040.00
	Breeding bulls	1398.00
	Jersey and other dairy cattle:	
	Rising one-year heifers	699.00
	Rising two-year heifers	1421.00
	Mixed-age cows	1782.00
	Rising one-year steers and bulls	399.00
	Rising two-year and older steers and bulls	690.00
	Breeding bulls	1255.00
Deer	*Red deer:*	
	Rising one-year hinds	164.00
	Rising two-year hinds	313.00
	Mixed-age hinds	380.00
	Rising one-year stags	210.00
	Rising two-year and older stags (non-breeding)	360.00
	Breeding stags	1341.00
	Wapiti, elk, and related crossbreeds:	
	Rising one-year hinds	198.00
	Rising two-year hinds	352.00
	Mixed-age hinds	397.00
	Rising one-year stags	230.00
	Rising two-year and older stags (non-breeding)	385.00
	Breeding stags	1403.00
	Other breeds:	
	Rising one-year hinds	105.00
	Rising two-year hinds	211.00
	Mixed-age hinds	229.00
	Rising one-year stags	140.00
	Rising two-year and older stags (non-breeding)	235.00
	Breeding stags	650.00
Goats	*Angora and angora crosses (mohair producing):*	
	Rising one-year does	51.00
	Mixed-age does	66.00
	Rising one-year bucks (non-breeding)/wethers	48.00
	Bucks (non-breeding)/wethers over one year	57.00
	Breeding bucks	328.00
	Other fibre and meat-producing goats (Cashmere or Cashgora producing):	
	Rising one-year does	51.00
	Mixed-age does	68.00

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Type of livestock	Classes of livestock	Average market value per head $
Goats (continued)	Rising one-year bucks (non-breeding)/wethers	50.00
	Bucks (non-breeding)/wethers over one year	56.00
	Breeding bucks	340.00
	Milking (dairy) goats:	
	Rising one-year does	400.00
	Does over one year	550.00
	Breeding bucks	250.00
	Other dairy goats	20.00
Pigs	Breeding sows less than one year of age	175.00
	Breeding sows over one year of age	235.00
	Breeding boars	335.00
	Weaners less than 10 weeks of age (excluding sucklings)	69.00
	Growing pigs 10 to 17 weeks of age (porkers and baconers)	136.00
	Growing pigs over 17 weeks of age (baconers)	211.00

This determination is signed by me on the 13th day of May 2014.

Sharyn Rea
LTS Manager, Technical Standards

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 14/02: INCOME TAX – ENTRY OF A NEW PARTNER INTO A PARTNERSHIP – EFFECT ON CONTINUING PARTNERS

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

This Question We've Been Asked is about ss HG 2, and YA 1 definitions of "dispose" and "partner's interests".

Question

1. We have been asked when the entry of a new partner into a partnership will have income tax consequences for continuing partners.

Answer

2. A taxable event is not triggered for continuing partners if a new partner simply "steps into the shoes" of an exiting partner and the continuing partners' interests in the assets of the partnership have not been changed.
3. However, there will be a taxable event for continuing partners if the addition of the new partner changes the continuing partners' interests in the partnership assets.
4. Where a taxable event arises for a continuing partner, the provisions of ss HG 5 to HG 10 then apply to determine whether the continuing partner needs to account for tax. If there is a disposal, then the partner will need to apply ss HG 5 to HG 10 to determine whether there is any tax payable. These provisions are safe harbour provisions that remove the need for a partner to account for tax when the required adjustment would be below certain thresholds.

Explanation

5. Under common law, the entry or exit of a partner to or from a partnership results in the dissolution of the old partnership and the formation of a new partnership. This could lead to tax consequences for continuing partners when a new partner enters a partnership, even where partnership interests are not changed.
6. In 2008 new tax rules for partnerships were introduced. These were intended to codify and clarify various aspects of the partnership rules. *Tax Information Bulletin* Vol 20, No 8 (September/October 2008) explained the new rules. The TIB contained the following statement:

   The introduction of a new partner into a partnership does not trigger a tax event for the existing partners. This is because the addition of a new partner would not result in a disposal of partnership property for an existing partner under s YA 1.

7. This statement could be seen as suggesting that the entry of a new partner into a partnership will never trigger a tax event for continuing partners and has created some uncertainty. We have, therefore, been asked to set out the Commissioner's position on this issue.

Partnerships are transparent

8. The Act treats partnerships as transparent. Section HG 2 gives effect to this. It deems everything done by the partnership to be done by the partners in proportion to their partnership share. Section HG 2(1) and (2) state:

   HG 2 Partnerships are transparent

   Look-through in accordance with share

   (1) For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise,—

   (a) the partner is treated as carrying on an activity carried on by the partnership, and having a status, intention, and purpose of the partnership, and the partnership is treated as not carrying on the activity or having the status, intention, or purpose:

   (b) the partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property:

   (c) the partner is treated as being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share, and the partnership is treated as not being a party to the arrangement:

   (d) the partner is treated as doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share, and the partnership is treated as not doing the thing or being entitled to the thing.

No streaming

(2) Despite subsection (1), for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

9. "Partnership share" is defined in s YA 1:

> **partnership share** means, for a particular right, obligation, or other property, status, or thing, the share that a partner has in the partnership.

