Vol 27 No 9 October 2015

TAX INFORMATION *Bulletin*

CONTENTS

1 In summary

3 Interpretation statements

IS 15/01: Income tax – tax exempt scholarships and bursaries – s CW 36

24 Standard practice statements

SPS 15/01: Finalising agreements in tax investigations

31 Operational statements

OS 15/01: GST and the costs associated with mortgagee sales

Withdrawal of Operational Statement OS 007: Income tax treatment of certain expenditures on conversion of land from one farming or agricultural purpose to another

35 Legislation and determinations

Approval – Income tax – currency conversions for branches

Special Determination S40: Spreading method to be used by Infrastructure Provider in respect of the Provision of Services Agreement and valuation of shares issued under that Agreement

Determination FDR 2015/02: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund in the Harness Macro Currency Fund

Determination FDR 2015/03: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund

46 Legal decisions – case notes

The Commissioner's discretion to amend assessments – s 113 of the Tax Administration Act 1994

Validity of Commissioner's assessments

Amounts held to be dividends, employment income or income under ordinary concepts

Inland Revenue
Te Tari Taake

Classified Inland Revenue – Public
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.

Tax Information Bulletin available online only

The November edition of the *Tax Information Bulletin* will be the last printed edition. If you currently receive the *Tax Information Bulletin* in printed form it's easy to ensure you continue to receive it by subscribing to the email.

Subscribe now for the email so you don't miss out. Simply go to our website **www.ird.govt.nz/technical-tax/tib** and complete the subscription form, or read the *Tax Information Bulletin* online.

IN SUMMARY

Interpretation statements

IS 15/01: Income tax – tax exempt scholarships and bursaries – s CW 36 3

This interpretation statement sets out the Commissioner's view of how the exemption in s CW 36 of the Income Tax Act 2007 should be interpreted and applied. Section CW 36 exempts some scholarships and bursaries from income tax. This interpretation statement updates and replaces "Exempting a scholarship from income tax", *Tax Information Bulletin* Vol 5, No 6 (November 1993): 7.

Standard practice statements

SPS 15/01: Finalising agreements in tax investigations 24

This Standard Practice Statement sets out the principles and parameters for finalising agreements in tax investigations by resolving issues that may be in dispute.

Operational statements

OS 15/01: GST and the costs associated with mortgagee sales 31

This Operational Statement sets out the Commissioner's position on GST input tax claims in relation to the costs of sale associated with mortgagee sales. This item replaces Operational Statement OS 005 issued in April 2004. It confirms the Commissioner's view set out in that earlier statement and also confirms that there is no entitlement to claim GST input tax associated with the costs of a mortgagee sale under the "business to business" rules.

Withdrawal of Operational Statement OS 007: Income tax treatment of certain expenditures on conversion of land from one farming or agricultural purpose to another 34

Since OS 007 was published, the Commissioner has issued a number of statements that more accurately state the Commissioner's view. After reviewing all of these matters, OS 007 is now withdrawn with immediate effect and there are no plans to republish this statement.

Legislation and determinations

Approval – Income tax – currency conversions for branches 35

When converting foreign currency amounts to New Zealand dollars, the default method under the Act is to use the close of trading spot exchange rate. This item approves six alternative currency conversion methods and four foreign exchange rate sources for use by branches. A branch includes a foreign branch of a New Zealand entity's business or a New Zealand branch of a foreign entity's business. This item should help reduce compliance costs and provide taxpayers with greater certainty by confirming existing practice.

Special Determination S40: Spreading method to be used by Infrastructure Provider in respect of the Provision of Services Agreement and valuation of shares issued under that Agreement 40

This determination relates to a share incentive scheme established by a company under which a major customer commits to increase the volume of throughput which is processed by the company. If the customer achieves the growth targets the customer receives new shares in the company.

Legislation and determinations (continued)

Determination FDR 2015/02: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund in the Harness Macro Currency Fund 43

This determination was made on 21 September 2015. Any investment a New Zealand resident investor makes in the shares of the Harness Macro Currency fund are a type of attributing interest for which a person may use the fair dividend rate method to calculate foreign investment fund income for the 2016 and subsequent income years.

Determination FDR 2015/03: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund 45

This determination was made on 18 September 2015. Any investment a New Zealand resident investor makes in the units of the GMO Systematic Global Macro Trust are a type of attributing interest for which a person may use the fair dividend rate method to calculate foreign investment fund income for the 2017 and subsequent income years.

Legal decisions – case notes

The Commissioner's discretion to amend assessments – s 113 of the Tax Administration Act 1994 46

Charter Holdings Limited ("Charter Holdings") applied to judicially review a decision of the Commissioner of Inland Revenue ("the Commissioner") not to amend her assessment of its tax liability in the 2006 to 2012 tax years pursuant to s 113 of the Tax Administration Act 1994. The Commissioner considered that Charter Holdings should have engaged the statutory disputes and challenge procedure, and that its judicial review was a collateral attack on the validity of her assessments and therefore must be refused.

Validity of Commissioner's assessments 48

This is a preliminary hearing dealing with the disputant's challenge as to the validity of the Commissioner of Inland Revenue's assessments.

Amounts held to be dividends, employment income or income under ordinary concepts 49

This was a decision of the Taxation Review Authority ("the Authority") confirming that the Commissioner of Inland Revenue ("the Commissioner") had made an honest appraisal of the disputant's 2006 income tax. The Authority agreed with the Commissioner that amounts deposited into various business and personal bank accounts were the disputant's assessable income as dividends, employment income or income under ordinary concepts.

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 15/01: INCOME TAX – TAX EXEMPT SCHOLARSHIPS AND BURSARIES – S CW 36

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

Summary

1. Certain scholarships and bursaries are exempt income under s CW 36. This Interpretation Statement sets out the Commissioner's view of how s CW 36 should be interpreted and applied.
2. A scholarship is a sum of money, or its equivalent, granted to a person for the primary purpose of assisting them with their education where the recipient is selected on merit or some other criteria.
3. A bursary is a sum of money, or its equivalent, granted to a person meeting certain criteria (often needs-based) for the primary purpose of assisting the recipient with funding their education.
4. If a scholarship or bursary is an amount of income under a provision of Part C or under ordinary principles, then s CW 36 may exempt that scholarship or bursary from income tax. Not all scholarships or bursaries received by a person will be amounts of income.
5. If a student receives a basic grant or independent circumstances grant from StudyLink (Ministry of Social Development), then the exemption in s CW 36 does not apply to that grant, and the grant will be taxable under s CF 1.
6. When applying the exemption in s CW 36, the New Zealand courts' approach is to determine the true character of the scholarship or bursary by considering the agreement that gives rise to the payment and the surrounding circumstances. There is no single rigid test. In particular, the courts consider:
   - the relationship between the payer and the payee;
   - the contractual basis for the payment;
   - the conditions of the agreement; and
   - anything the payee is required to provide in return for the payment.
7. For the exemption to apply, the scholarship or bursary must be made for the dominant purpose of assisting with the recipient's education.
8. A bursary or scholarship is usually granted by a public body or an independent private body to enable the recipient to pursue their education. However, sometimes there may be a special relationship between the payer and the recipient. A special relationship may be where the parties are not independent of each other, so that the payer may have competing reasons for the payment being made (eg, an employment relationship).
9. A special relationship between the payer and the recipient may make it harder to demonstrate that the primary purpose of a payment is to assist with the recipient's education because there can be competing reasons for making the payment. Where no special relationship exists between the payer and the recipient, education assistance is more likely to be regarded as the primary purpose of the payment. This may be the case even where the recipient subsequently takes up employment with the payer.
10. Sometimes a scholarship or bursary may be granted on the condition the recipient provides services for, or on behalf of, the payer. This may not prevent a payment from being a scholarship or bursary so long as the true character of the payment is to assist the recipient's education and the payment is not made primarily for the payer's benefit.
11. If a payment is equivalent to an amount previously paid as salary or wages, this suggests the payment is simply a re-characterisation of salary or wages and not a scholarship or bursary.

12. The existence of a bonding arrangement between the payer and the recipient may not prevent the payment being a scholarship or bursary. The amount to be repaid as a bond compared with the amount paid to the recipient can be a relevant factor. If all of the payment is to be repaid if the contract is cancelled, this may indicate it is not a scholarship or bursary.
13. For the purposes of s CW 36, an "educational institution" is a society or organisation founded for the sole or main purpose of promoting education and that actively provides that education. Education involves the imparting of knowledge through a systematic formal course of learning. The institution may be located in New Zealand or overseas. In New Zealand, educational institutions include, but are not limited to, schools, universities, wānanga, polytechnics and industry training organisations.
14. "Attendance at", in the context of an educational institution, can be:
    - the student's physical presence at the location where the course is being held;
    - the student being enrolled and pursuing an educational course offered by the educational institution if it involves requirements other than physical presence; or
    - a combination of both the above.
15. A scholarship or bursary is derived by the student (ie, the person who is attending at the educational institution). Where the student is a school child the scholarship or bursary is not derived by the child's parents, even though the payment may be used by the parents to meet their child's education costs. This is because it is the student who has qualified for and been granted the scholarship or bursary, and the amount is paid to assist that student with their attendance at an educational institution.
16. This Interpretation Statement updates and replaces "Exempting a scholarship from income tax", *Tax Information Bulletin* Vol 5, No 6 (November 1993): 7. That item explains what criteria have to be met before a scholarship by an organisation to sponsor a student would be considered exempt from income tax under s 61(37) of the Income Tax Act 1976 (the predecessor to s CW 36).
17. The Interpretation Statement also refers to "Retraining payments made on employment termination – assessability", *Tax Information Bulletin* Vol 7, No 3 (September 1995): 6. That item deals with the income tax treatment of retraining payments made by an employer to an employee on the termination of employment. Generally, a retraining payment paid to a former employee will be salary and wages and not a scholarship or bursary that meets the requirements of s CW 36.

Introduction

18. If a person receives a scholarship or bursary that is an amount of income, the amount received may be exempt income under s CW 36.
19. The approach taken in this Interpretation Statement to understanding when a scholarship or bursary is exempt income under s CW 36 is to:
    - consider briefly the relevant legislation;
    - discuss the approach New Zealand courts have taken to determining whether payments are scholarships or bursaries and, therefore, exempt income under s CW 36; and
    - consider the individual requirements for a scholarship or bursary to be exempt income under s CW 36, in particular:
      - when a payment is income;
      - whether a payment is a student allowance;
      - what is a "scholarship or bursary";
      - what is an "educational institution"; and
      - what is "attendance at" an educational institution.

Background

20. The Commissioner has previously been asked whether particular scholarships or bursaries are exempt income under s CW 36. The Commissioner has issued several product rulings confirming that s CW 36 applies to particular scholarships and bursaries (see the Inland Revenue website, **www.ird.govt.nz/technical-tax/product-rulings**). This Interpretation Statement outlines how s CW 36 applies in a general context.

Analysis

Relevant legislation

21. Part C sets out what is income and subpart CW sets out what is exempt income. For an amount to be exempt income, there first needs to be an amount of income. Section BD 1(2) provides that:

    > An amount of income of a person is **exempt income** if it is their exempt income under a provision in subpart CW (Exempt income) or CZ (Terminating provisions)

22. Not all scholarships or bursaries received by a person will be an amount of income (and not taxable on that basis). However, if a scholarship or bursary is an amount of income under a provision of Part C or under ordinary principles, then s CW 36 may exempt that scholarship or bursary from income tax.

23. If s CW 36 applies to a scholarship or bursary, then, from a practical point of view, whether that scholarship or bursary is income does not need to be decided. For this reason, this Interpretation Statement only briefly outlines the general principles the courts have developed to determine whether a scholarship or bursary is an income receipt. Instead, the focus of this Interpretation Statement is on determining when a scholarship or bursary will meet the requirements s CW 36 and be exempt income.

24. Section CW 36 provides:

> **CW 36 Scholarships and bursaries**
>
> A basic grant or an independent circumstances grant under regulations made under section 303 of the Education Act 1989 is not exempt income, but any other scholarship or bursary for attendance at an educational institution is exempt income.

25. Section CW 36 is a long-standing provision originally enacted in 1940 as part of a set of exemptions introduced to ensure symmetry of treatment between the tax legislation and the social security legislation that existed at the time. Scholarship and bursary payments were exempted from social security contribution requirements, so it was considered appropriate to also exempt these payments from income tax.

26. One minor change was made to the provision in 1988 when basic grants and independent circumstances grants (commonly referred to as "student allowances") were introduced as part of the government's Youth Support package. At that time, the predecessor to s CW 36 (s 61(37) of the Income Tax Act 1976) was amended to clarify that these grants were not included in the exemption.

27. The provision was reworded as part of the Income Tax Act rewrite process, becoming s CW 29 of the Income Tax Act 2004, then re-enacted as s CW 36 of the Income Tax Act 2007. Originally, when the provision was introduced it required the amount to be derived "from any maintenance or allowance provided for or paid to that person in respect of his or her attendance at an educational institution in terms of a scholarship or bursary". Some of these words were removed by the rewrite and the exemption was restructured. However, the rewrite changes were not listed as an intended policy change in schedule 22A of the Income Tax Act 2004.

28. The Commissioner considers the rewrite process has not changed the meaning of what is now s CW 36. The provision still aims to exempt from tax a scholarship or bursary received by the recipient for their attendance at an educational institution.

New Zealand cases considering s CW 36

29. Before considering the individual requirements of s CW 36, this Interpretation Statement outlines how the New Zealand courts have approached the question of whether payments are scholarships or bursaries and, therefore, exempt income under s CW 36.

30. Several cases have considered s CW 36 and its predecessors. Two main principles can be drawn from these cases. Firstly, to determine whether there is a bursary or scholarship within s CW 36, the true character of the payment must be determined. This requires looking at the characteristics of the payment and its primary purpose.

31. Secondly, the courts have drawn a distinction between scholarships and bursaries that are exempt income under s CW 36 and payments made for other purposes, such as services provided by an employee. Many of the cases considering s CW 36 involve payments made by current or prospective employers to employees while the employees are studying. In this context, where an employment relationship exists between the payer and the recipient, the courts have highlighted that, if the true character of the payment is not for the purpose of education but is a payment of salary and wages, then the payment is not a scholarship or bursary within s CW 36.

32. The leading New Zealand case on the exemption from tax for scholarships and bursaries is the Court of Appeal decision in *Reid v CIR* (1985) 7 NZTC 5,176. The case did not concern an employee situation, but rather a trainee teacher enrolled at a teachers' training college. While studying at the college, the trainee teacher received a student teacher allowance paid fortnightly by the Wellington Education Board. As a condition of receiving the student teacher allowance, the taxpayer was required to enter into a bond agreement undertaking to repay all or part of the bond if he failed to complete the prescribed course and three years' service as a teacher following graduation.

33. The Court of Appeal held the student teacher allowance was income according to ordinary concepts but the exemption for scholarships and bursaries applied to exempt the payments from tax.

34. On the question of whether the student teacher allowance payments were income, Richardson J confirmed the view of Quilliam J in the High Court (*Reid v CIR* (1983) 6 NZTC 61,624) that the payments were income according to ordinary concepts, stating, at 5,183:

> The sums in question were **regular periodical payments made to the appellant to defray his expenses** while attending teachers' college full-time as a teacher trainee. They were paid to him for that purpose and were the whole or part of the receipts upon which he depended for that purpose. **They were not gifts. They were contractual payments to which the appellant was entitled so long as he performed his part of the bargain.** They were emoluments received in respect of and in return for his performance of the obligations of the studentship he had undertaken. It is implicit in sec 61(37) that at least some scholarship and bursary payments constitute income according to ordinary concepts, otherwise it would be unnecessary to exempt such income.
>
> [Emphasis added]

35. On the question of whether the payments were exempt income, the Court of Appeal overturned the High Court's decision and found that the student teacher allowance was exempt from tax. Richardson J found the student teacher allowance was a bursary. He reached this conclusion by determining the true character of the payment received, stating, at 5,184:

> The essential question is as to the **true character of the sums received by the appellant**. The answer is not to be found through the application of any single rigid test. It must be **derived from a consideration of all the circumstances**, some of which may point in one direction, some in another.
>
> [Emphasis added]

36. Richardson J considered the student teacher allowance was an exempt bursary despite being a contractual payment requiring the student to fulfil his course requirements and be available to serve as a teacher for three years after graduation. He went on to note that these types of conditions were not unusual for scholarships and bursaries, whether expressed in terms of expectation or binding obligation.

37. Somers J took much the same view as Richardson J and considered the payments were a bursary because they were paid to, and received by, a student to assist in their education and for the purpose of sustaining the student while furthering their education. The fact conditions as to service for a period after graduation were attached to the arrangement did not make the payments any less a scholarship.

38. Thorp J thought the student teacher allowance was a bursary based on an objective assessment of the true character of the payment received by the student, taking into account all circumstances relevant to determining the true character. He stated, at 5,191:

> To my mind, subsec (37) [s 61(37) of the Income Tax Act 1976, the predecessor to s CW 36], which provides the exemption with which we are now concerned, the exemption of income "derived by any person … in terms of a scholarship or bursary", is of the second type, and the question whether particular payments or income are of **that nature should be determined in an objective fashion, taking into account all circumstances relevant to determining their true character**.
>
> …
>
> Within the Commonwealth, the only decision located on the existence of exemption provisions is that in *FC of T v Hall*. There the test finally selected by *Rath J* to determine the classification of the payments to the physician was **whether they had as their real character payment for education as distinct from payment for specific work. It is my view that a similar pragmatic balancing operation is the proper approach in determining the character and purpose of the payments to the appellant.**
>
> There is no gainsaying that in some respects they had the character of payments by way of retainer, payments to secure rights for the payer rather than benefits for the payee. However, in **determining which purpose was dominant**, the matter which seems to me greatly in favour of the appellant is the minimal sum required to be repaid if the appellant failed to make himself available to the department after his graduation. His maximum obligation in that event was $600. By contrast, failure by him to complete the course could, in terms of reg 39(3) of the 1959 Regulations, render him liable to refund of all sums paid to him by way of allowances to the date of termination of his studies. **Had the department's principal purpose been to secure the appellant's future services rather than finance his education the penalty provided for breach of the covenant to accept employment after graduation would surely not have been less than that resulting from failure to complete the course.**
>
> [Emphasis added]

39. Thorp J considered that the principal purpose of the payment was to assist the recipient with obtaining educational qualifications. This was despite the conditions restricting the subsequent employment and activities of the recipient.

40. Several other decisions followed *Reid* (CA). The High Court considered the exemption did not apply in *CIR v Drew* (1988) 10 NZTC 5,060. The taxpayer, a recent school leaver, applied for a bursar position with the Post Office. He was awarded the bursary and entered into an agreement with the Post Office. The agreement provided he was to be employed as an accounting bursar and the Post Office would grant him assistance to undertake a course of study. The assistance involved a leave of absence from his bursar position to enable him to study for an accountancy degree. During this time he would receive financial

assistance determined by the Postmaster-General. The taxpayer was also bonded to work at the Post Office for five years after completing his degree or otherwise repay the sums paid to him reduced by the value of the actual services rendered by him.

41. During the early years of the agreement, the taxpayer was paid his ordinary salary when he worked and an annual bursary of $700 during each academic year. In 1982 the arrangement changed and the taxpayer was paid his full salary while he was studying and no bursary was paid. Despite this change in arrangement, the Taxation Review Authority, in *Case G56* (1985) 7 NZTC 1,247, found that the payments from 1982 were an exempt "bursary or scholarship". This was on the basis the taxpayer had been awarded the bursary for his university studies based on merit. The taxpayer had submitted his secondary school academic record when he applied for the position and was awarded the bursary after a successful interview process. The Commissioner appealed this decision.

42. Ellis J, on appeal in the High Court, followed the approach in *Reid* (CA) and concluded the principal purpose of the payments was to secure the services of the taxpayer and therefore the payments were not exempt, stating at 5,062:

> **In my view the principal purpose of the payments was to secure for the Postmaster-General the services of Mr Drew and in particular, his services when he had qualified. The secondary purpose of the payment was to assist Mr Drew in his education** and accordingly I am of the view that the receipt by him of $9,721.00 was taxable in his hands …
>
> ...
>
> In my view the Court has to consider **the character of the payments against the total background of the situation**.
>
> [Emphasis added]

43. Ellis J considered it relevant that the agreement described the taxpayer as an "employee" and that the taxpayer was working for the Post Office during the whole period of the contract and was paid his normal salary during this time. Ellis J found it difficult to accept the taxpayer would receive more while he was studying by virtue of receiving his salary tax-free. He also considered it relevant that the operation of the bond required the taxpayer to repay all of the money advanced, subject to a reduction for time actually served. These factors distinguished *Drew* from *Reid* (CA), where it was less evident that an employee-employer relationship existed.

44. *Case L30* (1989) 11 NZTC 1,181 had similar facts to *Drew*. The taxpayer was an employee of the Post Office when he was granted a scholarship. This scholarship entitled him to complete a university degree for two years on full pay on the same bonding terms as in *Drew*. The taxpayer tried to distinguish his situation from the facts in *Drew* on the basis that he was an existing employee (unlike the taxpayer in Drew who was recruited from secondary school) who was given an educational opportunity more as a reward for effort than was the case in *Drew*. This opportunity came at a greater financial cost to his employer. Keane DJ was not persuaded by these arguments.

45. Keane DJ considered the payments were income according to ordinary principles. He then went on to acknowledge that the assistance provided could aptly be called a scholarship because it was an award for effort and merit. However, he concluded that the payments needed to be for the purpose of education to be exempt, although he acknowledged this purpose may not be the exclusive purpose of the payment. On this basis, Keane DJ concluded that the employer's primary purpose was to assist the taxpayer to become a better equipped employee, where both the employee and employer reaped the benefits from the arrangement. Keane DJ considered the arrangement to be more like an employer's incentive scheme, rather than a scholarship or bursary paid for attendance at an education institution. For these reasons, Keane DJ did not consider the exemption in what is now s CW 36 applied.

46. Other cases that are similar to the facts of *Case L30* and where the courts have also considered the true nature of the payments were salary payments rather than a scholarship or bursary payment are *Case L35* (1989) 11 NZTC 1,218 and *Case M24* (1990) 12 NZTC 2,146.

47. *Case M66* (1990) 12 NZTC 2,371 concerned an engineering cadet who was employed by a construction company. While employed, he attended a technical institute full time for a period of 19 weeks as part of gaining his trade certificate in engineering. During this time he received his salary. These payments were considered to be salary paid under a contract of employment that included a requirement to complete the study and not a scholarship or bursary for attendance at an educational institution. Bathgate DJ again saw the conditions set out in the contract of employment as very important in determining the character of the payments received by the taxpayer and the character of the payments made by the employer. The same decision was reached in *Case P2* (1992) 14 NZTC 4,010 based on similar facts.

48. In *Case P17* (1992) 14 NZTC 4,115 the terms of the agreement were similar to those in *Case L30* except

that the taxpayer completed his study overseas. This did not alter the Authority's finding that the nature of the payments was contractual payments.

49. *Case P23* (1992) 14 NZTC 4,166 involved the situation of a prospective employee receiving financial assistance while studying. A grant was made to the taxpayer while he was studying. One of the terms of the grant was that the taxpayer work for the organisation that made the grant for nine months and one week on completion of the taxpayer's studies. During the study period, the taxpayer was offered and took up employment with the organisation that made the grant under a separate agreement. The Taxation Review Authority found that the financial assistance payments were not made for the purpose of securing the future services of the taxpayer because the subsequent offer of employment was in an area unrelated to the taxpayer's study. The true flavour of the agreement was the provision of financial assistance to enable the taxpayer to complete his studies. At the time the agreement was entered into the taxpayer did not have an employment relationship with the provider of the assistance. For these reasons, Willy DJ found on the facts that the payments of financial assistance received by the taxpayer while studying were exempt.

50. In *Case T46* (1998) 18 NZTC 8,311 the taxpayer was granted special leave on full pay by his employer to study at an American university for three years. The taxpayer had to sign a bond guaranteeing that he would return to New Zealand after completion of his study and work for the employer for 3.4 years or repay the amount (which could be reduced in proportion to service rendered). Barber DJ accepted that the principal purpose of the overseas study arrangement was education-related. However, he did not think this overcame the fact the arrangement was an extension of the taxpayer's employment. The employment relationship did not significantly change during the special leave period, even though the taxpayer did not receive some entitlements during that period. The purpose of the arrangement was primarily to retain a highly qualified staff member.

51. These cases show that New Zealand courts have consistently looked to assess the true character of these types of payments by looking at the agreement that gives rise to the payment and the surrounding circumstances. The courts have considered, in particular, the relationship between the payer and the payee, the contractual basis for the payments, the conditions of the agreement(s) and anything the payee is required to provide in return for the payments. The cases show that where an employer pays for an employee to undertake study while employed and the employee receives study assistance equivalent to the employee's salary, then it is unlikely the payment will be exempt under s CW 36. This is because payments that have the character of salary or wages are not a bursary or scholarship to attend an educational institution. For a payment to be a scholarship or bursary it must be made for the dominant purpose of assisting with the recipient's education.

52. The Commissioner notes the above cases considered the exemption provision at a time when it still referred to "any maintenance or allowance … in terms of a scholarship or bursary". While s CW 36 no longer contains this reference, the Commissioner considers the above cases to be useful guidance on how s CW 36 is applied.

Principles drawn from the New Zealand cases

53. The courts have established that to determine whether a payment is a scholarship or bursary within s CW 36, the true character of the payment must be determined. In particular, for a payment to fall under s CW 36, the primary purpose of the payment must be to assist the recipient's education. This is determined by considering all the circumstances of the particular case. Usually no one single factor is dominant or conclusive. In reaching their decision, the courts consider such factors as any special relationship between the payer and the payee, the contractual basis for the payment, the conditions of the agreement(s) and anything the payee is required to provide in return for the payment. A special relationship may be where the parties are not independent of each other, so that the payer may have competing reasons for the payment being made (eg, an employment relationship). Further, the fact a payment is called a scholarship or bursary is not determinative of its nature. Similarly a payment referred to as an award or fellowship, may in fact be a scholarship or bursary.

54. The courts have most frequently considered the true character of scholarship or bursary-type payments where employment has been the special relationship between the payer and the recipient. In the employment context, the question is whether the true character of the payments is that of a scholarship or bursary within s CW 36 or whether they are salary and wages in the context of an employment relationship. In the Commissioner's view, the courts would take the same balanced approach to considering the true character of scholarship or bursary-type payments if there were a different type of special relationship between the parties. The primary purpose of the

payment must always be to assist the recipient's education.

55. The following factors have been extracted from the cases as being relevant when determining whether the true character of a payment is a scholarship or bursary for the purposes of s CW 36:

- There is no single rigid test. All circumstances relevant to determining the true character of the payment are to be taken into account. This may include considering any special relationship between the payer and the recipient, the contractual basis for the payment, the conditions of the agreement(s) and anything the payee is required to provide in return for the payment.
- The fact of an existing or a continuing employment contract between the payer and the recipient is a significant and important factor in determining the character of the payment received.
- Determining whether the primary purpose of the payment is to secure rights for the payer (eg, future services of the payee) rather than benefits for the payee is a relevant factor.
- If the amount paid for the study period equals the amount that was previously paid as salary, this suggests the salary and wages have simply been re-characterised as a scholarship or bursary, so will not be exempt income.
- The existence of a bonding arrangement in itself does not mean the payment is not a scholarship or bursary.
- The amount to be repaid as a bond compared with the amount paid to the recipient can be a relevant factor. If all of the money advanced is to be repaid if the employee cancels the contract, this may indicate payment for employment.
- Where no special relationship exists between the payer and the recipient at the time the agreement to provide financial assistance is entered into, the education of the recipient is more likely to be regarded as the primary purpose of the payment. This may be the case even where the recipient subsequently takes up employment with the payer.

Requirements of s CW 36

56. Having considered the courts' approach to deciding whether a payment is a scholarship or bursary for the purposes of s CW 36 and the words of the provision, the following questions establish whether a payment meets the particular requirements of s CW 36:

- Is the payment income?
- Is the payment a student allowance?
- Is the payment a "scholarship or bursary"?
- Is the recipient attending an "educational institution"?
- Is the payment for the recipient's "attendance at" an educational institution?

Is the payment income?

57. As mentioned, this Interpretation Statement only briefly outlines the general principles the courts have developed for determining whether a scholarship or bursary is an amount of income. This is because, from a practical perspective, whether the scholarship or bursary is income does not need to be considered in detail if the other requirements of s CW 36 are met. The main focus of this Interpretation Statement is on whether the payment is a bursary or scholarship that is exempt income under s CW 36 and not whether the payment is income in the first instance.

58. However, for the sake of completeness it is noted that not all scholarships and bursaries will be income in the hands of the recipient. For example, a scholarship awarded to a school child to attend a particular school might be a capital receipt (and not income under ordinary concepts) to the child and therefore not taxable income on that basis.

59. Part C sets out what amounts will be amounts of income. Section CA 1 provides the following general rule for establishing whether an amount is income:

> **CA 1 Amounts that are income**
>
> *Amounts specifically identified*
>
> (1) An amount is income of a person if it is their income under a provision in this Part.
>
> *Ordinary meaning*
>
> (2) An amount is also income of a person if it is their **income under ordinary concepts**.
>
> [Emphasis added]

60. Therefore, an amount will be income if it is income under one of the provisions of Part C. Part C is effectively a list of amounts that are treated as being amounts of income. Alternatively, an amount will be income if it is "income under ordinary concepts".

61. The phrase "under ordinary concepts" is not defined in the Act. However, the courts have considered the meaning of what is income "under ordinary concepts" in several cases.

62. It is generally accepted that income is something that "comes in" (ie, it is income in the hands of the taxpayer). In *Tennant v Smith* [1892] AC 150, the taxpayer's accommodation in his employer's premises where he was required to live was held to not be income, as the taxpayer received no amount. This was because the benefit could not be converted to

cash; it merely saved the taxpayer from having to pay for accommodation. This decision was cited with approval in the High Court judgment in *Reid*.

63. In *Scott v C of T* (1935) 35 SR (NSW) 215 (NSWSC), at 219 Jordan CJ observed, at 219 that:

> [T]he word "income" is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind except insofar as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts.

64. Justice Richardson cited this excerpt with approval in the Court of Appeal in *Reid*. After citing Jordan CJ, Richardson J said, at 5,183:

> There may be difficulty in marginal cases in determining what are the ordinary concepts and usages of mankind in this regard and to assist in that determination there has been much discussion in the cases of criteria which bear on the characterisation of receipts as income in particular classes of case. **The major determinant in many cases is the periodic nature of a payment** (*FC of T v Dixon* (1952) 86 CLR 540; and *Asher v London Film Productions* [1944] 1 All ER 77). **If it has that quality of regularity or recurrence then the payments become part of the receipts upon which the recipient may depend for his living expenses**, just as in the case of a salary or wage earner, annuitant or welfare beneficiary. But that in itself is not enough and **consideration must be given to the relationship between payer and payee and to the purpose of the payment, in order to determine the quality of the payment in the hands of the payee**.
>
> [Emphasis added]

65. According to Richardson J, the major determinant in many cases is the periodic nature of a payment. If payments have that quality of regularity or recurrence then they become part of the receipts on which the recipient may depend for their living expenses. However, that factor would not be enough on its own. Consideration must also be given to the relationship between the payer and the payee, and to the purpose of the payment. It is the quality of the payment in the hands of the recipient that is important.

66. The importance of considering the quality of the payment in the hands of the recipient was also emphasised in *FCT v Harris* 80 ATC 4238 (FCA), where the Australian Federal Court said at 4,240 to 4,241:

> Whether or not a particular receipt is income depends upon its quality in the hands of the recipient (*Scott v. F.C. of T.* (1966) 117 C.L.R. 514 at p. 526). The motives of the donor may be relevant but are seldom, if ever, decisive (*Scott v. F.C. of T.*, supra, at p. 526; *Hayes v. F.C. of T.* (1956) 96 C.L.R. 47 at p. 55). The regularity and periodicity of the payment will be a relevant though generally not decisive consideration (*F.C. of T. v. Dixon* (1952) 86 C.L.R. 540 at p. 568). **A generally decisive consideration is whether the receipt is the product in a real sense of any employment of, or services rendered by the recipient, or of any business, or, indeed, any revenue producing activity carried on by him** (*Squatting Investment Company Ltd. v. F.C. of T.*, supra, at p. 633; *Hayes v. F.C. of T.*, supra, at pp. 56-57; *Scott v. F.C. of T.*, supra, at pp. 527-528; cf. *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144; A.L. *Hamblin Equipment Pty. Limited v. F.C. of T.* 74 ATC 4001 at p. 4010).
>
> [Emphasis added]

67. Hill J in *FCT v Hyteco Hiring Pty Limited* 92 ATC 4,694 (FFCA), at 4,700, also considered that while regularity of receipt may often indicate that particular amounts are income, regularity alone will seldom be determinative. He considered that something more is required, "such as that the receipts be intended by the payer to be used by the recipient for regular expenditure and be relied upon by the recipient". He also noted that a single payment may also be income, despite it not being repeated.

68. In addition, a payment that is a gift in the ordinary sense will be income if it is so related to an income-earning activity as to be a product of the income-earning activity. In *Hayes v FCT* (1956) 11 ATD 68 (HCA), Fullager J, at 72:

> A voluntary payment of money or transfer of property by A to B is prima facie not income in B's hands. If nothing more appears than that A gave to B some money or a motor car or some shares, what B receives is capital and not income. **But further facts may appear which show that, although the payment or transfer was a "gift" in the sense that it was made without legal obligation, it was nevertheless so related to an employment of B by A, or to services rendered by B to A, or to a business carried on by B, that it is, in substance and in reality, not a mere gift but the product of an income-earning activity on the part of B, and therefore to be regarded as income from B's personal exertion.**
>
> [Emphasis added]

Summary of income concepts

69. Some key principles from the above cases concerning income under ordinary concepts are:
    - Income is something that "comes in" (*Tennant v Smith, Reid* (HC)).
    - Whether or not a particular receipt is income depends on its quality in the hands of the recipient (*Reid* (CA)).

- The periodic nature of payments made is the major determinant in many cases. Regularity or recurrence indicates that payments may become part of the receipts the recipient depends on for living expenses (*Reid* (CA), *Hyteco*).
- Consideration must be given to the relationship between payer and payee (*Reid* (CA)).
- A receipt that is the product in a real sense of any employment of or services rendered by the recipient or of any business or, indeed, any revenue-producing activity carried on by the recipient will be income (*Harris*).
- An amount that would ordinarily be considered a gift may be income if it is so related to an income-earning activity as to be a product of the income earning activity (*Hayes*).

70. It therefore follows that an amount of a scholarship or bursary paid to a person will be an amount of income under ordinary concepts if it has these types of qualities in the hands of the recipient. Payments without the requisite qualities and that are not income under a provision of Part C will not be taxable to the recipient. If a payment is an amount of income, then it falls to be decided whether it is exempt income under s CW 36.

Is the payment a student allowance?

71. To determine whether a payment is exempt from income under s CW 36, the payment must not be a "basic grant" or an "independent circumstances grant". This is because these payments have been expressly excluded from s CW 36 since 1988 when this exclusion was introduced. Under s CF 1(1), an education grant is income. An "education grant" is defined in s CF 1(2) in the same manner as the grants excluded under s CW 36. Consequently, s CF 1 treats these grants as taxable and s CW 36 confirms this treatment by specifically excluding these grants from the exemption provision.

72. The terms "basic grant" and "independent circumstances grant" are not defined but collectively they are a category of grants paid under the Student Allowances Regulations 1998. These regulations are made under s 303 of the Education Act 1989. These grants are commonly referred to as "student allowances". They are paid weekly by StudyLink to help with a student's living costs while the student studies full time at a secondary school or on a tertiary course approved by the Tertiary Education Commission. These tertiary courses include bachelor's degrees with honours, but exclude all New Zealand Qualifications Framework level 8 and above, postgraduate certificates, diplomas, master's degrees and doctorates.

73. In general, the eligibility criteria for receiving a basic grant are that the person is:
    - aged at least 18 years old (in certain circumstances 16–17-year-olds are also eligible);
    - aged under 65 on the start date of the course;
    - studying full time (or limited full time with approval) in an approved course; and
    - a New Zealand citizen or meets New Zealand immigration residency requirements.

74. To receive an independent circumstances grant, in addition to meeting the above criteria for a basic grant, the person must satisfy the following:
    - the student is a single student without a supported child or children;
    - the student is aged under 24;
    - the student is not living in a parental home or receiving financial assistance from a parent;
    - it would be unreasonable for the student to live with a parent and expect financial support from their parents (ie the student can demonstrate their circumstances show they are living independently); and
    - the student does not receive a basic grant.

75. If a student receives a basic grant or independent circumstances grant from StudyLink, StudyLink will deduct PAYE from the payment. StudyLink is required to deduct PAYE as these grants are treated as a "PAYE income payment" under subpart RD (see ss RD 3(1)(a) and RD 5(1)(b)(ii) and (6)(c)).

76. If a student is receiving one of these grants, then the exemption in s CW 36 does not apply to that grant, and the grant will be taxable under s CF 1. Generally, it will be clear from the circumstances of the payment whether it is one of these grants.

Is the payment a "scholarship or bursary"?

77. Having established that the payment is not a "basic grant" or an "independent circumstances grant", s CW 36 then requires the payment to be a scholarship or bursary. Neither term is defined in the Act. As discussed above, the courts have established that to determine whether there is a scholarship or bursary within s CW 36, the true character of the payment must be determined (*Reid* (CA), *Drew*). This requires looking at the characteristics of the payment and the primary purpose of the payment. (This is a different inquiry to determining whether the payment is an amount of income, and for that reason is not restricted

to considering the quality of the payment in the hands of the recipient.)

78. In summary, a scholarship or bursary is a sum of money granted to a person to assist the person with their education. In the case of a scholarship, the grant of money has an additional merit or some other rational criterion component (eg, academic performance criteria and applicants must be from a particular ethnic group).

79. To understand the meaning of the phrase "scholarship or bursary" as it is used in s CW 36, it is easier to consider the term "bursary" before the term "scholarship". This is because, while both terms have distinct meanings, the courts usually give "bursary" a wider definition than they do "scholarship".

Ordinary meaning of bursary

80. The *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) relevantly defines "bursary" as "a grant, especially one awarded to a student". The *Concise Oxford English Dictionary* defines a "grant" as follows:

> **1** a sum of money given by a government or public body for a particular purpose.
>
> **2** the action of granting something.
>
> **3** a legal conveyance or formal conferment.

81. The *Concise Oxford English Dictionary* defines the verb to "grant" as:

> agree to give or allow (something requested); give (a right, property, etc.) formally or legally to.

82. The *Oxford English Dictionary* (online, 3rd edition, Oxford University Press, 2013, accessed 4 September 2014) defines "bursary" as:

> an endowment given to a student in a university or school, an exhibition. Also in extended use, an endowment to a person other than a student.