10. Section HG 2 applies "unless the context requires otherwise". In the Commissioner's view nothing in the context of the provisions being considered in this item suggests that s HG 2 should not apply. Also, s HG 2 applies regardless of the particular terms of the partnership agreement (although the partnership agreement may set out what the partner's partnership share is). Consequently, where partnership assets are disposed of, the Act treats the disposal as being made by the partners.

11. An issue that arises when a new partner enters a partnership is whether there are tax consequences for the continuing partners. In particular, the issue is whether a continuing partner is treated as having disposed of partnership property when a new partner enters the partnership.

When a continuing partner "disposes" of partnership property

12. Under partnership law, when a partner leaves and/or a new partner enters a partnership, the original partnership is dissolved and a new partnership is formed. This would arguably have the effect of all partners disposing of (and, subsequently, reacquiring) their interests each time a partner leaves a partnership. However, the definition of "dispose" in s YA 1 means that this does not happen. "Dispose" expressly excludes the situation where a partner's interest is treated as disposed of by operation of law because another partner disposes of that partner's interests (unless the partnership is finally dissolved). It is noted that this QWBA does not cover the situation where a partnership is finally dissolved.

13. "Dispose" is relevantly defined in s YA 1 as:

> **dispose,—** …
>
> (h) for a partner,—
>
> (i) includes surrendering or extinguishing some or all of their partner's interests:
>
> (ii) does not include when their partner's interests may be treated as disposed of by operation of law because another partner disposes of that partner's interests, unless section HG 4 (Disposal upon final dissolution) applies

14. "Partner's interests" as defined in s YA 1:

> means the relevant interests in rights and obligations and other property, status, and things that a partner has as a result of applying section HG 2 (Partnerships are transparent)

15. "Dispose" is defined inclusively. Therefore, it also carries its ordinary meaning. The ordinary meaning of "dispose" is to "get rid of" (*Concise Oxford English Dictionary* 12th ed, 2011). This commonly includes disposals by way of sale or other transfer.

16. "Dispose" is also expressly defined to include "surrendering or extinguishing" some or all of a partner's interests. Neither "surrender" nor "extinguish" is defined in the Act. "Extinguish" is relevantly defined in the *Concise Oxford English Dictionary* as "to put an end to" "to render (a right or obligation) void". "Surrender" is relevantly defined as "give up (a person, right or possession) on compulsion or demand".

17. The ordinary meaning of "extinguish" implies that something ceases to exist. This does not seem to fit the current situations where partnership interests continue to exist (although they are held by a different person). However, it is considered that the ordinary meaning of "surrender" is wide enough to cover situations where a partner gives up some or all of their partnership interests to a new partner. It also covers both voluntary and involuntary situations.

18. Therefore, there will be a "disposal" for a partner if they sell, transfer, or surrender some or all of their interests in the partnership property (as determined under s HG 2). As noted above, a partner is treated as holding partnership property in proportion to the partner's partnership share.

19. For a continuing partnership, a disposal by one partner of their partner's interest will not automatically trigger a disposal by the remaining partners (s YA 1, paragraph (h)(ii) of the definition of "disposal").

Therefore, to be a "disposal" there must be some change in the partner's interest in the partnership property. If there is a "disposal" then the "safe harbour" provisions in ss HG 5 to HG 10 could potentially apply (see [24] below).

20. If a new partner purchases the partnership interests of an exiting partner, there will be an acquisition by the new partner and a disposal by the exiting partner. However, there will be no disposal by the continuing partners. This is because the continuing partners' "partner's interests" remain the same before and after the disposal by the exiting partner. This is illustrated by Example 1, below.

21. If a new partner purchases a share of the continuing partners' partnership assets, then there will be a partial disposal by those continuing partners. This is because those partners will have disposed of part of their partnership interests to the new partner. This is illustrated by Example 2, below.

22. The situation is less clear when a new partner introduces additional capital to the partnership. Take for example a partnership between X and Y where the only asset is land worth $200,000. Z joins the partnership by contributing funds of $100,000. It could be argued that nothing has changed for X and Y. Prior to Z joining the partnership, they each owned a 50% share of $200,000 worth of assets. They now each have a one-third share of $300,000 worth of assets. However, the Commissioner considers that the correct view is that X and Y have each disposed of part of their share of the partnership assets.

23. This is because, under s HG 2, X and Y were previously deemed to own a 50% share of the land. After the entry of Z into the partnership, X and Y are each deemed to own a one-third share of the land and a one-third share of the $100,000. The effect of s HG 2 is, therefore, that X and Y have each disposed of part of their share of the land to Z. This is illustrated by Example 3, below.

Consequences of disposition

24. If there is a disposal, then the partner will need to apply ss HG 5 to HG 10 to determine whether there is any tax payable. These provisions are safe harbour provisions that remove the need for a partner to account for tax when the required adjustment would be below certain thresholds.

25. The item applies to tax positions taken in the 2014–15 and later income years.

Examples

26. The following examples are included to assist in explaining the application of the law.

Example 1 – Exiting partner disposes of interest to new partner

27. Llama Farms Ltd and Reindeer Farms Ltd each have a 50% interest in a farming partnership. There are $1 million of assets in the partnership. Wallaby Farms Ltd purchases Llama Farms Ltd's share of the partnership for $500,000. Under the Act, Wallaby Farms Ltd is simply stepping into the shoes of Llama Farms Ltd. There are no tax consequences for Reindeer Farms Ltd because its interests in the partnership and the underlying net assets have not changed (that is, they remain at 50% of $1 million).