83. The *Concise Oxford English Dictionary* relevantly defines "endowment" as "the action of endowing" and "endow" as "to give or bequeath an income or property". The relevant definition in the *Concise Oxford English Dictionary* for "exhibition" in this context is "a scholarship awarded to a student at a school or university".

84. Based on the above, the ordinary meaning of "bursary" suggests that a bursary is a sum of money granted by a government or public body to someone. The recipient would commonly be a student, but in an extended meaning can be a person other than a student. The fact a bursary is granted suggests the recipient does not automatically receive the bursary but has to request or apply for it. A scholarship can also be a type of bursary.

Case law on the meaning of "bursary"

85. The leading case on the meaning of "bursary" is *Reid*. The Court of Appeal considered the meaning of "bursary" in the predecessor to s CW 36. All three judgments gave "bursary" a wider meaning than "scholarship". Richardson J stated, at 5,184:

> "Bursary" is defined in the same dictionary [the *Shorter Oxford English Dictionary*] as "an exhibition at a school or university" (Scotland); and "a scholarship enabling a pupil at an elementary school to proceed to a secondary school" (England).
>
> …
>
> Of more significance in this case, "bursary" is a widely used term referring to **the grant of financial assistance for educational purposes where the students** concerned, and there may be many thousands of them, **meet the criteria laid down. Grants of financial assistance for certain classes of students undertaking education in institutions and designated as "bursaries" have been regularly provided from public funds under statutory authority**.
>
> [Emphasis added]

86. Somers J was of the opinion that the term "bursary" has a wide scope. He said, at 5,186:

> The word "bursary" has reference to **moneys paid to and received by a scholar to assist in his education**. It has become extended by usage to embrace payments which sustain the recipient while furthering his education such as for food, board, and lodging.
>
> [Emphasis added]

87. Thorp J discussed the difference between a "scholarship" and a "bursary". He suggested that, compared with a "scholarship", a "bursary" did not require a special merit criterion. He commented on the meaning of bursary as outlined in the High Court by Quilliam J, who suggested a bursary as well as a scholarship was an "emolument expressly payable by reason of the winning of an award based on merit". However, Thorp J suggested, at 5,190, that a bursary did not require a merit criterion other than meeting certain "qualifying standards of attainment or ability". However, he did not consider the term so broad so as to cover all forms of financial assistance to tertiary education:

> As at 1976 tertiary bursaries, the form of assistance the appellant elected not to receive, would have been classified as a "bursary" for the purposes of sec 61(37). That proposition, which was accepted by both counsel in this Court, does not involve any direct conflict with *Quilliam* J's view that "bursar" connotes some merit qualification, as it is plain that to obtain entry to training college a student was required to meet stated academic standards. At most it may involve a different emphasis from that placed by *Quilliam* J on the

> significance of merit. If so, it should in my view suffice to satisfy the merit criteria if the term "bursar" be restricted to **a person who meets qualifying standards of attainment or ability** without the "bursar" being required to achieve the degree of competitive success or excellence or special merit expected of "scholars". Nor does the proposition involve any conflict, direct or indirect, with *Quilliam* J's view that **the exemption cannot have intended to cover all forms of financial assistance to tertiary education**. For example, an employee of a large company who was paid his normal salary while studying to gain the expertise necessary to introduce some new process to his employer's business would not, in my view, receive such payments as bursary.
>
> [Emphasis added]

88. The term "bursary" has been given a wide meaning in *Reid* (CA)—the granting of financial assistance to a student meeting certain criteria to assist with their education. It includes payments that assist a recipient with their living costs. To receive a bursary, the person needs to meet the qualifying criteria or standards laid down for the specific bursary. In New Zealand, the term "bursary" most commonly refers to payments made from public funds to assist a tertiary student with their living costs. Importantly, payments made to a person while studying will not be a bursary, unless the primary purpose of the payments is to assist with the person's education.

89. The other cases on the predecessor to s CW 36 did not consider the meaning of "bursary" in any detail. In *Drew*, the taxpayer had received a $700 annual bursary before a change in the arrangement with his employer. However, the court did not consider the characteristics of this payment because the exempt treatment of the payment was not disputed. In *Case P23*, Willy DJ considered that a bursary was a grant of financial assistance for educational purposes. Barber DJ in *Case T46* remarked on "bursary", after having considered the meaning of "scholarship" in terms of the predecessor to s CW 36, at 8,317:

> The indicia of a "bursary" are that merit need not have so much significance; and financial need is often more important.

90. Overall the cases have adopted a similar meaning to "bursary" as was given in *Reid* (CA).

Ordinary meaning of "scholarship"

91. The *Concise Oxford English Dictionary* relevantly defines "scholarship" as follows:

> a grant made to support a student's education, awarded on the basis of achievement.

92. Similar to the ordinary meaning of "bursary", the above definition suggests a scholarship is a sum of money paid to a student. It is a payment granted to a person to assist their education, based usually on merit or achievement.

Case law on the meaning of scholarship

93. The leading New Zealand case on the meaning of "scholarship" is also *Reid* (CA). Richardson J considered the dictionary meaning of "scholarship", at 5,184:

> "Scholarship" is defined in the *Shorter Oxford English Dictionary* as "the status of emoluments of a scholar at a school, college or university", and "scholar" is defined for this purpose as "a student who receives emoluments, during a fixed period, from the funds of a school, college, or university, towards defraying the cost of his education or studies, and as a reward of merit".

94. However, Richardson J did not find the dictionary definition of "scholarship" very satisfactory because, in his view, it did not take account of the common usage of the term in New Zealand. He continued, at 5,184:

> I am satisfied that these dictionary definitions of those words do not fully capture the wide meaning which they have in New Zealand usage. Speaking of the meaning of scholarship in Victoria in 1965, *Adam* J in *Re Leitch* [1965] VR 204, at p 206 said:
>
> > "I am not prepared to hold that according to common usages of speech, or by reason of any authoritative definition, the word 'scholarship' in the absence of expressed purposes or conditions attached to it, connotes anything more than the grant of an emolument, normally in a sum of money, to a scholar selected on merit or upon some other rational criterion."
>
> And *Webster's Third New International Dictionary* defines "scholarship" as "a sum of money or its equivalent offered (as by an educational institution, a public agency, or a private organisation or foundation) to enable a student to pursue his studies at a school, college, or university".
>
> When one considers the number and range of awards designated as scholarships in New Zealand, those wider definitions seem equally reflective of common usage in this country.

95. The discussions in *Reid* (CA) suggest that "scholarship" has a wide meaning and is a sum of money or its equivalent granted to a student. It is granted, usually by a public or independent private body with the primary purpose of assisting the student to pursue their studies. The student is selected on merit or some other rational criterion. The above also suggests that the student's study is at a school, college or university. This would appear consistent with the additional requirement of s CW 36 that the scholarship is "for attendance at an educational institution". The meaning of this phrase is discussed later.

96. In *Re Leitch* [1965] VR 204 Adam J considered the meaning of "scholarship" at 206, as cited in *Reid* (CA) and followed in *Drew*. He considered it to be, at 206:

> a grant of an emolument, normally in a sum of money, to a scholar selected on merit or upon some other rational criterion.

97. In *Case T46* Barber DJ looked at the discussion on the meaning of "scholarship" in *Reid* (CA) and concluded, at 8,317:

> Our case law establishes that the indicia of a "scholarship" are a grant of an emolument, normally a sum of money; the need for financial assistance is not usually a consideration; it is usually awarded on merit in recognition of achievement; and there may be a condition requiring the person to return and provide services for the payer. The indicia of a "bursary" are that merit need not have so much significance; and financial need is often more important.

98. From the above it can be seen that both a bursary and a scholarship have the element of granting financial assistance for educational purposes. Case law also suggests receiving a bursary or scholarship may be subject to conditions on the recipient to provide services to or on behalf of the payer. The granting of a scholarship will involve some selection based on merit or other achievement criteria whereas a bursary may be granted based on the meeting of certain eligibility criteria, often financial needs-based. In either case, in the Commissioner's view, the payer selects the recipient according to some pre-defined criteria. In the Commissioner's view, the more rigorous the application process and the greater the independence between the payer and the recipient, the easier it is for a recipient to demonstrate that the payment is a scholarship or bursary.

99. For example, an issue that often arises in the context of s CW 36 is whether a payment is a scholarship or bursary within s CW 36 or salary and wages by reason of an employment relationship. This distinction is important because, as seen above, the courts have established that if the true character of the amounts received is not for the dominant purpose of education but is primarily a payment of salary and wages under an employment relationship, then it is not a scholarship or bursary within s CW 36. This Interpretation Statement has outlined the factors the courts have considered to be relevant in this context at [55] above.

100. The Commissioner has published specific guidance on whether a retraining payment paid to a former employee would meet the requirements of what is now s CW 36 (see "Retraining payments made on employment termination – assessability", *Tax Information Bulletin* Vol 7, No 3 (September 1995): 6). Generally, a retraining payment paid to a former employee will be salary and wages and not a scholarship or bursary that meets the requirements of s CW 36.

Conclusion on the meaning of "scholarship or bursary"

101. Based on the above, the Commissioner concludes the following:

- A "bursary" or "scholarship" is usually granted by a public body or an independent private body to enable the recipient to pursue their education, but may also be granted in circumstances where a special relationship exists between the payer and the recipient.
- A bursary is a sum of money, or its equivalent, granted to a person meeting certain criteria (often needs-based) for the primary purpose of assisting the recipient with funding their education.
- A scholarship is a sum of money, or its equivalent, granted to a person for the primary purpose of assisting them to pursue their studies. The recipient is selected on merit or some other criteria.
- Where a special relationship exists between the payer and the recipient, it may be harder to show that the dominant purpose of a payment is to assist the recipient with their studies because there may be competing reasons for the payment.
- The granting of a scholarship or bursary may be on the condition that the recipient is required to provide services for, or on behalf of, the payer. However, the true character of the scholarship or bursary must be to assist the recipient's education, and the payment must not be primarily for the payer to receive some other benefit, such as services, from the recipient.

Is the scholarship or bursary for attendance at an "educational institution"?

102. Section CW 36 requires a scholarship or bursary to be primarily for the recipient's attendance at an "educational institution". It is, therefore, necessary to determine what "educational institution" means in s CW 36.

103. The term "educational institution" is not defined in the Act. The cases that have considered the exemption do not discuss the meaning of the term. In those cases it was implicit that the various organisations running the courses that the taxpayers were attending or intending to attend were "educational institutions". The educational institutions were all tertiary institutions: universities (*Drew*, *Case L30*, *Case L35*, *Case M24*, *Case*

P23 and *Case T46*), a technical institution (*Case M66*) and a teacher's training college (*Reid* (CA)).

104. These cases are consistent with the meaning of the term "institution", as specifically defined in s 159(1) of the Education Act 1989:

    (a) a college of education; or

    (b) a polytechnic; or

    (ba) a specialist college; or

    (c) a university; or

    (d) a wananga:

105. This definition of "institution" indicates that, for the Education Act 1989, the term "institution" means one of a prescribed list of tertiary education providers that have been established through a statutory process (see s 162 of the Education Act 1989). Section 162 details how each body is established and its characteristics. While this definition of "institution" is helpful in determining the meaning of "educational institution" in s CW 36, the Commissioner considers that the meaning in s CW 36 is not limited to "institution" as defined in the Education Act 1989.

106. The meanings of "education" and "institution" are considered separately before considering the composite term.

Ordinary meaning of "education"

107. The *Concise Oxford English Dictionary* defines "education" as:

> the process of educating or being educated; systematic instruction

and "educate" as:

> give intellectual, moral, and social instruction to; train or give information on a particular subject.

Case law on the meaning of "education"

108. The Supreme Court of New South Wales discussed the meanings of "education" and the related term "educational purpose" in *FCT v Hall* (1975) 75 ATC 4,156. This case considers s 23(z) of the Income Tax Assessment Act 1936 (Aust). That section is similar in context to s CW 36 and exempts from income tax "income derived by way of a scholarship, bursary or other educational allowance or educational assistance … by a student receiving full-time education at a school, college or university".

109. The case concerns the grant of a research fellowship by the Asthma Foundation to a researcher studying for a doctorate in medicine at a university. The main issue was whether the grant was a scholarship or bursary within s 23(z) of the Income Tax Assessment Act 1936 (Aust) or a payment for services rendered under an employment relationship.

110. Rath J discussed the meaning of "education", in the context of whether the purpose of the payment was for education, at 4,162 to 4,163:

> In *Chesterman v F.C. of T. Starke* J. said ((1923) 32 C.L.R. 362 at 400) that **the essential idea of education is training or teaching**. *Isaacs* J. said (pp. 385-6) that for purposes to be educational they must provide for the giving or imparting of instruction. In his view education connotes **the sense of imparting knowledge or assisting and guiding the development of body and mind**. "Within that orbit", he said, "the field is wide, and **extends from elementary instruction in primary schools to the highest technical scientific teaching in Universities**". In *Lloyd v F.C. of T.* ((1955) 93 C.L.R. 645), *Kitto* J., after referring to these views, said (at p. 676): "The conception is unquestionably much wider than mere book learning, and wider than any category of subjects which might be thought to comprise general education as distinguished from education in specialised subjects concerned primarily with particular occupations". In the same case *Dixon* C.J. referred (at p. 661) to **"systematic methods or procedures for the inculcation of knowledge"**.
>
> On these authorities education **involves the dual concepts of imparting of knowledge and system**. In educational institutions the imparting of knowledge is performed by various methods and combination of methods. The simplest, and this is the one that features prominently in primary education, is the direct inculcation of knowledge by the teacher in the pupil. A more sophisticated form of instruction is discussion, the exchange of ideas between teacher and student, a form which finds classical expression in the dialogues of Plato. In advanced education the element of direct inculcation may have little prominence. The professor's lectures may be better understood by reading his notes than by hearing him speak. It is not unknown for the lecturer to deliver his lecture at a speed which permits of every word being taken down in long hand. There can be little or no understanding of the subject matter in such a procedure, and understanding comes later from a study of the notes. In higher education much of the instruction comes, not from the teacher, but from the books the student reads. Indeed the element in education that has been referred to as imparting of knowledge (thus suggesting a necessary teacher-student relationship) might be better described as learning; and the process of learning may be fostered in many ways, without stress on the teacher-student relationship.
>
> **More significant perhaps is the element of system. In all educational establishments there is a planned course of learning.** It is primarily for the educator to plan the course of study, and the procedures of learning. Typically these procedures will involve reading, discussion and teaching, with the first two having the predominant role as the level of education advances.
>
> [Emphasis added]

111. The courts have considered the meaning of "education" in several cases when deciding whether an organisation had a charitable purpose, so was a charity. Charitable purposes include the "advancement of education" (see s YA 1). In this context, the courts have given "education" a wide meaning (see *Royal Choral Society v Commrs of IR* [1943] 2 All ER 101 (CA), *Re South Place Ethical Society, Barralet v Attorney-General* [1980] 3 All ER 918 (Ch); *Re Dupree's Trusts, Daley v Lloyds Bank* [1944] 2 All ER 443 (Ch), *Royal College of Surgeons of England v National Provincial Bank* [1952] AC 631 (HL), *Crystal Palace Trustees v Minister of Town & Country Planning* [1951] Ch 132 and *In re Delius (decd), Emanuel v Rosen* [1957] Ch 299.

112. While the meaning of "education" in the charitable purposes context has been given a wide meaning, this wide meaning is consistent with the view that education involves the imparting of knowledge or learning (by various methods) and requires an element of system (a planned course of learning). Education extends from elementary instruction in primary schools to the highest technical scientific teaching in universities. This is consistent with the ordinary meaning of "education".

Ordinary meaning of "institution"

113. The *Concise Oxford English Dictionary* defines "institution" as:

> a society or organisation founded esp. for charitable, religious, educational, or social purposes.

114. The ordinary meanings suggest that an "educational institution" is an organisation founded to give training on a particular subject by way of systematic instruction.

Case law on the meaning of "institution"

115. Lord Macnaghten described an institution in the following terms in *Mayor, etc of Manchester v McAdam (Surveyor of Taxes)* [1896] AC 500 (HL) at 511:

> It is a little difficult to define the meaning of the term 'institution' in the modern acceptation of the word. It means, I suppose, **an undertaking formed to promote some defined purpose**, having in view generally the instruction or education of the public. It is **the body (so to speak) called into existence to translate the purpose** as conceived in the minds of the founders **into a living and active principle**.
>
> [Emphasis added]

116. Both the ordinary meaning and common law meaning suggest an institution is a society or organisation founded for a particular purpose and to actively implement that purpose by instructing the public. Since s CW 36 is concerned with an "educational institution", an institution within the provision would have to be founded for educational purposes and to actively educate.

Meaning of "educational institution"

117. In South Africa, Grosskopf J in *ITC 1262* 39 SATC 114 looked at the meaning of "educational institution" in s 10(1)(f) of the Income Tax Act 58 of 1962 (SA). That section exempts from income "the receipts and accruals of all ecclesiastical, charitable and educational institutions of a public character". The issue in this case was whether a company that had as its main object the promotion of travel by students as an integral part of their education was an "educational institution" within the meaning of the provision.

118. Grosskopf J considered whether "educational" should be given the wide meaning it had been given in charities cases or should be limited to formal education. He stated, at 120:

> This, however, brings me back to the original question: where is the line to be drawn? No doubt foreign travel can be educational in the wide sense in which the acquisition of all knowledge or experience is considered educational. However, as I have already said, it is common cause that this is not the sense in which the word is used in the Act ...

119. Grosskopf J then concluded on the meaning of "educational institution", at 120:

> To sum up: I consider that **the concept of education** which the legislature had in mind when exempting 'educational institutions' from tax **requires at least an element of systematic or formal instruction, schooling or training**. And **an institution is 'educational'**, in my view, **if its sole or at least main purpose or activity is to provide education in that sense**.
>
> [Emphasis added]

120. The above case confirms the meaning that "institution" was given in *Mayor, etc of Manchester*. Additionally, it suggests that to be an "educational institution", an institution's sole, or at least main, purpose or activity needs to be to provide education that requires an element of systematic or formal instruction, schooling or training. This is consistent with the meaning of "education" in *FCT v Hall*.

121. In New Zealand, the New Zealand Qualifications Authority (NZQA) manages the New Zealand Qualifications Framework and provides independent quality assurance of education providers. Section CW 36 does not require an educational institution to be NZQA-approved. However, the fact an institution is NZQA-approved may be an indicator it is an educational institution offering formal and planned courses of learning.

Conclusion on the meaning of "educational institution"

122. From the above, it can be seen that courts have given "education" a wide meaning. It involves the imparting of knowledge and requires a planned, systematic course of learning. It can also be seen that an "institution" is a society or an organisation founded for a particular purpose that it actively pursues.

123. The Commissioner considers an "educational institution" in s CW 36 is a society or an organisation founded for the sole or main purpose of promoting education and that actively provides that education. Education involves the imparting of knowledge through a systematic formal course of learning. The institution could be in New Zealand or overseas. In New Zealand, educational institutions include, but are not limited to schools, universities, wānanga, polytechnics and industry training organisations.

Is the scholarship or bursary "for attendance at" an educational institution?

124. For s CW 36 to apply, the scholarship or bursary must be "for attendance at" an educational institution. Therefore, what "for attendance at" means must be determined. The phrase "for attendance at" is not defined in the Act.

Ordinary meaning "for attendance at"

125. The *Concise Oxford English Dictionary* relevantly defines "attendance" as:

> the action or state of attending

126. and "attend" as:

> be present at; go regularly to (a school, church, or clinic).

127. The *Concise Oxford Dictionary* relevantly defines "present" as:

> Being or occurring in a particular place.