Example 2 – Entry of new partner dilutes interests of continuing partners

28. Chris and Jo are partners who each own 50% of a forestry partnership. The forestry partnership holds assets worth $5 million. A new partner, Alex, enters the partnership, purchasing $4 million of Chris and Jo's partnership assets. As a result, Alex's share in the partnership becomes 80%, and Chris and Jo's shares in the partnership have been reduced to 10% each. Applying a look-through approach (as required by s HG 2), Chris and Jo's individual interests in the underlying partnership assets have each been reduced from $2.5 million to $500,000.

29. Chris and Jo have, therefore, both disposed of some of their "partner's interests", as their interests in the underlying assets of the partnership have been reduced.

30. There will be a taxable event for Chris and Jo because Chris and Jo have disposed of some of the interests in the partnership assets to Alex. Chris and Jo would then need to determine whether they should account for tax according to the provisions of ss HG 5 to HG 10.

Example 3 – New partner introduces additional capital to the partnership

31. Jack and Nicky own a block of land worth $200,000. Applying the principle in s HG 2, Jack and Nicky each own 50% of the land. Their neighbour, Lisa, joins the partnership and contributes her adjoining land, worth $100,000, to the partnership. The result is that the partnership assets have increased to a total of $300,000.
32. As a result of Lisa joining the partnership, all partners now have a one-third share of the partnership, and each owns one-third of the underlying partnership assets. Applying the principle in s HG 2, Jack and Nicky have each sold part of their interest in the land that they own to Lisa, in exchange for a share of Lisa's land. There has been a disposal of the continuing partners' underlying assets, which results in an event that will have to be considered for taxation purposes if the land is on revenue account.

References

Subject references
Disposal; Partner's interests; Partnerships
Legislative references
Income Tax Act 2007 – ss HG 2, HG 5, HG 6, HG 7, HG 8, HG 9, HG 10, YA 1 ("dispose", "partner's interests")

QB 14/03: GST – TRANSFER OF INTEREST IN A PARTNERSHIP

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

This question we've been asked is about ss 2, 3, 5, 6, 8, 14, 51 and 57.

This item updates and replaces Question 108 published in *Public Information Bulletin* No 158, p 26 (November 1986) and an item entitled "GST Treatment of the Sale of an Interest in a Taxable Activity" published in *Public Information Bulletin* No 164, p 31 (August 1987). Both items deal with the GST treatment of the sale of an interest in a partnership. The current relevance of this information was identified during a review of content published in *Public Information Bulletins* and *Tax Information Bulletins* before 1996. The *Public Information Bulletin* review has now been completed, see "Update on *Public Information Bulletin* review" *Tax Information Bulletin* Vol 25, No 10 (November 2013).

This item covers the situation where an interest in a partnership is transferred from one partner to another, either new or existing, partner. It does not cover the situation where a new partner receives a partnership interest in return for a contribution to the partnership capital.

This item does not cover the GST consequences of a final dissolution of a partnership (including where a partnership is dissolved as the result of a partner acquiring all the interests of other partners).

Question

1. Is a transfer of an interest in a partnership subject to GST?

Answer

2. Most transfers of partnership interests will not be subject to GST as the supply will not be made by a registered person or, if the transferor is registered, will not be a supply made in the course or furtherance of a taxable activity carried on by the transferor.
3. A transfer will be subject to GST if the transferor is registered for GST and the transfer is a supply made in the course or furtherance of a taxable activity carried on by the transferor. In addition, the interest in the partnership must not be a "participatory security" or an "equity security". A transfer will be an exempt supply and, therefore, not subject to GST if the partnership interest is a "participatory security" or an "equity security".
4. Generally, a partnership interest will be a "participatory security" where entry into the partnership involves an investment of money (or money's worth), and where the partnership has more than five partners (or a manager (or person associated with the manager) who also manages another such arrangement).
5. A partnership interest will be an "equity security" where the partnership is a body corporate (for example, a limited partnership registered under s 51 of the Limited Partnerships Act 2008).

Explanation

6. Section 8(1) imposes GST on supplies of goods and services made in New Zealand. "Supply" includes all forms of supply (s 5(1)) and "services" are defined as "anything which is not goods or money" (s 2).
7. To be subject to GST a supply must be made by a registered person in the course or furtherance of a taxable activity carried on by that person. A person is a "registered person" if they are registered, or liable to be registered, under the Act (s 2). A person's liability to be registered turns on the value of supplies they make, or expect to make, in New Zealand in a 12-month period (s 51).
8. A "taxable activity" is an activity carried on continuously or regularly by a person and which involves, or is intended to involve, the supply of goods or services (s 6(1)). An activity is not a taxable activity to the extent it involves making exempt supplies (s 6(3)(d)).
9. A partnership (which is not a limited partnership) is the "relation which subsists between persons carrying on a business in common with a view to profit" (s 4 of the Partnership Act 1908). That relationship gives rise to an unincorporated body of persons that does not have a legal personality separate from its members. For GST purposes, an "unincorporated body" in s 2 means "an unincorporated body of persons, including a partnership". An "unincorporated body of persons" is also a separate "person" for the purposes of the Act. Therefore, a partnership is a separate "person" for GST purposes.
10. A supply is not subject to GST if it is an exempt supply (s 8(1)). "Exempt supplies" include supplies of financial services (s 14(1)(a)). "Financial services" include the "issue, allotment or transfer of ownership of an equity security or a participatory security" (s 3(1)(d)).

Application of s 57

11. Section 57(2) sets out some specific rules that apply when an unincorporated body carries on a taxable activity and is registered. Subsection (2)(e) says:

> Subject to subsections 3 to 3B, any change of members of that body shall have no effect for the purposes of this Act.

12. It has been suggested that this wording means that a supply of an interest in a partnership has no GST effect. That is not the Commissioner's view. The subsection refers to a change of members of a body. It is possible to have a transfer of a partnership interest without having a change of members. That will be the case when an existing partner transfers some, but not all, of their interest in a partnership to one or more of the other partners. In that case, the partnership interests have changed but the members of the partnership have not changed.

13. In the Commissioner's view, the reference to a change of members, rather than to changes of membership interests, indicates the intended scope of the provision. For GST purposes, a registered unincorporated body, including a partnership, is treated as continuing to be the same body despite a change of members. For example, if a partnership has 25 partners and two retire and one new partner joins, the change of members does not create a new unincorporated body for GST purposes. The partnership is treated as being the same registered person before and after the change of members. It is noted that a partnership that reduces to one partner (and, therefore, is no longer a partnership at general law) will also no longer be an "unincorporated body of persons" or a partnership for GST purposes.

14. Section 57(2) is still relevant to the transfer of an interest in a GST-registered partnership because:

    - members of a partnership cannot register in relation to carrying on the taxable activity carried on by a GST-registered partnership (s 57(2)(a)),
    - any supply made in the course of carrying on a partnership's taxable activity is treated as supplied by the partnership and not by the partners (s 57(2)(b)), and
    - any supply made by a partner in their capacity as a partner is treated as made by the partnership and not the partner (s 57(2)(c)).

15. Accordingly, if the only taxable activity a person is involved in is that carried on by a partnership, the person cannot register for GST. If a partner carries on another taxable activity in their own right, the supplies made by the partnership cannot be counted to determine whether the partner is liable to register for GST in their own right.

16. Even where a partner in a GST-registered partnership is registered for GST in their own right, because they carry on some other taxable activity, a supply by them of an interest in the partnership can be liable to GST only if the partner makes that supply in the course or furtherance of that other taxable activity (and it is not an exempt supply). That is, the partnership interest is held, and then transferred, in the course or furtherance of the taxable activity carried on by the partner. This could arise in situations where the taxpayer holds the partnership interest as part of a separate taxable activity carried on by that partner in their individual capacity. Alternatively, a partner could carry on a taxable activity of buying and selling partnership interests.

17. The supply made by the partner in such cases is of a partnership interest, which is a chose in action (and, therefore, a service). The supply is not the supply of a portion of the underlying assets held by the partnership. Consequently, the nature of the underlying assets does not affect the characterisation of the supply as exempt, standard-rated, or zero-rated. For example, the transfer of an interest in a land-owning partnership would not be zero-rated under s 11(1)(mb).

18. In summary, for a partner of a GST-registered partnership:

    - the partner is not liable to register for GST for the activities of the partnership,
    - any supplies made by the partnership do not count towards determining whether the partner has to register for GST in their own right, and
    - if the partner is registered for GST in their own right, a transfer of an interest in a partnership will be subject to GST only if it is a supply made in the course or furtherance of a taxable activity carried on by the partner (ie, not the partnership taxable activity) and is not an exempt supply.

19. The two potentially relevant types of exempt supplies in the context of partnerships are "participatory securities" and "equity securities". These are considered below.

Participatory security

20. "Participatory security" is defined in s 3(2) as:

> … any interest or right to participate in any capital, assets, earnings, or other property of any person where that interest or right forms part of a contributory scheme (as defined in section 2 of the Securities Act 1978); … but does not include an equity security, a debt security, money, or a cheque:

21. The Commissioner's view is that an interest in a partnership is an "interest or right to participate in any capital, assets, earnings, or other property of any person".

22. A partnership interest will not be an "equity security" (unless the partnership is a body corporate, for example, a limited partnership registered under s 51 of the Limited Partnerships Act 2008). A partnership interest is not a "debt security" as it is not a right to be paid money that is, or is to be, owing by any person. Further, a partnership interest is neither "money", nor "cheques".

23. "Contributory scheme" is defined in s 2 of the Securities Act 1978 as:

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

24. "Money" in s 2 of the Securities Act 1978 includes "money's worth".

25. The Commissioner's view is that a partnership interest will be a "contributory scheme" where it involves an "investment of money" and where the partnership meets the size threshold.

26. A partnership interest will involve an investment of money where partners lay out money (or money's worth) in the hope of return from the partnership (in the form of capital or income or both). The return could be in the form of cash, or in kind, such as the provision of services (see *Culverden Retirement Village v The Registrar of Companies* [1997] 1 NZLR 257 (PC)).

27. A partnership will meet the size threshold if it has greater than 5 partners or a manager of the arrangement (or an associated person) is a manager of another such arrangement.

Equity security

28. An "equity security" is "any interest in or right to a share in the capital of a body corporate" (s 3(2)). Accordingly the supply of an interest in a partnership that is a body corporate is an exempt supply and not subject to GST.