128. The *Oxford English Dictionary* (online, accessed 25 August 2015) relevantly defines "attendance" as:

> The action or condition of applying one's mind or observant faculties to something;
>
> The action of coming or fact of being present, in answer to a summons, or to take part in public business, entertainment, instruction, worship, etc.

129. The ordinary meaning suggests that attendance can mean the being at or going to a particular place (regularly or not). It can also mean the taking part in or applying one's mind to something.

Case law on the meaning of "attendance"

130. None of the cases discussed earlier on the predecessors to s CW 36 considered the meaning of "attendance at an educational institution".

131. However, the Court of Appeal implicitly accepted in *Reid* that the trainee teachers were in attendance at the teachers' college. The trainee teachers were required under their course of study to physically attend the teachers' college, but also to physically attend schools outside the teachers' college. This shows that the court accepted that "attendance at an educational institution" under the predecessor to s CW 36 was not restricted to physical attendance at the educational institution itself. It could also include going to a different location to fulfil the requirements or obligations of the particular formal course of education offered by the educational institution. This is consistent with the ordinary meaning of "attendance at".

132. Other jurisdictions have looked at what constitutes attendance at a school, university or similar.

133. The United Kingdom Court of Appeal decision in *Flemming v Secretary of State for Work and Pensions* [2002] EWCA Civ 641 was a social security case. It concerned whether a daughter was entitled to an invalid care allowance under s 70 of the Social Security Contributions and Benefits Act 1992 (UK) ("1992 Act") for caring for her disabled mother. The daughter had commenced a degree course at a university. Section 70 of the 1992 Act provides that a person is not entitled to an allowance under the section if the person is "receiving full-time education". Regulation 5 of the Social Security (Invalid Care Allowance) Regulations 1976 sets out that for the purposes of s 70 of the 1992 Act:

> … a person shall be treated as receiving full-time education for any period during which he **attends** a course of education at a university, college, school or other educational establishment for twenty-one hours or more a week.
>
> [Emphasis added]

134. One of the issues was whether the word "attends" was, as submitted for the claimant, only physical presence at the university. Pill LJ stated on this issue at [17]:

> I would construe the expression "attends a course of education at a university" in the sense of being enrolled upon such a course at the university. In ordinary language, the student who says he attends a course of education at Glamorgan University is saying no more than that he is **enrolled upon and pursuing such a course offered by the University**. The expression does not have the locational connotation for which Mr Stagg argues. Some of the student's time will almost inevitably be spent in study upon the premises of a university but the hours during which he is attending the course of education are not confined to the hours on the premises. Hours of study away from the premises of the university are capable of coming within

> the period during which the student is attending the course of education. This construction is supported by the presence of the word "attending" in reg 5(3). **The word does not have a locational limitation in that context** and it would be surprising if the word attendance has a different meaning in two paragraphs of the same Regulation, as Mr Stagg contends it has.
>
> [Emphasis added]

135. Several Canadian cases have looked at what "attendance as a full-time student" means within the definition of "dependent son" and "dependent daughter" in s 2(1)(b)(i) of the Immigration Regulations 1978, SOR/78-172. Whether someone is a dependent son or daughter determines whether they can be included in a parent's principal application for a permanent residence visa. In the Federal Court decision in *Dhami v Canada (Minister of Citizenship and Immigration)* [2001] FCT 805, Dawson J stated at [43]:

> I conclude that because the regulatory definition speaks of both enrollment and attendance, a visa officer is obliged to look beyond the mere fact of registration in a program of study. The reference in the definition to "attendance" is, in my view, for the purpose of testing the reality of a claim to full-time student status. The visa officer must inquire whether an applicant is simply enrolled on paper or whether an applicant is **actually engaged in a bona fide manner in a program of study**.
>
> [Emphasis added]

136. In the same context, the Canadian Court of Appeal in *Minister of Citizenship and Immigration v Jagwinder Singh Sandhu* 2002 FCA 79 stated in [20] and [21]:

> [20] In my view, the words "enrolled and in attendance as a full-time student" require that the student, on a continuous basis, make a bona fide attempt to assimilate the material of the subjects in which the student is enrolled.
>
> [21] This does not suggest that a student must be either successful in the examinations or that the student have acquired a mastery of the subject. What is required is **a genuine effort** on the part of the student **to acquire the knowledge that the course seeks to impart**.
>
> [Emphasis added]

137. While the above cases look at attendance in a different context and may not be directly relevant to the meaning of "attendance at an educational institution" in s CW 36, they are, however, consistent with the ordinary meaning of the term. They are also consistent with the decision in *Reid* (CA) that "attendance" in the context of an educational course has an aspect of actively taking part in or genuinely pursuing the particular course of education.

138. Attendance is not limited to a certain location, so a student can still be "attending at an educational institution" when not on the premises of the educational institution. In the Commissioner's view, it therefore follows, that a student will be attending at an educational institution even when they are attending remotely (eg, by being enrolled in and actively pursuing a distance learning programme of an educational institution) or when required to attend at premises other than those of the educational institution. This is consistent with the commonly accepted usage of the word "attendance" today. For example, under ordinary usage a person is regarded as attending a meeting when dialling into a meeting over the internet or phone without being at the physical place where the meeting is held. Further, it is acceptable to refer to people as "attending at" court when giving evidence remotely or in person.

Conclusion on the meaning of "attendance at"

139. From the above, it can be seen "attendance", in the context of an educational course, can be the student's physical presence at the location where the course is being held or the student being enrolled and pursuing the educational course if it involves requirements other than physical presence, or a combination of both.

140. The Commissioner considers a scholarship or bursary will be for "attendance at an educational institution" when the payment is for a person to enrol and take part in a formal course of education offered by an educational institution.

Who derives a scholarship or bursary?

141. Another question that is sometimes important to resolve is who derives the scholarship or bursary. For example, sometimes, a bursary might take the form of a regular payment that is used to meet a student's school fees that the student's parents would otherwise pay.

142. In the Commissioner's view a scholarship or bursary is derived by the scholar or bursar (ie, the person who is attending at the educational institution), and not by the recipient's parents, even though the parents may use the payment to meet their child's education costs. This is because it is the student who has qualified for and been granted the scholarship or bursary, and the amount is paid to assist that student with their attendance at an educational institution.

143. Before s CW 36 was rewritten, the predecessor exemption in s CB 9(d) of the Income Tax Act 1994 provided that the exemption from income was for "any amount derived by any person from any maintenance or allowance provided for or paid to that person in respect of his or her attendance at an educational

institution in terms of a scholarship or bursary". This wording made it clear that the income exemption is for scholarship or bursary income derived by a person for *their* attendance at an educational institution. There was no intended policy change to this position when the Income Tax Act was rewritten.

Examples

144. The following examples are included to assist in explaining the application of s CW 36. They assume the payments are amounts of income.

Example 1: Scholarship for course requiring practical work aspect

145. Ruby is enrolled in a relaxation massage course at the Holistic Centre of Massage Therapies Ltd. Graduates who successfully complete the full-time one year course gain the Certificate in Relaxation Massage. The course includes components such as anatomy and physiology and the theory and practice of massage. Half of the time spent on the course is practice-based massage at a clinic the centre works with to enable the application of the students' knowledge and skills in a supervised clinical environment. The centre was founded with the mission to produce multi-skilled graduates with a broad knowledge base in massage. The centre's purpose is to teach massage therapies. The centre and the course both have NZQA approval.

146. Ruby has been granted a Women's Restart Education Scholarship by a local community trust. The scholarship reimburses her for the first year course fee of $5,000 and pays $12,000 in monthly instalments of $1,000 per month over 12 months while she is pursuing her studies. The payments are intended to financially assist female students who, through a change in circumstances, are studying full time towards a nationally recognised qualification. The payments will be stopped if Ruby pulls out of the course.

147. The payments are exempt income under s CW 36 because:

- they are not a "basic grant" or an "independent circumstances grant" under s 303 of the Education Act 1989;
- they are a scholarship or bursary because they are granted to Ruby (who meets the criteria laid down for the payments) to assist her education financially.

148. The centre is an educational institution because it was founded for the sole purpose of teaching massage and related therapies and it actively runs systematic formal courses for this purpose. Section CW 36 does not require an educational institution to be NZQA approved. However, the fact that the centre is NZQA approved may indicate that it is an educational institution that offers formal and planned courses of learning.

149. Ruby receives the payments "for attendance at the educational institution" because she is enrolled in the formal course, relaxation massage, and takes part in this course by fulfilling the obligations, (ie, attending theory classes at the centre and practice-based training at the clinic. Attending the practice-based half of the course at the clinic outside the centre's premises is part of fulfilling the obligations of the course, so is part of attendance at the educational institution.

Example 2: Literary residency not a scholarship or bursary

150. William, a young author, has applied for and is granted a literary residency by a New Zealand university. He is provided with an office in the English Department of the university for 12 months and receives the minimum salary of a full-time university lecturer over this period. The grant has been created to foster New Zealand writing by providing an opportunity to write full time within an academic environment for the period of tenure.

151. William would like to know whether the grant he receives is exempt income under s CW 36.

152. While the university is an educational institution as referred to in s CW 36 and the payments are to assist William's education in a broad sense, they are not "for attendance at an educational institution" within the meaning of the term in s CW 36. This is because William is not enrolled in, and does not pursue, a planned, formal course of education at the university. The payments are to provide William with the opportunity to further his skills in his profession and to focus on his professional work and projects during the period. The payments are not exempt from tax under s CW 36.

Example 3: Employment income rather than a scholarship or bursary

153. Kiri is working full time in a garden centre. She would like to gain a Certificate in Floristry Practice at the North Island Institute of Technology. The course is a one-year full-time course requiring attendance at the institute as well as some online course participation.

154. The garden centre like having Kiri as an employee and does not want to lose her. To encourage her to stay working for it long term, the garden centre offers to financially assist Kiri with her studies. The garden centre and Kiri sign an agreement whereby the garden centre agrees to pay her a fortnightly bursary payment for the duration of her studies equivalent to the amount she earned before studying full time. In return, Kiri is required to work in the garden centre on weekends (without pay) while studying and guarantees that after completing her studies she will work full time for the garden centre for two years or repay 75% of the payments made to her during the study period.

155. Kiri would like to know whether the payments she will receive from the garden centre while she is studying floristry practice are exempt income under s CW 36.

156. The payments Kiri will receive from the garden centre while she is studying are not exempt income under s CW 36. This is because the true character of the payments is that of employment income rather than of a scholarship or bursary for attendance at an educational institution.

157. This is supported by the following:
- An existing employment relationship exists between Kiri and the garden centre at the time Kiri enrols in the educational course and this relationship continues throughout the study period.
- The garden centre's principal purpose in making the payments is to ensure that it retains Kiri's services. The provision of financial assistance while Kiri is studying is only a secondary purpose of the garden centre.
- Kiri is required to work for the garden centre (on weekends) during the period of study.
- The amount of the fortnightly bursary the garden centre pays is equivalent to Kiri's previous salary.
- Kiri is required to repay a significant portion of the money the garden centre pays during her study period, if she does not work for the garden centre for two years after finishing her studies.

Example 4: Distance learning course

158. Callum is enrolled in an online business studies distance learning course through an NZQA approved business school. Graduates who successfully complete the one-year full-time course gain a Certificate in Business Studies. Callum has been granted a scholarship by his local Chamber of Commerce to assist him with his course costs and living expenses while he studies.

159. The scholarship is exempt income under s CW 36 because:
- it is not a basic grant or an independent circumstances grant under s 303 of the Education Act 1989; and
- it is granted to Callum (who meets the criteria laid down for the payments and who has no special relationship with the Chamber of Commerce) to assist with him pursuing his education.

160. Callum receives the scholarship for the primary purpose of assisting his attendance at an educational institution. He is enrolled in a formal course of education provided by an educational institution and the payment is for him to pursue that course.

References

Related rulings/statements
"Exempting a Scholarship from Income Tax" *Tax Information Bulletin* Vol 5, No 6 (November 1993): 7
"Retraining payments made on employment termination – assessability" *Tax Information Bulletin* Vol 7, No 3 (September 1995): 6
Subject references
Income tax, exempt income, bursary, scholarship
Legislative references
Education Act 1989 – ss 2, 159, 303
Income Tax Act 2007 – ss BD 1, CF 1, CW 36
Income Tax Act 1994 – s CB 9(d)
Income Tax Act 1976 – s 61(37)
Case references
Case G56 (1985) 7 NZTC 1,247
Case L30 (1989) 11 NZTC 1,181
Case L35 (1989) 11 NZTC 1,218
Case M24 (1990) 12 NZTC 2,146
Case M66 (1990) 12 NZTC 2,371
Case P2 (1992) 14 NZTC 4,010
Case P17 (1992) 14 NZTC 4,115
Case P23 (1992) 14 NZTC 4,166
Case T46 (1998) 18 NZTC 8,311
CIR v Drew (1988) 10 NZTC 5,060 (HC)
Crystal Palace Trustees v Minister of Town & Country Planning [1951] Ch 132
Delius (dec'd), In re, Emanuel v Rosen [1957] Ch 299

Dhami v Canada (Minister of Citizenship and Immigration) [2001] FCT 805 (FCC)
Dupree's Trusts, Re, Daley v Lloyds Banks [1944] 2 All ER 443 (Ch)
FCT v Hall [1975] 75 ATC 4,156 (SCNSW)
FCT v Harris 80 ATC 4238 (FCA)
FCT v Hyteco Hiring Pty Limited 92 ATC 4,694 (FFCA)
Flemming v Secretary of State for Work and Pensions [2002] EWCA Civ 641 (UK CA)
Hayes v FCT (1956) 11 ATD 68 (HCA)
In re Delius (decd), Emanuel v Rosen [1957] Ch 299 ITC 1262 39 SATC 114
Mayor, etc of Manchester v McAdam (Surveyor of Taxes) [1896] AC 500 (HL)
Minister of Citizenship and Immigration v Jagwinder Singh Sandhu 2002 FCA 79
Re Dupree's Trusts, Daley v Lloyds Banks [1944] 2 All ER 443 (Ch)
Reid v CIR (1983) 6 NZTC 61,624 (HC)
Reid v CIR (1985) 7 NZTC 5,176 (CA)
Re Leitch [1965] VR 204
Re South Place Ethical Society, Barralet v Attorney-General [1980] 3 All ER 918 (Ch)
Royal Choral Society v Commrs of IR [1943] 2 All ER 101 (CA)
Royal College of Surgeons of England v National Provincial Bank [1952] AC 631 (HL)
Scott v C of T (1935) 35 SR (NSW) 215 (NSWSC)
South Place Ethical Soc, Re, Barralet v A-G [1980] 3 All ER 918 (Ch)
Tennant v Smith [1892] AC 150

APPENDIX: LEGISLATION

Income Tax Act 2007

1. Section BD 1 provides:

BD 1 Income, exempt income, excluded income, non-residents' foreign-sourced income, and assessable income

Amounts of income

(1) An amount is income of a person if it is their income under a provision in Part C (Income).

Exempt income

(2) An amount of income of a person is **exempt income** if it is their exempt income under a provision in subpart CW (Exempt income) or CZ (Terminating provisions).

Excluded income

(3) An amount of income of a person is **excluded income** if—

(a) it is their excluded income under a provision in subpart CX (Excluded income) or CZ; and

(b) it is not their non-residents' foreign-sourced income.

Non-residents' foreign-sourced income

(4) An amount of income of a person is **non-residents' foreign-sourced income** if—

(a) the amount is a foreign-sourced amount; and

(b) the person is a non-resident when it is derived; and

(c) the amount is not income of a trustee to which section HC 25(2) (Foreign-sourced amounts: non-resident trustees) applies.

Assessable income

(5) An amount of income of a person is **assessable income** in the calculation of their annual gross income if it is not income of any of the following kinds:

(a) their exempt income:

(b) their excluded income:

(c) their non-residents' foreign-sourced income.

2. Section CF 1 relevantly provides:

CF 1 Benefits, pensions, compensation, and government grants

Income

(1) The following amounts are income:

(a) an accident compensation payment:

(b) an education grant:

(c) an income-tested benefit:

(d) [Repealed]

(e) a New Zealand superannuation payment:

(f) a parental leave payment paid under Part 7A of the Parental Leave and Employment Protection Act 1987:

(g) a pension:

(h) a veteran's pension.

Some definitions

(2) In this section,—

…

education grant means a basic grant or an independent circumstances grant under regulations made under section 303 of the Education Act 1989

….

3. Section CW 36 provides:

CW 36 Scholarships and bursaries

A basic grant or an independent circumstances grant under regulations made under section 303 of the Education Act 1989 is not exempt income, but any other scholarship or bursary for attendance at an educational institution is exempt income.

Education Act 1989

4. Section 2 relevantly provides:

2 Interpretation

(1) In this Part, and Parts 2, 3, and 11, unless the context otherwise requires,—

…

institution has the same meaning as it has in section 159

5. Section 159 relevantly provides:

159 Interpretation

(1) In this Part and Part 13A to Part 24, and in Schedules 13 to 17, unless the context otherwise requires,—

...

institution means—

(a) a college of education; or

(b) a polytechnic; or

(ba) a specialist college; or

(c) a university; or

(d) a wananga

6. Section 303 provides:

303 Student allowances

(1) The Governor-General may, by Order in Council, make regulations establishing allowances to help people pursue courses of education or training (in the case of courses of secondary education, whether within or outside New Zealand).

(2) Every allowance shall—

(a) be awarded in accordance with the regulations that established it; and

(b) have an annual or other value from time to time set out in those regulations.

(3) Regulations under subsection (1) may, in relation to the payment of allowances in respect of courses of study at registered private schools or private training establishments, apply to—

(a) all such schools or establishments; or

(b) registered private schools or private training establishments of a specified class or description only; or

(c) particular schools or establishments.

(3A) Regulations made under this section may be expressed to come into force, and may accordingly come into force, before the date on which they are made, but only if the regulations—

(a) increase the value or maximum value of any allowance, or the rate or maximum rate at which any allowance may be paid; or

(b) extend the class or classes of person entitled to receive an allowance, or entitled to be paid an allowance at any particular rate.

(3B) The rates of student allowances set under this section (except the rates of allowances provided in respect of accommodation expenses) must be adjusted, by regulations made under subsection (1), as at 1 April each year so that in each case the new rate (after the deduction of standard tax) is the rate at that date (after the deduction of standard tax and before the adjustment under this section is made) adjusted by an amount equal to the percentage movement upwards in the CPI between the CPI for the quarter ended with 31 December 1 year before the immediately preceding 31 December and the CPI for the quarter ended with the immediately preceding 31 December.

(3C) The adjustments (by any percentage movement upwards in the CPI) required under subsection (3B) as at 1 April in any year from 2011 to 2017 (inclusive) must, despite subsections (3B) and (3F), be calculated,—

(a) if, and insofar as, they relate to movements during quarters that end before 29 April 2010, using index numbers for those quarters of the consumers price index-all groups published by Statistics New Zealand; and

(b) if, and insofar as, they relate to movements during quarters that end after 28 April 2010, using index numbers for those quarters of the consumers price index-all groups excluding cigarettes and other tobacco products published by Statistics New Zealand.

(3D) An adjustment under subsection (3B) must not reduce the weekly amounts of student allowances payable.

(3E) Every adjustment made under subsection (3B) comes into force, or is considered to have come into force, on 1 April of the calendar year in which it is made, and applies to student allowances payable on and after that date.

(3F) In this section,—

CPI means the consumers price index-all groups published by Statistics New Zealand

standard tax means the amount of tax reckoned on a weekly basis that would be withholdable in accordance with tax code "M" stated in section 24B of the Tax Administration Act 1994.