29. A limited partnership, registered under s 51 of the Limited Partnerships Act 2008, "is a separate legal person" (ss 6 and 11 of the Limited Partnership Act 2008). A limited partnership is deemed to be a "company" for GST purposes (see s 2 of the GST Act), although it is not specifically deemed to be a body corporate. "Body corporate" is defined in *Butterworths New Zealand Law Dictionary* (LexisNexis, 2011) as "an association of persons regarded in law as a single legal person". This is also consistent with the definition of "body corporate" in the *Shorter Oxford English Dictionary* (6th ed). The Commissioner's view is, therefore, that a limited partnership is a "body corporate" for the purposes of the Act.

30. Whether an interest in a limited partnership established in a foreign jurisdiction is an "equity security" will depend on whether that limited partnership is treated under that foreign law as a body corporate.

Examples

Example 1 – New partner joins partnership

31. Mary, Jane and Dave are equal partners in Sports Law, a GST-registered partnership. The partnership makes taxable supplies of around $500,000 per year. Jane carries on a part-time business as a personal trainer and makes supplies in that business of around $15,000 per year. Jane is not registered for GST. Dave owns a farm and is registered for GST for his farming activity. Mary is not registered for GST.

32. Bob, a senior employee of Sports Law, is invited to become an equal partner in the firm. Bob makes a cash payment to each of Mary, Jane and Dave. The effect of Bob joining the partnership is that Mary, Dave and Jane each transfer ¼ of their interest in the partnership to Bob. That is a supply made by each of them. These supplies are not subject to GST because they are not supplies made by a registered person in the course or furtherance of a taxable activity.

33. Mary is not required to be personally registered for GST for the partnership's taxable activity. Although Jane carries on a taxable activity, as a personal trainer, the supplies she makes in that activity are under the registration threshold. The supplies made by the partnership are not taken into account in determining whether Jane has to register. Dave is registered for GST but the supply of the partnership interest is not a supply made in the course or furtherance of his taxable activity of farming.

Example 2 – Sale of partnership interest and separate property

34. Robert, Helen and Bruce carry on practice as accountants through a GST-registered partnership. As senior partner, Robert has a 50% interest in the partnership. Robert also owns the building in which the partnership business is carried on. Robert is personally registered for GST for his taxable activity of renting out commercial buildings, including the building rented to the partnership.

35. Robert decides to retire and he agrees to sell his share in the partnership to Michelle. The sale agreement also includes the sale of the practice premises to Michelle.

36. The supply of the partnership interest from Robert to Michelle is not subject to GST. Although Robert is registered for GST, he does not make the supply of the partnership interest in the course or furtherance of his taxable activity (his rental activity). The supply of the building is subject to GST. The building is not a partnership asset. The building is Robert's separate property that he supplies to Michelle in the course of his taxable activity. As that is a supply of an interest in land, the correct GST treatment (ie, whether this supply is zero-rated) will depend on whether Michelle is registered, or liable to be registered, for GST and her intended use of the building.

Example 3 – Partner previously carried on partnership activity

37. Simon bought a farm and registered for GST. After two years of farming Simon entered into partnership with two of his children, Fiona and Diane. The partnership registered for GST and Simon sold the farming business, including the land, to the partnership. This supply was zero-rated, as it included a supply of land. Simon did not deregister for GST because he had recently started a part-time pest control business.

38. After another two years, Simon's son Brian returned from overseas and asked to join the partnership. By this stage Simon had decided to expand his pest control business into a full-time activity and he agreed to sell his partnership interest to Brian.

39. The sale of the partnership interest by Simon to Brian is not subject to GST. It is not a supply made in the course or furtherance of a taxable activity carried on by Simon. Although Simon originally registered to carry on the taxable activity of farming the land that was subsequently farmed by the partnership, Simon is not carrying on that activity when he transfers the partnership interest to Brian. Simon carries on a taxable activity of pest control and the partnership interest is not supplied in the course or furtherance of that activity.

References

Subject references
GST; Exempt supply; Partnership; Taxable activity; Taxable supply
Legislative references
Goods and Services Tax Act 1985 – ss 2, 3, 5, 6, 8, 14, 51 and 57
Limited Partnerships Act 2008 – ss 6, 11 and 51
Partnerships Act 1908 – ss 4, 8 and 27
Securities Act 1978 – ss 2 and 2D
Cases
Braemar Lodge 2004 Limited (in receivership) v Owers [2010] NZCA 300
Culverden Retirement Village v The Registrar of Companies [1997] 1 NZLR 257 (PC)
Murray v Morel & Co Ltd [2007] NZSC 27

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.

COMMISSIONER AWARDED INDEMNITY COSTS

Case	Accent Management Ltd/Lexington Resources Ltd v Commissioner of Inland Revenue
Decision date	14 April 2014
Act(s)	Companies Act 1993, Rule 14 High Court Rules, Income Tax Act 1994
Keywords	Indemnity costs, Trinity scheme, setting aside statutory demands

Summary

The High Court awarded indemnity costs in respect of an unsuccessful application by Trinity investors to set aside a statutory demand issued in respect of tax assessments confirmed by the Supreme Court.

Impact of decision

The Court found the plaintiffs' arguments to be groundless and unsupported, and that the history of the case justifies awarding indemnity costs. In doing so, reliance was made on the decision of the Court of Appeal in *Bradbury v Westpac Banking Corporation* [2009] 3 NZLR 400 (CA) ("*Bradbury v Westpac Banking Corporation*").

Facts

This decision relates to Justice Faire's judgment in *Accent Management v Commissioner of Inland Revenue* [2010] 24 NZTC 24,126, dismissing the plaintiffs' applications to set aside the statutory demands issued by the Commissioner of Inland Revenue ("the Commissioner"). The plaintiffs were participants in the Trinity tax avoidance scheme and the statutory demands they sought to set aside were issued in connection with assessments confirmed by the Supreme Court in *Ben Nevis Forestry Ventures & Ors v Commissioner of Inland Revenue* [2008] NZSC115; [2009] 2 NZLR 289.

Following the substantive hearing, his Honour left the costs issues for the parties to discuss. However, they were unable to agree on the cost issues and therefore the parties filed memoranda in support, opposition and reply setting out issues for determination.

Decision

Justice Faire first dealt with the plaintiffs' submission that costs should be reduced under rule 14.7 of the High Court Rules ("HCR"). This issue was linked to an application to admit further evidence to the effect that the defendant recklessly failed to disclose its knowledge of the existence, application and effect of section EH 8(1) of the Income Tax Act 1994 to procure orders of the hearing authority that did not represent the tax charge already imposed by Parliament. His Honour agreed with the Commissioner's submission that evidence regarding the application of section EH 8(1) was not relevant, and even if it were, the result would not have been different. His Honour further noted the Commissioner's submission that the same allegations had already been made and dismissed by the High Court twice and also by the Supreme Court.

The second issue was whether it was premature to award costs because the plaintiffs had filed an appeal to the Court of Appeal challenging this Court's jurisdiction. Justice Faire did not consider that it added anything to the first issue he had analysed and dismissed it for the same reasons.

His Honour then moved on to consider the defendant's submissions that costs on the applications should be made on a Category 2 Band B basis up until the date of the judgment in the related matter of *Bristol Forestry Venture Ltd v Commissioner of Inland Revenue* [2013] NZHC 2384 ("*Bristol*") and thereafter indemnity costs or increased costs were appropriate.

HCR 14.6 sets out the circumstances where increased or indemnity costs can be awarded. Justice Faire made reference to the case of *Hedley & Ors v Kiwi Co-operative Dairies Ltd* (2002) 16 PRNZ 694 (HC), where the Court noted that indemnity costs were awarded where truly exceptional circumstances exist. He noted that the Court of Appeal in *Bradbury v Westpac Banking Corporation* [2009]

3 NZLR 400, (2009) 19 PRNZ 385, approved this approach, and set out circumstances that are not listed in HCR 14.6, but in which the Court can exercise its discretion. These circumstances include fraud allegations made known to be false, misconduct that causes loss of time, commencing proceeding for some ulterior motive and prolonging a "hopeless case".

Justice Faire referred to the Commissioner's submissions pointing out the similarities (both legally and factually) between these proceedings and the *Bristol* and *Redcliffe Forestry Venture Ltd v Commissioner of Inland Revenue* [2013] NZHC 2818, (2013) 26 NZTC 21-041 ("*Redcliffe*") cases. His Honour agreed and considered there was no real distinction to justify a different conclusion to that reached in *Redcliffe* that the litigation history and groundless and unsupported arguments meant indemnity costs were appropriate on a number of the grounds in *Bradbury v Westpac Banking Corporation*.

Justice Faire concluded that there was a proper basis for awarding 2B costs up until 12 September 2013 and that thereafter costs on an indemnity basis should be awarded. Accordingly, his Honour ordered that the plaintiffs pay the defendant's costs in relation to both applications; in total a sum of $26,013.65 and disbursements of $2,529.26.

JUDICIAL REVIEW

Case	P v Commissioner of Inland Revenue
Decision date	14 April 2014
Act(s)	Judicature Amendment Act 1972, Tax Administration Act 1994
Keywords	Serious hardship

Summary

This case concerned an application for judicial review of the Commissioner of Inland Revenue's decision declining an application by Mr P for financial relief under section 177 of the Tax Administration Act 1994 ("TAA").

Impact of decision

The Court confirmed that with the introduction of subsection (1B) into section 177 of the TAA, the year-by-year analysis will no longer be open to the Commissioner of Inland Revenue ("the Commissioner"); a global approach is mandated. However, the subsection does not require the Commissioner to depart from the causation approach.

Taxpayers' late responses to the Commissioner's requests for further information must be treated as a new application for financial relief. Accordingly, it is necessary for the Commissioner to obtain updated information from taxpayers as to their financial position as at the date of the deemed application before making a decision whether or not to accept the taxpayer's application for relief under section 177 of the TAA.

Facts

The applicant is a self-employed professional who earned well in excess of $200,000 for each of the 2000–2007 tax years, with the exception of 2002, when he earned $190,000. He earned $215,000 in 2008, $182,000 in 2009, $132,000 in 2010, $347,000 in 2011 and $94,000 in 2012. Mr P has experienced significant health difficulties since the late 1980s. Mr P's wife also suffers from significant health issues.

Despite his not insignificant income, Mr P has frequently defaulted on his tax payments and has repeatedly fallen into arrears. He has claimed that his inability to meet his tax obligations is due to his health issues and on a number of occasions he has applied for financial relief under section 177 of the TAA.