(4) The power to make regulations under subsection (1) includes (and is deemed always to have included) power to make regulations—

(a) authorising the Secretary, for the purposes of assessing the eligibility of any person for an allowance, to take into account the income of that person's parents or spouse or partner:

(b) defining the terms parent, spouse, partner, and any related terms, for the purposes of the regulations:

(c) stating when and to what extent that income is to be taken into account.

(5) Until regulations under this section set out the value of allowances established by the regulations, the allowances have the annual or other value prescribed by the Minister by notice in the *Gazette*.

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

SPS 15/01: FINALISING AGREEMENTS IN TAX INVESTIGATIONS

Introduction

1. This Standard Practice Statement ("SPS") sets out the principles and parameters for finalising agreements in tax investigations by resolving issues that may be in dispute.
2. "Dispute" in this context includes both a difference of opinion on the application of the law that may occur during the course of an investigation as well as issues where the formal disputes resolution process contained in Part 4A of the Tax Administration Act 1994 ("the TAA") has been initiated.

Application

3. This SPS applies from 21 August 2015 and replaces Standard Practice Statement IR-SPS INV-350 *Finalising agreements in tax investigations* (see *Tax Information Bulletin* Vol 10, No 8 (August 1998)).
4. This SPS applies to agreements reached by resolving disputed issues, whether or not as part of the statutory disputes process, and is intended to be complementary to and not replace the Commissioner's SPSs relating to disputes, *SPS 11/05 Disputes resolution process commenced by the Commissioner of Inland Revenue* ("SPS 11/05") and *SPS 11/06 Disputes resolution process commenced by a taxpayer* ("SPS 11/06") or other publications issued in replacement by the Commissioner.
5. This SPS should also be read in conjunction with *IS 10/07 Care and Management of the taxes covered by the Inland Revenue Acts – Section 6A(2) and (3) of the Tax Administration Act 1994* ("IS 10/07"), *SPS 06/03 Reduction of shortfall penalties for previous behaviour* ("SPS 06/03"), and *SPS 09/02 Voluntary disclosures* ("SPS 09/02") or other publications issued in replacement by the Commissioner.
6. Although, when finalising an investigation, staff should discuss with the taxpayer their ability to pay any taxes that are to be assessed as a result of the final agreement reached (see paragraphs 31 and 32 below), this statement does not apply where the agreement results from negotiations to settle tax debt as provided for by sections 176, 177, 177A, 177B, 177C and 177D of the TAA. In addition, this statement does not apply to settlements involving the use of the Commissioner's general discretion under section 6A of the TAA including the settlement of litigation.

Summary

7. For the purposes of this SPS, "resolution" involves an exchange of information or argument that enables either Inland Revenue or the taxpayer to change their view on how the law applies to that taxpayer's situation. In such cases the matter will be resolved on the basis of that changed understanding, resulting in either an agreed adjustment or the dispute being abandoned by Inland Revenue.
8. Wherever possible conflicts and disputes between the Commissioner and taxpayers should be resolved by discussion and agreement. Both the Commissioner and taxpayers can help to facilitate this resolution by disclosing in a timely and useful way all relevant information. Issues should not be resolved and agreements finalised for the sake of expediency or involve coercion to complete the investigation. All issues must be resolved issue by issue, based on the law and the evidence available.
9. Although there is an expectation that taxpayers will sign any final agreement in good faith, it is acknowledged that where a final agreement is signed by a taxpayer prior to the issuing of a Notice of Proposed Adjustment (NOPA) or a Notice of Response (NOR) from the Commissioner, the taxpayer may still potentially contest the issues that were subject to the final agreement, by following the statutory disputes process. However, when a final agreement is entered into after disputes notices have been issued, the signed agreement precludes the taxpayer from commencing a challenge (in a hearing authority) in relation to those issues finalised in the agreement.

Background

10. Investigations will generally be finalised by way of either resolving issues that are in dispute or by "settlement"; through the use of the Commissioner's general discretion contained in section 6A of the TAA.
11. The Commissioner will generally not consider using the general discretion contained in section 6A

of the TAA to finalise an investigation. However, Inland Revenue recognises that good management practices occasionally require departure from normal operational practices in exceptional cases. For this reason Inland Revenue may settle a case outside the terms of this SPS but within the parameters of the care and management provisions. The Commissioner's view of how the care and management provisions apply is outside the scope of this SPS, but is set out in IS 10/07.

12. Although the Courts have not specifically considered whether the Commissioner can reach settlement with a taxpayer before litigation or the formal disputes process has started, the Commissioner considers that, in principle, there is no impediment to this being done.

13. Inland Revenue practice is to endeavour to resolve disputes and other issues arising from tax investigations through the process of reaching resolution with taxpayers by discussion, if at all possible.

14. It is essential for Inland Revenue and taxpayers that a code of good practice in relation to how issues are resolved, and agreements finalised, be defined. This SPS ensures that taxpayers, when attempting to resolve issues with the department that may be in dispute, will be treated consistently, impartially and in accordance with the law by Inland Revenue.

15. These guidelines apply to finalising agreements by resolving issues that may be in dispute in respect of all the Inland Revenue Acts, although the principal focus is on the Income Tax Acts 2004 and 2007 and the Goods and Services Tax Act 1985. These comments, with the necessary modifications, apply equally to the other Inland Revenue Acts (as listed in the Schedule to the TAA).

Standard Practice

Agreements, whether reached by resolution or settlement, must be made on a principled basis

16. Assessments arising as a result of the resolving disputed issues are no different from tax assessments issued in other circumstances and must be made on a principled basis.

17. On many occasions the New Zealand Courts have stated that the Commissioner merely acts in the quantification of tax due, and it is the taxing Acts that charge tax. The Commissioner has a duty to assess the tax properly payable within the terms of the statutory framework and in carrying out that duty the Commissioner must be completely impartial. All assessments arising as a result of resolving disputed issues must conform to the relevant Revenue Act.

18. This does not mean that the Commissioner has an absolute obligation to collect the "right" amount of tax. Section 6A of the TAA charges the Commissioner with the care and management of taxes and so, as stated previously in this SPS, she may be able to settle issues in dispute in some cases. Any settlement must be within the boundaries set out in IS 10/07. The principles relating to the settlement of cases are outside the scope of this SPS.

Reaching final agreement through resolution

19. A final agreement reached by resolving issues with a taxpayer represents an agreement on the relevant facts and the application of the law to those facts. The process of resolution is one that will occur on an issue by issue basis. Resolution is not to be seen as a process of bargaining between the parties where issues are traded off against each other. The Commissioner will consider representations from the taxpayer or their adviser on the relevant issues in the dispute and these issues will be resolved on their individual merits.

20. Any resolution should be based on a genuine agreement as to the relevant facts and be the result of the application of the law to those facts. Issues should not be resolved and agreements finalised for the sake of expediency or involve coercion to complete the investigation.

21. In the context of formal disputes (where either the Commissioner or the taxpayer has issued a NOPA) the Commissioner accepts that a final agreement will not be reached in all cases. Where agreement is not reached the disputes resolution process will continue to apply and SPSs 11/05 and 11/06 should be followed.

Fundamentals of resolution

22. The process of reaching resolution is one that must occur on an issue-by-issue basis.

23. Inland Revenue will not agree to resolve issues in some circumstances. These are:

    - where such an agreement would mean not assessing an amount which is clearly assessable, or allowing a deduction, rebate or credit that is clearly not allowable;
    - where agreement would require Inland Revenue to act contrary to a settled view of the law (for example as stated by the Courts, or an Inland Revenue Public Ruling or Interpretation Statement);
    - where the only consideration is the taxpayer's ability to pay (for further discussion on this matter please see paragraphs 31 and 32 below);
    - where an adjustment can be made only on an "all or nothing basis"; that is, either an adjustment

would be made for the total amount in question or no adjustment be made at all. For example, the assessability of a transaction may depend solely on such concepts as whether the taxpayer is carrying on a business or whether there was a profit making purpose. Generally, on the facts the taxpayer either satisfies the criteria for assessability of income or the taxpayer is not liable for tax in respect of that transaction;

- where the matter relates to use of money interest (UOMI) and/or prosecution action.

24. Situations where Inland Revenue may agree to resolve issues are:
    - where the quantum of a disputed amount depends on the facts. For example, a claim may be subject to apportionment and there could be doubt as to the correct portion to be allowed (for instance, how much is deductible as business expenditure and how much is non-deductible because of its private nature);
    - when an adjustment may rely on a question of valuation for which there are competing bases. For example, in the determination of an arm's length transaction for GST purposes;
    - when an item may not be subject to precise computation. For example, the estimation of living expenses in an assessment based on assets accretion methodology; and
    - where an issue of quantum or valuation has been resolved for one period and is likely to apply to prior periods.

    In these cases, where determination of the taxable income will depend on the facts, a factual position must be agreed between the taxpayer and Inland Revenue.

Penalties, tax in dispute, and use of money interest

25. Penalties, if applicable, should be discussed along with the substantive issues and can, where the taxpayer and the Commissioner are able to reach agreement on these, be included in the final agreement. This includes shortfall penalties and late payment penalties. Shortfall penalties will not be used as leverage to achieve an agreement. That is, staff may not impose shortfall penalties of a less culpable category (for example, reducing a penalty for "gross carelessness" to "not taking reasonable care") to persuade a taxpayer to agree to a proposed adjustment on a substantive tax issue. Conversely, staff may not use the potential of increasing the category of shortfall penalty or the likelihood of prosecution action being taken by the Commissioner, as leverage for finalising tax investigations.

26. The Commissioner may impose civil penalties[1] after a taxpayer has been prosecuted, even where the prosecution is unsuccessful (section 149(4) of the TAA). However, where a shortfall penalty has been imposed on a taxpayer, prosecution action cannot be taken (section 149(5) of the TAA). These are important outcomes for taxpayers and staff should ensure that taxpayers are aware of potential actions that may be taken in their case. For this reason the potential application of shortfall penalties should be discussed with the taxpayer, even in situations where prosecution action is being considered. In these circumstances, and consistent with the "all cards on the table" approach fundamental to the disputes regime, the taxpayer should at least be made aware that the imposition of shortfall penalties and/or prosecution action is being contemplated and may be taken notwithstanding a final agreement being reached on the substantive issues.

27. While it is preferable that final agreements include agreement as to the level of shortfall penalties to be imposed, failure to agree on penalties will not preclude a final agreement on the substantive issues being reached. Where agreement is not reached on the question of penalties the final agreement should note this and inform the taxpayer that the agreement does not cover penalties and that the taxpayer may still be liable for the imposition of shortfall penalties. The taxpayer and their adviser should not be left to make inferences about penalties.

28. The final agreement that is drafted and sent to the taxpayer for their signature should merely reflect the oral agreement already reached. Even where this is done, disagreement over the terms of the written agreement may occur. For example, a situation may arise where the taxpayer reads the agreement, crosses out the paragraph dealing with penalties and returns it to Inland Revenue whereupon the investigator's team leader/manager signs the agreement as so amended. The taxpayer may in these circumstances believe that Inland Revenue has agreed not to impose any penalty. However, the effect of the amendment made by the taxpayer is simply that penalties are no longer covered by the agreement and accordingly have still to be agreed or, failing agreement, will be addressed through the disputes resolution process. In these

[1] As this term is defined by section 3(1) of the TAA.

circumstances any modification of the document should be discussed with the taxpayer in the first instance. A new document reflecting any accepted changes, and making it clear that penalties are still to be agreed should then be sent to the taxpayer.

29. In the case of shortfall penalties, discussion can occur and agreement can be reached as to the correct penalty that should be imposed. Where a shortfall penalty is to be imposed then there may also be discussion around the percentage of the penalty (such as whether it may be *reduced* for previous behaviour, etc, or *increased* for obstructing the Commissioner in determining the correct tax position in respect of the taxpayer's tax liabilities). The SPSs dealing with the reduction of shortfall penalties should be referred to, including SPS 06/03 and SPS 09/02.

30. Where an agreement is signed involving an increase in tax payable, an assessment will follow which will set a new due date for the payment of the increased tax. The taxpayer will be liable for UOMI from the original due date. However, provided the interest charged up to the date of assessment and the tax assessed in the notice is paid by the new due date, the UOMI from the date of the notice of assessment will be cancelled (section 183C(1)).

Ability of the taxpayer to pay

31. When finalising an investigation, staff should discuss with the taxpayer their ability to pay any additional taxes that are to be assessed as a result of the agreement reached. Staff must also ensure that the taxpayer is aware of how to obtain information relating to Inland Revenue's debt-collection processes and available payment options, including the availability of financial relief.

32. The ability of the taxpayer to pay the tax is not relevant in determining their tax liability. When the facts and law support issuing an assessment but the taxpayer will not be able to pay the tax, the assessment will be issued. The taxpayer should then apply under the relevant sections of the TAA for financial relief by either requesting an instalment arrangement or stating why recovery would place them in serious hardship (sections 177, 177A, 177B, 177C and 177D of the TAA). The administration of the remission and relief provisions of the TAA are outside the scope of this SPS.

Timing of final agreements

33. Agreements should be finalised at the completion of an investigation, after discussing the proposed adjustments with the taxpayer and their representatives. It is only after this discussion that any agreement should be formalised in writing.

34. Due to the limitation of time for amending assessments contained in sections 108 and 108A of the TAA it may be necessary, where periods under investigation are about to become time-barred and are not able to be reopened, to finalise the investigation before all issues in dispute have been resolved. In this circumstance, it may be necessary for the Commissioner to seek a final agreement for the agreed issues and issue a Commissioner's NOPA in respect to those issues that are unresolved. The disputes process will then be followed in respect of these unresolved issues. In circumstances where time-barred years are reopened, the Commissioner will continue to attempt to reach resolution in respect of all issues in dispute or, where agreement cannot be reached, to follow the disputes process.

35. Where an investigation covers a number of years, it may be possible to make an assessment on a year-by-year basis so that any dispute may be limited to particular years. Where this situation arises, any agreement reached will not be a precedent for the treatment of future years (except where the matter concerns an adjustment arising from an agreed adjustment in a previous year or where an issue subject to an agreed adjustment spans more than one year).

36. While it is recognised that there may be circumstances where an agreement is finalised post assessment, such an occurrence should be avoided. It should occur only in rare circumstances, such as where the circumstances stated in section 89C of the TAA apply. For instance, the Commissioner has good reason to believe that issuing a NOPA may cause the taxpayer to leave New Zealand and therefore makes an assessment of additional tax in respect of periods under investigation. As it transpires, the taxpayer does not leave the country and a final agreement is subsequently reached with the taxpayer.

Form of agreement

37. Where the final agreement reached is straightforward, it is considered that use of the form *Agreement to amend assessment(s) (IR 774)* will be an appropriate means of recording the final agreement (see Appendix). However, in more complex cases a final agreement may be more appropriately recorded in letter form. For instance, a letter may be appropriate in cases where there are a large number of adjustments, a large number of revenues and/or periods subject to adjustment, or the adjustments are legislatively complex. Where a letter is used it must contain, as a minimum, all of the information contained in form IR 774 and be signed and dated by or on behalf of both parties. A copy of the IR 774 (or letter, where one has been used) must

be provided to both the taxpayer and any agent that has been acting for the taxpayer at the time that the investigations is finalised. Where no adjustments are required, a letter advising them of this fact, and that the investigation has been concluded, will be provided to both the taxpayer and any agent that has been acting for the taxpayer.

38. It should be noted that a formal written agreement is not required where the assessment being made is as a result of the Commissioner exercising her discretion to correct an assessment pursuant to a taxpayer's request in terms of section 113 of the TAA. Please see *SPS 07/03 Requests to amend assessments* (originally published in *Tax Information Bulletin* Vol 19, No 5 (June 2007)) or other publications issued in replacement by the Commissioner.

39. Where there are many issues in dispute it may not be possible to finalise an agreement in respect of them all. In this situation the disputes resolution process would be limited to the unresolved issues.

40. Where a situation involves a number of taxpayers, for example, partners or shareholders, an agreement reached through resolution with one person may not necessarily form the basis of an agreement for all the other parties. This is because it is important to consider the factual background to each person's involvement and the tax position taken by that person.

Adherence to agreement by Commissioner

41. Where the issues in dispute have been resolved, Inland Revenue will adhere to the terms of this final agreement for the periods subject to the agreement. Re-examination of the taxpayer's affairs for the periods and issues covered by the final agreement would be undertaken only where, for example, new evidence suggests that the full material facts were not known to the Commissioner at the time of the agreement and in particular that tax avoidance, evasion or fraud has occurred. Any re-examination will also be subject to the time-bar rules of sections 108 and 108A of the TAA.

42. Where a period has been adjusted following a partial review of a taxpayer's affairs (such as, for instance, a review in respect of a single issue following a policy ruling) nothing in this SPS prevents Inland Revenue from later undertaking a further review of that period (other than in respect of the particular issue or issues that have been the subject of the final agreement).

Agreement following commencement of disputes process

43. Where the disputes process in Part 4A of the TAA has commenced by the issuing of a NOPA the taxpayer/disputant may not challenge an adjustment that has been agreed to in the final written agreement if:
    - that adjustment was proposed by the Commissioner during the disputes process, or
    - that adjustment was a matter specified in a notice from the Commissioner rejecting an adjustment proposed by the taxpayer/disputant during the disputes process.

44. As stated previously, at paragraph 9 above, although the Commissioner has an expectation that taxpayers will sign a final agreement in good faith, it is acknowledged that the taxpayer may, where the dispute process in Part 4A of the TAA has not commenced, subsequently contest the adjustments that have been agreed provided they do so within the statutory time frame and follow the statutory disputes procedures.

Failure to negotiate a final agreement

45. Not all issues subject to dispute may be resolved and final agreement reached. During the resolution process Inland Revenue may enter into correspondence and discussions on a "without prejudice" basis. However, where a final agreement is not reached neither Inland Revenue nor the taxpayer may be bound by any factual or legal matters which may have been "agreed" on a without prejudice basis in any unsuccessful attempt to facilitate a final agreement.

Authority to approve final agreements

46. The staff member who has undertaken the investigation is not authorised to approve the final agreement. There must be (and be seen to be) objectivity in the approval of final agreements. It is therefore necessary for an independent review of the case to be carried out by a person with authority to approve the agreement. Generally, this will be a team leader or higher level person.

47. In cases where approval of an assessment is required at a certain delegated level, such as sections BG 1 (tax avoidance) of the Income Tax Act 2007, or sections 6 and 6A of the TAA (care and management), approval of any final agreement is to be given at that level. With respect to a scheme involving many participants, once the appropriate delegated person has approved the application of the avoidance provisions, individual agreements may be signed by a team leader.

This Standard Practice Statement is signed by me on 21 August 2015.

Graham Tubb

Group Tax Counsel

APPENDIX: SAMPLE IR 774 FORM

Inland Revenue
Te Tari Taake

Agreement to amend assessment(s)

Tax Administration Act 1994

IR 774
September 2011

Precedential effect
This agreement applies only to the amendments and/or shortfall penalties set out below. This agreement is not to be used as a precedent for the resolution of the same or any similar issues for any other periods, issues or taxpayers.

Taxpayer's details

Taxpayer's name First name(s)

Surname

Taxpayer's IRD Number (8 digit numbers start in the second box)

Taxpayer's address

Street address or PO Box number

Suburb, box lobby or RD Town OR city

Inland Revenue officer completing this form.

Agreement
This document records the terms of agreement between the above taxpayer and the Commissioner of Inland Revenue, in relation to the amendments that both parties agree are to be made to the taxpayer's assessment(s).

If applicable, the date that a Notice of Proposed Adjustment was issued by the Commissioner Day Month Year

Revenue Acts and tax periods

Tax Act and Section(s)	Tax type	Tax period

Amendments (including shortfall penalties and use of money interest)

Tax type & Tax period	As returned	As proposed	Tax shortfall	Shortfall penalty	Total
Indicative use of money interest charge as at Day Month Year					$
				Total	$

Under section 120D of the Tax Administration Act 1994, use of money interest is charged on under paid tax from the day after the original due date until payment of any outstanding balance is made in full. This interest generally cannot be remitted.

The indicative use of money interest charge shown above is an approximation only and can be affected by other factors such as new provisional tax liabilities being triggered or the transfer of payments. Please contact your adviser or the Inland Revenue staff member dealing with this matter if you need more information.

Due date of amended taxes

The due date for payment will be two months from the date of the amended assessment and will be detailed on Statement(s) of Account. If payment is not made by the new due date, late payment penalties may apply.

Effect of signing

If the items in this agreement relate to the items outlined in a Notice of Proposed Adjustment, by signing this agreement the person below acknowledges that they have no rights to challenge this adjustment further in terms of section 89I of the Tax Administration Act 1994.

If however, the items in this agreement relate to items which have not been outlined in a Notice of Proposed Adjustment the person below acknowledges that the Commissioner will make assessments consistent with this agreement in terms of section 89C(d) of the Tax Administration Act 1994. Any rights to further challenge the new assessments are contained in Part IV A of the Tax Administration Act 1994.

Please refer to our guide *If you disagree with an assessment (IR 778)*.

Declaration

This declaration confirms that the person named below fully understands the implications of signing this agreement.

Full disclosure

By signing this agreement the person named below acknowledges that they have made to the Commissioner a full and true disclosure of all known facts or facts which are subjected to this agreement.

The Commissioner gives notice that in reaching this agreement reliance has been placed on the person disclosing all known facts.

The Commissioner also gives notice that the making of false statements to officers of the Inland Revenue (and various acts and omissions) can result in prosecution.

Name of person making this declaration	
	Signature Date / /
Name of officer completing for Inland Revenue	
	Signature Date / /

OPERATIONAL STATEMENTS

Operational statements set out the Commissioner's view of the law in respect of the matter discussed. They are intended to be a preliminary view in the absence of a public binding ruling or an interpretation statement on the subject.

OS 15/01: GST AND THE COSTS ASSOCIATED WITH MORTGAGEE SALES

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

Introduction

1. This Operational Statement sets out the Commissioner's position on GST input tax claims in relation to the costs of sale associated with mortgagee sales, namely:
   i) whether the mortgagee's costs of sale can be deducted prior to the calculation of GST due; and
   ii) whether a mortgagee can claim input tax on a mortgagee sale for the costs associated with the mortgagee sale; and
   iii) whether a mortgagee can claim input tax on the costs associated with the mortgagee sale where the sale is subject to the business to business financial services rules; and
   iv) whether a mortgagor can claim input tax on a mortgagee sale for the costs of sale incurred by the mortgagee.

Application

2. This Operational Statement applies on or after 24 August 2015 and sets out the Commissioner's position in relation to the Goods and Services Tax Act 1985. It replaces OS 005 *GST and the costs of sale associated with mortgagee sales* (April 2004).

Discussion

Whether the mortgagee's cost of sale can be deducted prior to the calculation of GST due

3. The term "costs of sale" in this statement refers to expenses that are occasioned by the mortgagee sale. Examples of such expenses are legal fees, valuation fees and real estate advertising and commission. The term "costs of sale" does not include money that is owed under the mortgage such as the interest or principal of the mortgage.
4. Section 5 deems a supply to take place in specific situations. In particular, section 5(2) deals with a sale in satisfaction of debt situation. It provides for there to be a supply by the defaulting person (the mortgagor) where the goods (the mortgaged property) are sold under a power exercisable by another person (the mortgagee) under the terms of the mortgage agreement. As there is a supply under a mortgagee sale, GST is to be charged pursuant to section 8 or section 11.
5. It should be noted that section 5(2)(a) and (b) provide for exceptions where a sale in satisfaction of debt would not be deemed a supply.
6. Section 5(2) alone does not aid in determining whether or not GST is to be calculated on the sale price inclusive of the costs of sale. It has to be read in conjunction with section 17.
7. Section 17 requires a person selling goods in a sale in satisfaction of a debt to perform certain duties.
8. Section 17(1)(a) states that the person selling the goods (whether or not GST registered) must furnish a return to the Commissioner in the prescribed form. The prescribed form is the *Goods and services tax return for goods sold in satisfaction of debt (IR 373).* This is referred to as the "special return" in this statement.
9. The special return must be furnished on or before the date set out in section 17(1B). Sales made in any month must be returned by the 28th of the following month except where the sale is made in either November or March, in which case they must be returned by the following 15th January and 7th May respectively.
10. The person selling the goods must at the same time, pay to the Commissioner the amount of tax that was charged on the supply and furnish to the person whose goods were sold, details of the information in the special return pursuant to sections 17(1)(c).
11. Section 17(2) deems the amount of tax charged on the supply to be tax payable and recoverable as a debt that is due to the Crown.

Section 185, Property Law Act 2007 and section 17, Goods and Services Tax Act 1985

12. Section 185(1)(a) of the Property Law Act 2007, by way of section 185(2), provides for the proceeds from the mortgagee sale to be applied to amounts reasonably paid or advanced by the mortgagee with a view to realisation of the security. This is the

Classified Inland Revenue – Public

equivalent provision to the now repealed section 104 of the Land Transfer Act 1952. However, section 104 and its successor section 185 of the Property Law Act 2007 are not relevant to the question of who must pay the GST on mortgagee sales. The Privy Council's judgment in *Edgewater Motel Limited v Commissioner of Inland Revenue* (2004) 21 NZTC 18,664 dealt with this issue. Paragraph [10] of the Privy Council judgment was the response to Counsel for Edgewater's submission that GST was not an expense occasioned by the sale. It reads:

> [10] … There is no conflict between s 17 and s 104 of the 1952 Act because s 17 does not purport to interfere with the order of priorities laid down by s 104. It does not say that the mortgagee must pay the GST out of the proceeds of sale or of any particular fund. It simply says that he must pay the GST. As s 17(2) says, it creates a debt. The Crown has no concern with how the payment of this debt affects the distribution of the proceeds of sale. In claiming payment of the GST, the Crown is not seeking to assert a priority in the distribution of the assets of the mortgagor, any more than an estate agent instructed by the mortgagee and claiming commission on the sale. The claim lies directly against the mortgagee.

13. Paragraph [12] of the Privy Council judgment then goes on to say:

> [12] Once the mortgagee has paid the GST, the question of the priority of his claim for reimbursement will arise. Their lordships consider that it is "plainly an expense occasioned by the sale" within the meaning of para (a). It is an obligation imposed upon the mortgagee by virtue of his having sold the property. He is therefore entitled to deduct it from the proceeds before payment of his own debt and is accountable to subsequent encumbrancers only for the balance.

14. The Privy Council is saying that the GST liability lies with the mortgagee, and is not dependent on any priority to the sale proceeds. Section 185 of the Property Law Act 2007 simply provides that the mortgagee is entitled to reimbursement of their costs from the proceeds of sale ahead of other claims on the proceeds including that of the mortgage itself.
15. There is no ability for the costs of sale related to a mortgagee sale to be deducted prior to the calculation of GST output tax due under section 17.

Whether a mortgagee can claim input tax in a mortgagee sale for the costs associated with the mortgagee sale

16. A mortgagee is not able to claim input tax incurred on costs associated with the mortgagee sale.
17. *Case Y2* 23 NZTC (2007) 13,017 is directly on point and confirms the Commissioner's view. Judge Barber of the Taxation Review Authority found at paragraph [72]:

> The disputant is not entitled to input tax deductions with respect to its sale of the property as mortgagee. The express language of s 17 of the GST Act provides that, in a s 17 Special Return, the disputant must pay the full amount of output tax, without any deduction for input tax. There is nothing in the scheme and purpose of the Act which supports input tax deductions being available for the deemed supply.

18. This confirms the Commissioner's position. One argument to the contrary is that the mortgagee acts as the mortgagor's agent in a mortgagee sale and therefore the mortgagee is entitled to claim input tax on the sold property. However, it is Inland Revenue's view that the relationship between a mortgagee and a mortgagor is one of creditor and debtor. The mortgagee acts on their own behalf when exercising a power of sale.
19. Usually, the mortgagee sale occurs through a power exercised by the mortgagee as agreed in the mortgage agreement because of the mortgagor's default in the mortgage payments. Consequently, the mortgagee cannot purport to claim input tax on the costs of sale as agent for the mortgagor.
20. For the mortgagee to be permitted to claim input tax for costs associated with the mortgagee sale, the costs would have to be incurred in the course or furtherance of a taxable activity undertaken by the mortgagee. The mortgaged property would have to have been supplied in the course or furtherance of a taxable activity undertaken by the mortgagee. Putting aside the fact that section 5(2) deems the mortgaged property to be supplied in the course or furtherance of the mortgagor's taxable activity, in some cases the mortgagee may argue an indirect connection with some other activity that the mortgagee is GST registered for. This matter was also considered in *Case Y2*. It was felt that this indirect connection is incidental to a mortgagee's activity of providing financial services. And in that case, the provision of financial services was an exempt supply (section 14) and not part of a taxable activity (section 6). However, it should be noted that *Case Y2* was not decided on this basis. The Case was decided on the fact that the costs associated with the mortgagee sale were incurred in the course of a taxable supply deemed to be made by a mortgagor.

Whether a mortgagee making a mortgagee sale that is subject to the business-to-business financial services rules can claim input tax for the costs associated with that mortgagee sale

21. Sections 11A(1)(q) and 11A(1)(r) allow financial service providers that are registered for GST to zero-rate supplies of financial services to their customers (or in the case of a group of companies, the group's customers) that are registered for GST if the level of taxable supplies made by the customers, in a given 12-month period, is equal to or exceeds 75% of their total taxable supplies for the period. Section 20C and sections 20D to 20F support the financial services rules.

22. Input tax deductions may be made to the extent goods and services are used for making those supplies under the business to business financial services rules. However, the effect of section 5(2) is that the goods sold are deemed to be supplied in the course or furtherance of a taxable activity carried on by the mortgagor. There is no scope to suggest that the same goods are contemporaneously being supplied in the course or furtherance of a taxable activity being carried on by the mortgagee.

23. There is an argument that the expenses are directly or indirectly related to a mortgagee's money lending activity. However, the Commissioner believes that the nexus test between an expense and a person's supplies must generally be applied narrowly where the expense is directly related to and wholly consumed in a particular supply. Only where this is not the case and the expenses are in the nature of overhead type expenses is it appropriate to apply the nexus test to an overall activity. There is various New Zealand case law that supports the direct nexus approach including *C of IR v Databank Systems Ltd* (1990) 12 NZTC 7,227 and *Wairakei Court Limited v CIR* (1999) 19 NZTC 15,502.

24. Support for the overhead approach can be found in *CIR v Trustees in the Mangaheia Trust and Trustees in the Te Mata Property* (2009) 24 NZTC 23,711. Although this case is not completely on point, it does deal with aspects of the breadth of a supply, and states that it is well understood that in terms of claiming for business expenditure, the reference to "making taxable supplies" is to be read broadly (paragraph [31]). A simple example referred to in the case is the situation where input tax credits are claimed on supplies such as tea or coffee used by employees in a taxable activity.

25. A supply can be acquired for the purpose of making taxable supplies, without necessarily being able to identify a specific supply to which the goods or services acquired relate. However, the costs in relation to a mortgagee sale are in fact acquired specifically in relation to the supply which the Act deems to be undertaken by someone else (the mortgagor). In that context input tax is not available to the mortgagee. The input tax on these costs is not available by reference to some wider activity conducted by the mortgagee. The Act's very specific treatment of the output tax consequences indicates the resulting input tax consequences. The Privy Council's decision in *Edgewater* seems to support this view.

26. As such, no input tax deduction is available to a mortgagee for costs associated with a mortgagee sale made under the business to business financial services rules. The costs are directly related to and wholly consumed in the deemed taxable supply by the mortgagor.

Whether the mortgagor can claim the input tax credits on the sale costs directly incurred by the mortgagee

27. As the mortgagee is the recipient of the supply in these circumstances, the mortgagor cannot claim the input tax. Section 3A(1)(a) defines input tax as tax charged under section 8(1) on a supply of goods or services acquired by the registered person. The recipient of the supply of these services is the mortgagee and the purpose of the sale is for the mortgagee to receive the amount or part of the amount owing on the mortgage. The mortgagor may ultimately receive the net proceeds of the sale, if there are any, but it cannot be said that the mortgagor is the recipient of the costs.

Conclusions

28. A mortgagee in a mortgagee sale cannot deduct the costs of sale before calculating the GST due under section 17 of the Goods and Services Tax Act 1985.

29. A mortgagee cannot claim input tax for the costs associated with a mortgagee sale.

30. A mortgagee who is a registered person and makes a mortgagee sale that is subject to the business-to-business supply of financial services rules is unable to claim input tax for the costs associated with that mortgagee sale.

31. A mortgagor cannot claim input tax for the costs, incurred by the mortgagee, associated with a mortgagee sale.

This Operational Statement is signed on 24 August 2015.

Rob Wells

LTS Manager, Technical Standards

WITHDRAWAL OF OPERATIONAL STATEMENT OS 007: INCOME TAX TREATMENT OF CERTAIN EXPENDITURES ON CONVERSION OF LAND FROM ONE FARMING OR AGRICULTURAL PURPOSE TO ANOTHER

Operational Statement OS 007 sets out the Commissioner's practice and provides guidelines on the income tax treatment of certain expenditures incurred on the conversion of land from one agricultural purpose to another. OS 007 took effect on or after 5 July 2004 and was published in the *Tax Information Bulletin* Vol 16, No 6 (July 2004).

Since that time there have been a number of legislative changes, which means this statement can no longer be relied on as being the Commissioner's view of the current state of the law. In addition, since OS 007 was published, the Commissioner has issued a number of statements that more accurately state the Commissioner's view. These include:

- Interpretation Statement IS 12/03: *Income tax – deductibility of repairs and maintenance expenditure – general principles* (June 2012)
- QB 12/01: *Income tax – deductibility of expenditure on replacing and extending an inlet race to a dairy shed* (February 2012)
- QB 12/03: *Income tax – deductibility of expenditure on cattle stops* (May 2012)
- QB 12/04: *Income tax – deductibility of expenditure on widening and metalling a farm access road or track* (May 2012)
- QB 12/05: *Income tax – deductibility of expenditure on stock yards* (May 2012)
- QB 14/08: *Income tax – costs of demolishing an existing building on a building site* (August 2014).

After reviewing all of these matters, OS 007 is now withdrawn with immediate effect and there are no plans to republish this statement.

Rob Wells

LTS Manager, Technical Standards

LEGISLATION AND DETERMINATIONS

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

APPROVAL – INCOME TAX – CURRENCY CONVERSIONS FOR BRANCHES

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

Summary

1. The Act requires foreign currency amounts to be converted to New Zealand dollars to calculate a taxpayer's New Zealand income tax liability.
2. In some cases, the Act may prescribe a currency conversion method or foreign exchange rate source to use, but in most cases it does not. Section YF 1(2) applies where the Act does not provide a specific currency conversion method or exchange rate source to use. It requires taxpayers to convert foreign currency amounts to New Zealand dollars by applying the close of trading spot exchange rate on the date the amount is required to be measured or calculated.
3. However, the Act gives the Commissioner the power to approve alternative currency conversion methods and foreign exchange rate sources. The following currency conversion methods have been approved by the Commissioner for branches:
    - Entities that prepare financial statements that comply with International Financial Reporting Standards (IFRS) (as defined in s YA 1) may use the currency conversion method and rates adopted under IFRS to convert their branch's foreign currency amounts to New Zealand dollars (the IFRS method).
    - Non-IFRS taxpayers may use:
        - the average mid-month exchange rate method;
        - the average end-of-month exchange rate method;
        - the mid-month exchange rate method;
        - the end-of-month exchange rate method; or
        - the monthly average exchange rate method.
4. Use of the annual and monthly methods is subject to certain conditions and thresholds that are discussed later in this item.
5. Entities using one of the approved currency conversion methods may need to make tax adjustments. Where relevant, entities using the IFRS method should use the actual amounts, as already converted to New Zealand dollars, in their financial statements (see para [13]).

    When making tax adjustments under an annual or monthly method, the adjustments should be consistent with the nature of the item being adjusted (see para [25]).
6. The Commissioner also approves the following alternative foreign exchange rate sources for branches under ss YF 1(5) and YF 2(2), subject to conditions outlined at [34] to [42]:
    - The foreign exchange rates published on the Inland Revenue website: **www.ird.govt.nz/how-to/overseas-currency/**.
    - The foreign exchange rates published on the Reserve Bank of New Zealand website: **www.rbnz.govt.nz**.
    - Foreign exchange rates from one of New Zealand's registered banks.
    - Any reputable externally-sourced exchange rate that is appropriate given the nature of the branch's business.
7. All of the methods and exchange rate sources are approved for a foreign branch of a New Zealand entity's business or a New Zealand branch of a foreign entity's business.
8. This Approval does not apply to financial arrangements. Financial arrangements must be converted to New Zealand dollars using the methods and rates prescribed under the financial arrangements rules.
9. If a taxpayer is using, or would like to use, a method or rate source not outlined in this Approval, the taxpayer may apply to the Commissioner under ss YF 1(5), YF 1(6) or YF 2(2) for approval to use that method or rate source. (Applications can be emailed to: **fxconversions@ird.govt.nz**.)
10. This Approval updates and replaces "Tax effects of exchange alterations on 21 November 1967" *Public Information Bulletin* No 44 (February/March 1968), and "How revaluation affects tax" *Public Information Bulletin* No 75 (November 1973).

Interpretation

11. Unless the context otherwise requires, these terms have the following meanings:

- "Annual method" means the average mid-month exchange rate method or the average end-of-month exchange rate method.
- "Branch" means a division of an entity's business located somewhere other than the head office. A branch is not a separate legal entity.
- "Currency conversion method" means an "annual method", a "monthly method" or the "IFRS method".
- "Foreign currency amount" means an amount denominated in a currency other than New Zealand dollars.
- "IFRS method" is the method set out at [12].
- "Monthly method" means the mid-month exchange rate method, the end-of-month exchange rate method, or the monthly average exchange rate method.

IFRS method

12. Entities that prepare financial statements that comply with IFRS (as defined in s YA 1) may use the currency conversion method and rates adopted under IFRS to convert their branch's foreign currency amounts to New Zealand dollars. When separate financial statements are not prepared for the branch, the IFRS method can be used when the entity (of which the branch is a part) prepares IFRS financial statements that include the branch.

13. When making tax adjustments, where relevant, entities should use the actual amounts (as already converted to New Zealand dollars) in those financial statements.

14. For fixed assets, tax depreciation should be calculated in New Zealand dollars on the New Zealand dollar cost, determined under subpart EW (if applicable), using the cost in New Zealand dollars as per the Statement of Financial Position, or determined using the spot rate on the date of acquisition.

Annual methods

15. The Commissioner has approved two annual currency conversion methods. These are the average mid-month exchange rate method and the average end-of-month exchange rate method. The essential difference between the two methods is the rate used to convert the foreign currency amounts to New Zealand dollars.