Mr P again requested financial relief in July 2011 ("the July 2011 application"). This application was declined on 26 September 2011. Mr P then wrote to the Commissioner disputing the decision. The application was referred to one of the Commissioner's officers and then on 7 November 2011, it was again declined. In November 2011, the parties entered into an instalment arrangement. However, Mr P failed to pay any of the instalments agreed to.

In March 2012, Mr P in effect asked the Commissioner to reconsider his application for financial relief on the grounds of serious hardship ("the March 2012 application"). The Commissioner declined that application and it was recommended that debt recovery action be taken against Mr P. In July 2012, Mr P commenced judicial review proceedings against the Commissioner.

In September 2012, the Commissioner agreed to reconsider both the July 2011 application and the March 2012 application. On 30 May 2013 she requested further information from Mr P. The required information was mostly provided by Mr P on 1 July 2013, with a further tax return being provided on 3 July 2011.

Prior to a decision being made on the July 2011 and March 2012 applications, Mr P made a further application for relief based on the serious hardship provisions.

On 16 August 2013 the Commissioner wrote to Mr P declining his request for hardship.

Decision

Wylie J began his analysis of the issue by setting out the relevant statutory provisions of the TAA including section 177, which sets out the circumstances in which a taxpayer may apply for financial relief, and section 177A which defines "serious hardship".

In relation to section 177, his Honour's focus was on subsection (1B) (an amendment to section 177 that came into force in 2012) which requires the Commissioner to assess the taxpayer's financial position as at the date on which the application for financial relief is made.

Counsel for Mr P submitted that the introduction of subsection (1B) into section 177 changed the effect of the section. He argued that the introduction of subsection (1B) changed the previously applied "causation test" to a "prospective test" and that the focus is now on the taxpayer's ability to pay the tax assessed without financial difficulties at the time the application was made. In opposition, the Commissioner submitted that the "causation test" still applied.

Wylie J, in his analysis of subsection (1B), referred to the cases of *W v Commissioner of Inland Revenue* (2005) 22 NZTC 19,602 ("*W*") and *Larmer v Commissioner of Inland Revenue* (2010) 24 NZTC 24,016 (HC); [2011] NZCA 157, (2011) 25 NZTC 20-043 ("*Larmer*"), which considered section 177 prior to the introduction of section 177 (1B) and which both held that in determining whether a person is in serious hardship, it was necessary to consider the causes of that hardship. In the present case, Wylie J concluded that subsection (1B) was introduced to do away with the year-by-year approach and mandate a global approach. His Honour found that in accordance with subsection (1B) the Commissioner is required to consider the taxpayer's financial position at the date on which the application for financial relief is made. Subsection (1B) does not, however, either expressly or by implication, require the Commissioner to depart from the causation approach discussed in *W* and in *Larmer*.

In relation to the Commissioner's decision letter, Wylie J emphasised the absence of any express reference to Mr P's financial position as at the date of the application. Wylie J also considered that the decision letter was not clear as to which application was being considered. His Honour observed that the Commissioner's memorandum, which served as the background information upon which the Commissioner's decision was made, did not include any analysis of Mr P's financial position as at the date of the application. Further, he considered the letter appeared to be based on out-of-date information. Accordingly, his Honour concluded that the Commissioner had not abided with the relevant statutory provisions and had not, in her decision of 16 August 2013, considered Mr P's financial position as at the date on which his application for financial relief was made.

Further, his Honour found that the March 2013 application had been overtaken by a later application. Section 177(5) of the TAA states that if additional information is received out of date, that this information is to be considered an additional request. As Mr P did not respond to the request for further information that the Commissioner made on 30 May 2013 within the timeframe required (within 20 working days), his Honour found that a new application for financial relief was deemed to be made on 3 July 2013. It was on this date that Mr P provided, and the Commissioner received, the requested information.

Wylie J found the provision of this late information to be relevant because it meant that the Commissioner did not possess up to date information as to the applicant's financial position at the date of this deemed date of application. This was important as the Commissioner did not have, and could not know, Mr P's financial position as at the deemed date of the application, being 3 July 2013. The significance of this was that in an earlier statement of financial position as at 1 June 2013, one of Mr and Mrs P's properties was for sale which potentially could have impacted on the plaintiff's financial position and substantially reduced his mortgage outgoings.

His Honour noted that the provisions in section 177(5) are in his view odd and may enable a defaulting taxpayer to potentially abuse the process by providing requested information late and thereby obtaining a fresh application date. However, he did not suggest that to be the position in the present case.

In conclusion, his Honour held that the Commissioner had not properly applied the law as required by sections 177(1B) and (5). Wylie J referred to section 6(1) as requiring the Commissioner to use her best endeavours to protect the integrity of the tax system, recognising the right of taxpayers to have their liability determined according to the law, and the responsibility of those administering the law to do so according to law. His Honour held that that had not occurred in this instance and as a result the Commissioner had failed to take into account a relevant consideration, namely Mr P's financial position as at the deemed date of his application. The Court allowed Mr P's judicial review and set aside the Commissioner's decision.

The Court also directed that the orders made by Venning J prohibiting publication of Mr and Mrs P's names and his identifying particulars were to continue on a permanent basis.

It was Wylie J's preliminary view that costs should lie where they fall. However, if this view was not accepted, then any application for costs by Mr P was to be made within 10 days of the release of the reserved judgment. The Commissioner was to respond and the application would be dealt with on the papers.