16. The annual methods can only be used by a branch where the New Zealand group (ie, the branch and any associated New Zealand entities) has an annual turnover of less than NZD$10,000,000. The threshold has been imposed because the annual methods are a significant departure from the close of trading spot exchange rate (the default position under the Act). Therefore, the Commissioner has only approved the annual methods for smaller taxpayers. This should help reduce compliance costs for those taxpayers in circumstances where the variances between the methods are likely to be less significant.

Average mid-month exchange rate method

17. The average mid-month exchange rate method converts foreign currency amounts using the average mid-month exchange rate. This means that instead of converting foreign currency amounts on a daily basis, a branch's income and expenditure can be separately aggregated and converted at the end of the income year.

18. The average mid-month exchange rate for the currency conversion is calculated by adding together the exchange rates for the 15th day of each month in the relevant period (usually 12 months) and then dividing that total by the number of months in the relevant period (usually 12) to arrive at a single annual exchange rate. This exchange rate is then applied to the aggregated foreign currency amounts.

Average end-of-month exchange rate method

19. The average end-of-month exchange rate method converts foreign currency amounts using the average end-of-month exchange rate. This means that instead of converting foreign currency amounts on a daily basis, a branch's income and expenditure can be separately aggregated and converted at the end of the income year.

20. The exchange rate for the currency conversion is calculated by adding together the exchange rates for the last day of each month in the relevant period (usually 12 months) and then dividing that total by the number of months in the relevant period (usually 12) to arrive at a single annual exchange rate. This exchange rate is then applied to the aggregated foreign currency amounts.

Monthly methods

21. The Commissioner has approved three monthly currency conversion methods. These are the mid-month exchange rate method, the end-of-month exchange rate method, and the monthly average exchange rate method. The essential difference between the three methods is the rate used to convert the foreign currency amounts to New Zealand dollars.

Mid-month exchange rate method

22. The mid-month exchange rate method converts foreign currency amounts using the exchange rate for the 15th day of the month. This means that instead of converting foreign currency amounts on a daily basis,

a branch's income and expenditure can be separately aggregated and converted at the end of each month using the exchange rate for the 15th day of the month.

End-of-month exchange rate method

23. The end-of-month exchange rate method converts foreign currency amounts using the exchange rate for the last day of the month. This means that instead of converting foreign currency amounts on a daily basis, a branch's income and expenditure can be separately aggregated and converted at the end of each month using the exchange rate for the last day of the month.

Monthly average exchange rate method

24. The monthly average exchange rate method converts foreign currency amounts using the average exchange rate for the month. This means that instead of converting foreign currency amounts on a daily basis, a branch's income and expenditure can be separately aggregated and converted at the end of each month using the average daily exchange rate for the month.

Annual tax adjustments under the annual and monthly methods

25. When using an annual method or a monthly method, entities may need to make tax adjustments. The adjustments should be consistent with the nature of the item being adjusted. Items could be adjusted in one of the following ways:
    - An item could be adjusted using the actual amount converted during the period (eg, reversing out non-deductible legal fees using the New Zealand dollar amount already converted in the Statement of Financial Performance).
    - An item could be adjusted using the daily rate on the last day of the period for adjustments to items in the Statement of Financial Position (eg, adjustments reversing/including the opening and closing balances of provisions or reserves).
    - An item could be adjusted using an average annual rate for adjustments that occur throughout the period.
    - For fixed assets, tax depreciation should be calculated in New Zealand dollars on the New Zealand dollar cost, determined under subpart EW (if applicable), using the cost in New Zealand dollars as per the Statement of Financial Position, or determined using the spot rate on the date of acquisition.

Conditions for use of currency conversion methods

26. If a branch is part of a company that is part of a consolidated tax group (subpart FM of the Act), all companies in the group must also use the chosen currency conversion method to convert their branches' foreign currency amounts.

27. Where the Act specifies a method to be used for a particular transaction or arrangement, an entity will not be able to use an annual method or a monthly method for that transaction or arrangement. For example, s EX 57 specifies methods for calculating income or loss for foreign investment funds. Similarly, any financial arrangements will need to be converted under the financial arrangements rules.

28. Where a branch has paid foreign income tax, the entity must convert the tax payments to New Zealand dollars at the exchange rate on the date the foreign income tax was paid. This is because foreign tax credits are allowed under subpart LJ when foreign tax is paid.

Notification requirements for currency conversion methods

29. An entity does not need to notify the Commissioner that it will be using a currency conversion method approved in this item to convert its branch's foreign currency amounts to New Zealand dollars. However, once an entity decides to use that method, it must use that method consistently for all future income years.

30. If an entity wishes to change to a different method, it will need to apply to the Commissioner for approval to do so. (Applications can be emailed to: **fxconversions@ird.govt.nz**.)

31. If a branch becomes unable to satisfy the annual method threshold conditions outlined at [16] above, the entity has four options:
    - It could convert its branch's foreign currency amounts to New Zealand dollars using the close of trading spot exchange rate (s YF 1(2)).
    - It could convert its branch's foreign currency amounts to New Zealand dollars using one of the monthly methods set out in this Approval.
    - It could apply to the Commissioner, under s YF 1(6), seeking approval to continue to convert its branch's foreign currency amounts to New Zealand dollars using the annual method.
    - It could apply to the Commissioner under s YF 1(6), seeking approval to convert its branch's foreign currency amounts to New Zealand dollars using an alternative currency conversion method.

Foreign exchange rate sources for branches

Approval of alternative foreign exchange rate sources for branches

32. The Act gives the Commissioner the power to approve alternative foreign exchange rate sources. Section YF 1(5) permits the Commissioner to

approve alternative foreign exchange rate sources in circumstances where the Act has failed to specify a rate. Section YF 2(2) permits the Commissioner to do the same in circumstances where the Act has specified a foreign exchange rate source.

33. The Commissioner has approved the following foreign exchange rate sources for use by branches under ss YF 1(5) and YF 2(2):
    - The foreign exchange rates published on the Inland Revenue website: **www.ird.govt.nz/how-to/overseas-currency/**.
    - The foreign exchange rates published on the Reserve Bank of New Zealand website: **www.rbnz.govt.nz** (daily or monthly average exchange rates are available).
    - Foreign exchange rates from one of New Zealand's registered banks (a list of registered banks is available on the Reserve Bank of New Zealand's website at **www.rbnz.govt.nz/regulation_and_supervision/banks/register/**).
    - Any reputable externally-sourced exchange rate.
34. A foreign exchange rate obtained from a registered bank or a reputable external source will need to be appropriate, given the nature of the business carried on by the entity and branch. For example, depending on the nature of the business, a wholesale rate may be more appropriate than a retail rate.
35. These foreign exchange rate sources are approved for a foreign branch of a New Zealand entity's business or a New Zealand branch of a foreign entity's business.
36. The foreign exchange rate sources can be used even where the Act specifies a foreign exchange rate source to use. However, they cannot be used where the financial arrangements rules specify that a particular foreign exchange rate source must be used (see [37] below).

Conditions

37. The approved exchange rate sources cannot be used where the financial arrangements rules specify that a particular foreign exchange rate source must be used. For example, Determination G6D specifies the foreign exchange rate sources that must be used to determine foreign exchange rates for financial arrangements.
38. Some of the foreign exchange rate sources listed may only provide rates for trading days. If the relevant date is not a trading day, an entity should use the foreign exchange rate on the preceding trading day.
39. Entities are reminded of their obligation to keep sufficient records in case they later need to verify the foreign exchange rates used. This is especially important where the source of rates is not published or readily available. Further, where an entity uses a registered bank rate or a reputable externally-sourced exchange rate, the entity must be able to show that the rate is appropriate for its business.
40. The rates must be applied consistently. This means that a branch must use the same exchange rate source for all foreign currency amounts derived in a particular year, and that the same exchange rate source must be used from year to year.

Notification

41. An entity does not need to notify the Commissioner that it will be using one of the approved foreign exchange rate sources to convert its branch's foreign currency amounts to New Zealand dollars. However, once an entity decides to use an approved foreign exchange rate source, it must use that source consistently throughout the income year and for future income years.
42. If, in a later income year, an entity wants to use a foreign exchange rate from another source to convert its branch's foreign currency amounts to New Zealand dollars, the entity will need to seek approval from the Commissioner to do so. (Applications can be emailed to: **fxconversions@ird.govt.nz**.)

Examples

Example 1: Average end-of-month exchange rate method

Pink Enterprises is a New Zealand company with an Australian branch. Pink Enterprises has an annual New Zealand group turnover of NZD$6,000,000 and a balance date of 31 March. The branch transacts in Australian dollars. For New Zealand tax purposes, Pink Enterprises must convert its branch's foreign currency amounts to New Zealand dollars. For the 2016 income year, Pink Enterprises decides to use an annual method to convert its branch's foreign currency amounts. It chooses the average end-of-month exchange rate method.

Pink Enterprises does not need to notify the Commissioner of this change.

For the purposes of this example, assume that the branch has income of AUD$5,000,000 and expenditure of AUD$3,000,000 earned/incurred over the 2016 income year. These amounts must be converted using the average exchange rate for the last day of each complete month in the relevant period (in this case, 12 months):

Income: AUD$5,000,000 ÷ 0.9509* = NZD$5,258,176.40

This amount is included in Pink Enterprises' gross income from a foreign branch.

Expenditure: AUD$3,000,000 ÷ 0.9509* = NZD$3,154,905.80

This amount is included in Pink Enterprises' expenditure from a foreign branch.

(*For the purposes of this example, the assumed AUD$ average exchange rate for the last day of each complete month in the 2016 income year.)

During the year the branch makes two Australian tax payments—on 1 August 2015 and on 1 December 2015. These amounts must be converted using the daily exchange rate that applied on the date the tax payments were made.

Example 2: Threshold exceeded

For the last four years, Purple Enterprises has used the average mid-month exchange rate method to convert its branch's foreign currency amounts to New Zealand dollars. In 2018, Purple Enterprises' annual New Zealand group turnover increases to NZD$15,000,000. The branch is no longer able to use an annual method. Purple Enterprises has four options:

- It could convert its branch's foreign currency amounts to New Zealand dollars using the close of trading spot exchange rate (s YF 1(2)).
- It could convert its branch's foreign currency amounts to New Zealand dollars using one of the monthly methods set out in this Approval.
- It could apply to the Commissioner, under s YF 1(6), seeking approval to continue to convert its branch's foreign currency amounts to New Zealand dollars using the average mid-month exchange rate method.
- It could apply to the Commissioner, under s YF 1(6), seeking approval to convert its branch's foreign currency amounts to New Zealand dollars using an alternative currency conversion method.

Example 3: Mid-month exchange rate method

Maroon Enterprises is a New Zealand company with an Australian branch. Maroon Enterprises has a balance date of 31 March. The branch transacts in Australian dollars. For New Zealand tax purposes, Maroon Enterprises must convert its branch's foreign currency amounts to New Zealand dollars. For the 2016 income year, Maroon Enterprises decides to use the mid-month exchange rate method to convert its branch's foreign currency amounts.

Maroon Enterprises does not need to notify the Commissioner of this change.

For the purpose of this example, assume that the branch has income of AUD$400,000 and expenditure of AUD$300,000 earned/incurred in June 2016. These amounts must be converted using the exchange rate for the 15th day of June:

Income: AUD$400,000 ÷ 0.9509* = NZD$420,654.11

This amount is included in Maroon Enterprises' gross income from a foreign branch for the month of June.

Expenditure: AUD$300,000 ÷ 0.9509* = NZD$315,490.58

This amount is included in Maroon Enterprises' expenditure from a foreign branch for the month of June.

(*For the purpose of this example, the assumed AUD$ average exchange rate for the 15th day of June 2016.)

On 1 June 2016 the branch makes an Australian tax payment. This amount must be converted using the daily exchange rate that applied on the date the tax payment was made.

References

Subject references
Branch, currency conversion, foreign currency amount, exchange rate
Legislative references
Income Tax Act 2007 – ss YA 1, YF 1, YF 2

SPECIAL DETERMINATION S40: SPREADING METHOD TO BE USED BY INFRASTRUCTURE PROVIDER IN RESPECT OF THE PROVISION OF SERVICES AGREEMENT AND VALUATION OF SHARES ISSUED UNDER THAT AGREEMENT

This determination may be cited as Special Determination S40: "Spreading method to be used by Infrastructure Provider Ltd in respect of the Provision of Services Agreement and valuation of shares issued under that Agreement".

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

1. This determination relates to the Provision of Services Agreement (the Agreement) established between Infrastructure Provider Limited (IPL) and Provider Logistics (Provider).
2. Under the Agreement, Provider commits to delivering a specified volume of freight to IPL each year for the duration of the Agreement, and to increasing the volume of freight over the duration of the Agreement (the Commitment).
3. In consideration for the Commitment:
   - IPL will issue shares to Provider, and
   - Provider will grant IPL a call option.
4. If Provider does not meet the Commitment over the term of the Agreement, IPL can exercise the call option to require Provider to sell shares back to IPL for nil consideration. The combination of the share issue and the call option leave Provider in the net position that the number of shares it will retain in IPL is determined by the extent to which Provider meets the Commitment.
5. For any of Provider's freight that is sent via IPL, IPL will provide freight services to Provider's freight handlers and will receive payment in return (the Freight Services Agreement).
6. The Arrangement is the subject of private ruling BR Prv 15/29 issued on 10 August 2015, and is fully described in that ruling.
7. The Agreement is a financial arrangement under s EW 3 and an agreement for the sale and purchase of property or services as defined in s YA 1. The Freight Services Agreements are short-term agreements for sale and purchase as defined in s YA 1. Together, the Agreement and the Freight Services Agreement are a wider financial arrangement.

2. Reference

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

3. Scope of determination

1. This determination applies to the Agreement between IPL and Provider.
2. Under the Agreement, Provider commits to sending freight to IPL's facilities as set out in the Commitment. In consideration, IPL will issue shares to Provider and Provider will grant a call option over those shares to IPL.
3. This determination applies to determine the spreading method to be used by IPL for the Arrangement.
4. This determination also applies when:
   - Freight Services are provided by IPL to Provider's freight handlers, to determine the value of the services provided by IPL for the financial arrangements rules;
   - Shares are issued by IPL to Provider, to determine the value of the shares issued by IPL for the financial arrangements rules.
5. This determination is made subject to the following condition:
   i) IPL will continue to recognise income derived from the Freight Services Agreement and deduct expenditure incurred in relation to the Freight Services Agreement under the Income Tax Act 2007 (primarily Parts C and D) (other than amounts dealt with under this determination).

4. Principle

1. The Agreement is a financial arrangement under s EW 3 and an agreement for the sale and purchase of property or services as defined in s YA 1. Together, the Agreement and the Freight Services Agreement are a financial arrangement as defined in s EW 3.
2. The Freight Services Agreements are excepted financial arrangements (a short-term agreement for sale and purchase) under s EW 5(22). Under s EW 6(3), all amounts solely attributable to that excepted financial arrangement are taken into account under the financial arrangements rules.
3. Under s EW 15I, because the financial arrangement includes in part an excepted financial arrangement, s EW 15C(1) does not apply and one of the methods in s EW 15I(2) must be used to allocate an amount of income or expenditure to an income year.

4. One of the methods available under s EW 15I(2)(c) is a determination made by the Commissioner.
5. To determine the consideration paid or payable under the financial arrangements rules, the value of the freight services provided by IPL and the IPL shares issued by IPL to Provider must be established under s EW 32.
6. Under s EW 32(6), the Commissioner must determine the value of the services and shares. Both IPL and Provider must use this amount.
7. The only amounts payable under the Arrangement that must be spread under the financial arrangements rules are the amounts allocated to the issue of the IPL shares to Provider.

5. Interpretation

In this determination (and the Explanation), unless the context otherwise requires:

Words and expressions used (which have not been defined elsewhere within the determination) have the same meaning as in s YA 1 of the Income Tax Act 2007.

"Agreement" means the Provision of Services Agreement between IPL and Provider.

"IPL" means Infrastructure Provider Limited.

"Provider" means Infrastructure Provider Limited.

"Provider's freight handlers" means the freight handlers that are engaged by Provider to provide freight services for Provider's customers.

"Freight Services Agreement" means the agreements between IPL and Provider's freight handlers under which IPL agrees to provide freight services to Provider's freight handlers for consideration.

6. Method

1. The amount to be spread will not exceed the market value of the shares issued on the commencement date. The market price will be determined by reference to the volume weighted average sale price of the shares on the NZX Main Board over the 20 business days prior to the date the shares were issued (subject to adjustment by the Board of IPL).
2. The amounts to be spread in relation to the shares issued by IPL must be allocated to an income year by applying a method that treats the market value of the shares issued to Provider as, in substance, a volume rebate. The amount of the rebate will be reported as a reduction in revenue to be recognised in each year that the rebate is earned (ie at the time it becomes reasonably clear that Provider's Commitment will be met).
3. The amounts spread each year will be spread on a pro-rata basis based on the number of shares in each tranche that have been estimated each year will be eventually released from the call option.
4. For s EW 32(6), the value of the shares issued by IPL is equal to the market price of the shares as at the issue date. The market price will be determined by reference to the volume weighted average sale price of the shares on the NZX Main Board over the 20 business days prior to the date the shares were issued (subject to adjustment by the Board. The same value will be used for any shares that are acquired pursuant to the exercise of the call option.
5. For s EW 32(6), the value of the freight services provided by IPL under the Freight Services Agreement is equal to the price paid for the services by Provider's freight handlers.
6. On termination of the Arrangement, a base price adjustment (BPA) will be calculated under s EW 31. The BPA will take into account all consideration received by IPL (being the fees received by IPL for facilities services provided to Provider freight handlers and any amount paid by Provider on exercise of the call option calculated by reference to dividends received on those shares plus interest), and all consideration provided by IPL (being the facilities services and the shares issued to Provider at the commencement of the Arrangement net of any shares (if any) that were acquired pursuant to the exercise of the call option).

7. Example

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

Under the Agreement, IPL has issued 1m in Tranche 1 shares (value approximately $100m) and a further 1m in Tranche 2 shares (value approximately $100m to Provider).

Provider's commitment to IPL under the Agreement consists of an initial volume commitment of freight and an increase in the volume of freight for each year the Agreement is in force. Provided the Provider has satisfied the applicable freight commitment for each vesting period, the Agreement provides for a percentage of the Tranche 1 and Tranche 2 shares to be released from the call option every 3 years, and at year 10. The percentage of shares available for release under the Agreement in each vesting period is set out below:

LEGISLATIONS AND DETERMINATIONS

Vesting Period	Years 1–3	Years 4–6	Years 7–9	Year 10
% of Tranche 1 shares available for release	30.00	30.00	30.00	10.00
% of Tranche 2 shares available for release	20.00	30.00	40.00	10.00

Further, assume that in year 1 IPL provides Provider's freight handlers with facilities services costing $30m in return for fees of $100m.

At the end of every year, IPL will assess whether Provider has satisfied the Commitment for that year. Where it appears likely that the Commitment will be satisfied, IPL will recognise a reduction to Revenue in the Income Statement for an amount equal to the value of the shares that are likely to vest in Provider as a result of satisfying its Commitment, and an increase to Equity will be recognised in the Balance Sheet.

For example, in year 1, if Provider was considered likely to satisfy its Commitment, IPL would recognise a reduction in revenue in its P&L of $10m for the Tranche 1 shares and $6.66m for the Tranche 2 shares.

The reduction in revenue recognised by Provider in each subsequent year (assuming that its Commitment is satisfied) is set out below:

Deduction available to Provider if Commitment is satisfied:	Years 1–3	Years 4–6	Years 7–9	Year 10
In relation to Tranche 1 shares/year ($m)	10	10	10	10
In relation to Tranche 2 shares/year ($m)	6.66	10	13.33	10
Total deduction available/year ($m)	16.66	20	23.33	20

The value of the shares for s EW 32 is $200m.