STRIKE-OUT APPLICATION DISMISSED

Case	TRA 02/12; 2014 NZTRA 02
Decision date	15 April 2014
Act(s)	Tax Administration Act 1994
Keywords	Strike-out, stay, damages

Summary

The Taxation Review Authority ("TRA") rejected the disputants' application to strike out or stay the Commissioner of Inland Revenue's ("the Commissioner") defence to their challenge.

Impact of decision

The TRA in this decision confirmed the statutory process to challenge the correctness of assessments is as set out in section 138B and Part 8A of the Tax Administration Act 1994 ("TAA") as well as confirming the statutory role of the TRA.

Facts

Mr C and his family controlled the disputant companies, which are in the business of producing and publishing DVDs. The disputants are part of a group of separate companies, the others being administration companies.

Each of the companies is registered for goods and services tax ("GST"). The disputants were involved in a dispute with the Commissioner concerning GST claims arising from a number of supplies made to the disputants by the administrative companies in the group. The disputants filed GST returns on a monthly invoice basis, while the administration companies filed on a six-monthly payment basis. The Commissioner considered the disputants were part of a tax avoidance arrangement under section 76 of the Goods and Services Tax Act 1985 ("GST Act") involving mismatched inputs and output tax. She also disputed the value and content of the supplies between the administration companies and the disputants.

The disputants, having filed a Notice of Claim in January 2012 in the TRA challenging the Commissioner's decision, subsequently filed an application seeking the following orders:

a) strike out the proceedings; or

b) stay the proceedings; and

c) award costs/damages, or

d) alternatively if the proceedings are not struck out or stayed, that an order for the Notice of Proposed Adjustment to be reissued after proper investigation "where the applicants sit down with the disputant or a Special Conference Facilitation be carried out with a DVD player available Before the matter comes back to the TRA".

Decision

Striking out the proceedings

The disputants argued that the Commissioner has disclosed no reasonable grounds or evidence to support any claim of tax avoidance under section 76 of the GST Act and accordingly, an order striking out the challenge proceedings should be made.

In making this argument, the disputants relied on rule 2.50 of the District Court Rules 2009 ("DCR") and submitted that this rule gives the widest discretion for a strike-out application. The disputants argued that although it was the disputants who had brought the claim, the disputant companies were in reality defending themselves against the Commissioner's assessments.

The Commissioner submitted that the strike-out application was misconceived as the effect of granting the application would be to strike out the disputants' own proceedings, which would leave the assessments as they stand with tax to be paid by the disputants.

The TRA referred to section 138B and Part 8A of the TAA, which outline the disputes process to be followed, noted that the process to challenge the correctness of the Commissioner's assessments had been followed by the disputants and that that procedure was set down by statute. Judge Sinclair held that the TRA could not possibly treat the disputants as the defendant and consider the application on that basis. Instead, Judge Sinclair found that the disputants were required to put their case to the TRA for determination at a substantive hearing.

The TRA considered whether the Commissioner's defence to the disputants' challenge could be struck out under rule 2.50.1 of the DCR. In that regard, Sinclair J referred to the case of *Attorney-General v Prince and Gardiner* [1998] 1 NZLR 262 (CA) (endorsed by the Supreme Court in *Couch v Attorney-General* [2008] NZSC 45, [2008] 3 NZLR 725), which sets out the established criteria for strike-outs, and held that this was not a case where the Commissioner's defence was clearly untenable. Again, the TRA considered that whether or not the assessments were correct was a question for the substantive hearing and not for a strike-out application.

Stay of proceedings

Judge Sinclair outlined rule 2.50.3 of the DCR which allows the Court to stay a proceeding if the Notice of Claim does not disclose a reasonable cause of action, the proceeding is frivolous or vexatious, or is an abuse of the process of the court. Judge Sinclair went on to conclude that the grounds in rule 2.50.3 related to the disputants' claim and there was no allegation by the Commissioner that the Notice of

Claim does not disclose a reasonable cause of action, that the proceeding is frivolous or vexatious or is an abuse of process. Accordingly, as the proceedings were brought by the disputants and not by the Commissioner, rule 2.50.3 did not apply in this case.

Cost/damages

The TRA held that the disputants' claims for costs and damages for wasted time and expenditure, abuse of process, breach of natural justice and breach of contract/estoppel were not available in its jurisdiction.

The TRA stated that it could only award costs in limited circumstances where the Commissioner failed to appear for a hearing or where the objection/challenge was vexatious. The TRA concluded that neither of those circumstances applied in this case.

In terms of the damages claimed, the TRA referred to section 138P of the TAA which sets out its powers on hearing a challenge to an assessment. Judge Sinclair held that the TRA did not have power to award damages and even if it had jurisdiction, the causes of action would have to be fully pleaded and proceeded by way of a substantive hearing with witnesses giving evidence and the evidence being tested under cross-examination, as appropriate.

Reissue of the Notice of Proposed Adjustment

The TRA, in considering the disputants' argument, outlined its statutory role under the TAA and Taxation Review Authorities Act 1994 to hear and determine challenges to tax assessments. It held that its powers did not extend to directing the Commissioner to issue a Notice of Proposed Adjustment or recommence the dispute process. Judge Sinclair found this alternative application of the disputants also to be misconceived.

The TRA dismissed the disputants' application in its entirety.

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