The value of the services for s EW 32 is $100m.

This Determination is signed by me on the 10th day of August 2015.

Dinesh Gupta

Manager Taxpayer Rulings

DETERMINATION FDR 2015/02: USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND IN THE HARNESS MACRO CURRENCY FUND

This determination does not apply to the Harness Macro Currency Fund which was a sub-fund of CitiFirst Investments plc (FDR 2014/03).

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager, Investigations and Advice, under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Shares in the Harness Macro Currency Fund (the Harness Fund), to which this determination applies, are attributing interests in a foreign investment fund (FIF).

The investments held by the Harness Fund, a sub-fund of the Harness Investment Fund, are predominantly financial arrangements. Therefore, section EX 46(10)(cb) of the Income Tax Act 2007 could apply to prevent the investor from using the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

Despite the Harness Fund having assets predominantly comprising financial arrangements, the overall arrangement contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument. Accordingly, I consider it is appropriate for an investor to use the fair dividend rate method to calculate FIF income from its attributing interest in the Harness Fund.

Scope of determination

This determination applies to shares held in the Harness Fund, a sub-fund of the Harness Investment Fund.

Harness Investment Fund:

- is organised under the laws of Luxembourg as a limited liability company;
- is authorised in Luxembourg as a UCITS (Undertakings for Collective Investment in Transferable Securities);
- is an umbrella, open-ended investment company;
- has variable capital;
- invests in and trades in global currency markets and foreign exchange related derivatives.

The Harness Fund is a sub-fund of the Harness Investment Fund and directly invests in trades in global currency markets and foreign exchange related derivatives.

This determination is made subject to the following conditions:

1. The investment in the Harness Fund is not part of an overall arrangement that seeks to provide the investor with a return that is equivalent to an effective New Zealand dollar denominated interest exposure.
2. To mitigate the volatility of the liquid investments, the Harness Fund has a risk management process whereby if the fund experiences a 7.5% decline in a month or experiences a 10% decline in a rolling 12-month period, then the total value foreign currency exposure in the Harness Fund will be reduced to 20% of its net asset value. Should this reduction in the value of foreign currency exposure occur, it is expected that the normal level of this type of investment would be restored within 45 days. Failure to restore the investment to its normal levels would result in this determination ceasing to apply from the first day of the following quarter.
3. If the Harness Fund ceases to trade continuously in foreign exchange and foreign exchange related derivative financial instruments or there is a reduction of investment holdings in favour of an investment that provides a New Zealand-resident investor with a return akin to a New Zealand dollar denominated debt investment, then this determination will cease to apply from the first day of the following quarter unless corrective action is undertaken to increase the foreign currency exposure back to its previous level within a continuous period of 45 days.

Interpretation

In this determination unless the context otherwise requires:

"Harness Fund" means the Harness Macro Currency Fund, which is a sub-fund of the issuer the Harness Investment Fund;

"Fair dividend rate method" means the fair dividend method under section YA 1 of the Income Tax Act 2007;

"Financial arrangement" means financial arrangement under section EW 3 of the Income Tax Act 2007;

"Foreign Investment fund" means foreign investment fund under section YA 1 of the Income Tax Act 2007;

"Quarter" has the meaning contained in section YA 1 of the Income Tax Act 2007;

"The investor" means the person who has a share in the Harness Fund.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2015–2016 and subsequent income years. However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination also applies for an income year beginning before the date of this determination for an investor in the Harness Fund that chooses for this determination to apply for that year.

Dated this 21st day of September 2015.

John Trezise

Investigations Manager, Investigations and Advice

DETERMINATION FDR 2015/03: USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager, Investigations and Advice, under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Class A and B units in the GMO Systematic Global Macro Trust ("GMO Trust"), to which this determination applies, are attributing interests in a foreign investment fund ("FIF") for New Zealand resident investors.

The investments held by the GMO Trust are predominantly financial arrangements. In addition, some resident investors may hedge their attributing interests in the GMO Trust back to New Zealand dollars. Therefore, section EX 46(10)(cb) of the Income Tax Act 2007 could apply to prevent the investors from using the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

Despite the GMO Trust having assets predominantly comprising financial arrangements and the presence of the hedging arrangements, the overall arrangement contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument. Accordingly, I consider it is appropriate for resident investors to use the fair dividend rate method to calculate FIF income from its attributing interest in the GMO Trust.

Scope of determination

This determination applies to both Class A and Class B units held by New Zealand resident investors in the GMO Trust.

The GMO Trust:

- is an Australian registered managed investment scheme;
- issues units, denominated in AUD;
- invests in a range of global equity, bond, currency and commodity markets with its normal investment strategy being to trade exchange traded futures, forward foreign exchange contracts, swaps, options and other derivatives using a high degree of leverage; and
- may also hold exchange traded funds and other funds.

New Zealand resident investors may hedge their attributing interests in the GMO Trust back to New Zealand dollars.

It is an additional condition of this determination that the investment in the GMO Trust is not part of an overall arrangement that seeks to provide the New Zealand resident investor with a return that is equivalent to an effective New Zealand dollar-denominated interest exposure.

Interpretation

In this determination unless the context otherwise requires:

"Fair dividend rate method" means the fair dividend method under section YA 1 of the Income Tax Act 2007;

"Foreign investment fund" means foreign investment fund under section YA 1 of the Income Tax Act 2007;

"Financial arrangement" means financial arrangement under section EW 3 of the Income Tax Act 2007;

"GMO Trust" means the GMO Systematic Global Macro Trust, which is an Australian registered managed investment scheme.

Determination

This determination applies to an attributing interest in a FIF, being a direct income interest in the GMO Trust. This is a type of attributing interest for which the investor may use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2017 and subsequent income years.

However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination also applies for an income year beginning before the date of this determination for a person who invests in the GMO Trust and who chooses that the determination applies for that income year.

Dated at Hamilton this 18th day of September 2015.

Graham Poppelwell

Investigations Manager, Investigations and Advice

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.

THE COMMISSIONER'S DISCRETION TO AMEND ASSESSMENTS – S 113 OF THE TAX ADMINISTRATION ACT 1994

Case	Charter Holdings Limited v Commissioner of Inland Revenue
Decision date	27 August 2015
Act(s)	Tax Administration Act 1994, Income Tax Act 2004, Income Tax Act 2007
Keywords	Carry forward losses, judicial review, s 109 and s 113 of the Tax Administration Act 1994

Summary

Charter Holdings Limited ("Charter Holdings") applied to judicially review a decision of the Commissioner of Inland Revenue ("the Commissioner") not to amend her assessment of its tax liability in the 2006 to 2012 tax years ("the Decision") pursuant to s 113 of the Tax Administration Act 1994 ("TAA"). The Commissioner considered that Charter Holdings should have engaged the statutory disputes and challenge procedure, and that its judicial review was a collateral attack on the validity of her assessments and therefore must be refused.

Impact

The decision supports the *Tannadyce Investments Ltd v Commissioner Inland Revenue*, [2011] NZSC 158, [2012] 2 NZLR 153 ("*Tannadyce*") principle that tax assessments cannot be challenged by way of a judicial review unless the taxpayer's concerns could not practically be addressed via the relevant statutory procedure. Moore J held that "judicial review must be refused except when the statutory process could never be invoked".

Facts

On 12 December 2012, the Commissioner sent Charter Holdings a final notice advising that its income tax returns were overdue for the eight tax years between 2005 and 2012. Charter Holdings' 2004 return was also outstanding, but not requested.

On 5 March 2013, Mr Padfield, director of Charter Holdings, filed the requested returns recording a loss in 2005 and net profit in the 2006 to 2012 years. Charter Holdings had claimed losses in previous years' returns, none of which were carried forward because of the way Mr Padfield filled in its income tax returns.

Between 17 March 2013 and 31 May 2013, notices of assessment were automatically generated and issued for these returns. These notices showed that Charter Holdings had tax to pay on its profits recorded in its 2006 to 2012 income tax returns.

On 10 April 2013, Charter Holdings sent a letter to the Commissioner setting out that the losses reported in its earlier income tax returns had not been applied to its subsequent profits. Charter Holdings requested that the assessments for the 2006 to 2012 years be amended to take its losses into account.

On 19 July 2013, the Commissioner responded stating that the outstanding 2004 return would need to be filed before the requested amendments could be considered. Charter Holdings filed its 2004 return eight and a half months later but again did not carry forward any losses.

After receiving the 2004 return, the Commissioner asked Charter Holdings to provide further information to substantiate the validity of the losses it wished to carry forward. Mr Padfield provided Charter Holdings' financial statements for these years and requested that the losses be applied to trading in subsequent years.

The Commissioner reviewed Charter Holdings' request and the information provided in support. She was not satisfied as to the legitimacy of the losses and declined to exercise her discretion under s 113.

Decision

Moore J began by explaining the Statutory Disputes and Challenge Procedure ("SDCP"), as set out in parts 4A and 8A of the TAA. His Honour set out Charter Holdings' compliance history, and the dates by which it would need to have filed a Notice of Proposed Adjustment ("NOPA") to engage in the SDCP. His Honour noted that Charter Holdings had consistently failed to file its income tax returns within statutory timeframes.

Moore J considered that the present case involved the effectiveness of the Ouster Provisions. His Honour explained that the Ouster Provisions generally prevent the Commissioner's assessments from being questioned outside the SDCP.

Moore J considered the Supreme Court's decision in *Tannadyce* where the majority held that assessments could not be challenged by way of a judicial review unless the taxpayer's concerns could not practically be addressed through the relevant statutory procedure. Moore J considered that "*Tannadyce* has established a settled practice that the Court must refuse judicial review except when the statutory process 'could never be invoked'".

Moore J discussed *Arai Korp Ltd v CIR* [2013] NZHC 958, (2013) 26 NZTC 21,014 ("*Arai Korp*") as an example of an application of the practice set out in Tannadyce. In *Arai Korp*, Wylie J rejected an application to judicially review a decision not to invoke s 113 of the TAA for default income tax assessments. Wylie J observed that the dispute procedure was clearly available to Arai Korp and its real challenge was to the correctness of the default assessments. The accuracy of the tax assessments should have been challenged through the disputes procedure, and if necessary the challenge procedure. Wylie J held that s 113 was not meant to be used as a mechanism to bypass these procedures.

In this proceeding the Commissioner relied on *Arai Korp* as emphasising the principle that before a taxpayer can engage in the SDCP, it needs to file a tax return and have issued a NOPA within the statutory timeframes. If *Arai Korp* sought to correct the assessments, it should have used the SDCP regime rather than seek to judicially review the decision under s 113 of the TAA not to amend the assessments. Here the Commissioner submitted that the SDCP was available to Charter Holdings and no proper explanation had been proffered as to why it was not engaged.

Charter Holdings submitted it had no opportunity to make use of the SDCP. Charter Holdings alleged that on 10 April 2013 it made the request to supply corrected new assessments but it was not until 19 July 2013 that the Commissioner responded by which time the NOPA periods for the 2005, 2006, 2009, 2010, 2011 and 2012 tax years had expired. However, although the Commissioner's response predated the expiry of the NOPA periods for the 2007 and 2008 tax years, she suggested Charter Holdings take a different course to filing a NOPA, namely to file the 2004 return and seek to have the losses carried forward. By the time the Commissioner responded, declining to re-assess under s 113, the SDCP was no longer available.

Prior to examining the availability of the statutory objection procedure, Moore J emphasised the central importance of complying with statutory time limits in tax administration, referring to *Commissioner of Inland Revenue v Wilson* (1996) 17 NZTC 12,512 (CA).

Moore J then found that *Arai Korp* had direct application, and that Charter Holdings had opportunity to engage in the SDCP. His Honour determined that Charter Holdings, through its own defaults, did not take the steps necessary to engage in the statutory process. Charter Holdings was obliged to put itself into a compliant position and engage in the SDCP to seek any necessary adjustments so that its tax position was correct.

Moore J considered that Charter Holdings had ample opportunity to issue NOPAs and that Mr Padfield would have known that a procedure existed for determining disputes over tax liability. Furthermore, the reverse side of every notice of assessment contains a general description of what a taxpayer needs to do to engage in the SDCP if it does not agree with the assessment.

Consequently, Moore J held that "applying the principles of *Tannadyce*, I am not satisfied that this is one of those rare cases where judicial review is not precluded where a hearing authority does not have the ability to consider any challenge on whatever grounds". Furthermore, His Honour set out that "judicial review must be refused except where the statutory process could never be invoked", and that "the statutory process could have been invoked by Charter Holdings". Moore J described Charter Holdings' judicial review application as "a collateral challenge to the Commissioner's assessments".

Moore J dismissed the application for judicial review on the basis that the Court had no jurisdiction to deal with or determine matters of tax liability or quantum. His Honour considered that these are properly matters which should have been pursued through the SDCP.

VALIDITY OF COMMISSIONER'S ASSESSMENTS

Case	XXX v Commissioner of Inland Revenue [2015] NZTRA 13
Decision date	6 August 2015
Act(s)	Tax Administration Act 1994, Taxation Review Authorities Act 1994
Keywords	Partnership, s 138P and validity

Summary

This is a preliminary hearing dealing with the disputant's challenge as to the validity of the Commissioner of Inland Revenue's ("the Commissioner") assessments.

Impact

This case will be a useful precedent, in particular as it relates to the powers of a hearing authority under s 138P(1)(a) of the Tax Administration Act 1994 ("TAA") and the Commissioner's power/obligation to amend under s 113 of the TAA.

Facts

Following an investigation, the Commissioner took the view that there was a three-person partnership comprising the disputant, AB and XZ that was engaged in the business of breeding, agistment and selling of horses.

During the 2007–2011 income tax years, amounts totalling over $5 million were transferred from overseas to the alleged partnership by or on behalf of the disputant. The Commissioner formed the view the transfers were income of the alleged partnership's activities and default assessed the disputant for a one-third share of the partnership's income.

The disputant filed returns and issued a Notice of Proposed Adjustment ("NOPA") contending the overseas transfers were derived from non-taxable activities (namely gambling) undertaken by him personally.

The dispute proceeded to the Disputes Review Unit ("DRU") with the Commissioner adding the further ground that the business of the alleged partnership included the gambling activities of the disputant and XZ.

The DRU concluded that the only partnership was that between the disputant and AB in relation to the horse related activities, and that the gambling was a business activity carried on by the disputant on his own behalf.

However, the DRU found that the disputant had not satisfied the onus of proving that the default assessments were wrong and by how much they were wrong. In particular, the disputant had not shown that his gambling was not a business activity, nor had he shown that the amounts default assessed did not reflect the net income from his combined income-earning activities.

The Commissioner issued a challenge notice, and the disputant challenged the assessments on grounds which included the validity of the assessments in light of the DRU's decision.

The Taxation Review Authority ("the Authority") ordered that the validity question be dealt with by way of preliminary hearing.

Decision

Adjudication report – amended assessment envisaged?

The disputant argued that the DRU report suggested the Commissioner should have amended the default assessments on the basis they were wrong both as to liability and quantum. Furthermore, as tax returns had been filed, new default assessments could not be issued, and therefore the Commissioner is required to recast her view of the disputant's liability in a NOPA in anticipation of then seeking an amendment to the assessment pursuant to s 113 of the TAA.

The Authority did not agree that the DRU envisaged or intended the Commissioner to issue amended assessments—there was no statement or direction of that nature. The Authority also noted that while a matter of good practice, the Commissioner is not bound as a matter of law to the determination or reasoning of the DRU (*Ch'elle Properties (NZ) Limited v Commissioner of Inland Revenue* [2004] 3 NZLR 274; (2004) 21 NZTC 18,618 (HC), at [21] to [32]).

Importantly, there was no obligation on the Commissioner to amend the assessments under s 113 of the TAA. Even when she has formed the view that the assessment is incorrect, she will not exercise the power unless or until she can be satisfied that the amendment will ensure correctness (as best this can be achieved). In this case, the disputant provided only limited information during the dispute process, and the Commissioner is not in a better position to make a correct assessment. Prima facie, the assessments remain correct until the disputant can show they are incorrect and, if so, by how much.

Validity of assessments – fresh liability?

The disputant argued that the Commissioner was seeking in this challenge proceeding to increase the quantum of the disputant's liability by the Authority imposing a fresh liability (using the hearing authority's powers under s 138P of TAA), and that this was inappropriate without having engaged in the disputes process as required by ss 89C and 89N(2) of the TAA.

The Authority agreed with the Commissioner that she was simply proceeding on the existing default assessment. The Authority noted that the disputant's liability to pay tax and the quantum (if any) will be matters for determination by the Authority on the eventual hearing of the challenge.

Authority's powers

The Authority agreed that a hearing authority has the power under s 138P(1)(a) of the TAA on considering a challenge to confirm or cancel or vary an assessment, or reduce the amount of an assessment, or increase the amount of an assessment, to the extent to which the Commissioner was able to make an assessment of an increased amount at the time the Commissioner made the assessment to which the challenge relates. These powers are reinforced by those contained in s 16(2) of the Taxation Review Authorities Act 1994.

The disputant contended that s 138P powers are to be applied in the context of, and for the purposes of, addressing the correctness of an assessment that is properly advanced by the Commissioner and is under challenge. It does not envisage the assessment process being handed over to the Authority so that a liability greater than that originally assessed by the Commissioner can be argued for on grounds not maintained by the Commissioner.

The Authority disagreed, stating the Commissioner is not somehow abrogating or abandoning the assessment process in favour of the Authority. The Authority's powers are wide under s 138P and the focus of the hearing will be on determining the correct position in relation to the disputant's tax liability on the evidence before it.

The Authority also rejected the disputant's contention that an inference can be drawn from the Supreme Court's judgment in *Tannadyce Investments Limited v Commissioner of Inland Revenue* (2011) 25 NZTC 20,103 (SC) that challenge proceedings may not always be the most appropriate forum for resolution of a dispute where there is an issue as to procedural fairness. The Authority was of the view that, had there been any issue of unfairness or invalidity (which was not accepted), the de novo hearing before the Authority would cure that defect. Accordingly, it is not necessary or appropriate for the matter to proceed again through the Part 4A disputes process.

Prejudice

The Authority did not accept there was any prejudice to the disputant if the challenge remains before the Authority. The issues in dispute were live during the disputes process and are well known to the disputant. The disputant has the opportunity in discovery to ensure that all relevant documents are before the Authority.

The Authority noted that the disputant may make an application under s 138G(2) of the TAA if there are any additional issues or propositions of law which have not been sufficiently referred to by the parties in their respective Statements of Position.

Orders sought

The Authority did not consider it had the power under reg 12 of the Taxation Review Authorities Regulation 1998, or r 7.37 of the District Court Rules 2014, to direct the Commissioner to withdraw the default assessment and that the proceedings be abandoned. Nor could the Authority direct the matter back to the disputes process. It did not follow that if the matter was referred back, the Commissioner would necessarily issue a NOPA if she was not satisfied that there was sufficient information to propose an amendment under s 113 of the TAA.

The Authority did not accept the disputant's alternative submission that it ought to decline jurisdiction on the basis the assessments were no longer a valid expression of the Commissioner's opinion as to the disputant's liability to tax because the assessments were incorrect. In the Authority's view, the assessments continue to be a genuine attempt by the Commissioner to arrive at the amount of the disputant's taxable income on the information available.

AMOUNTS HELD TO BE DIVIDENDS, EMPLOYMENT INCOME OR INCOME UNDER ORDINARY CONCEPTS

Case	XXX v Commissioner of Inland Revenue [2015] NZTRA 12
Decision date	27 July 2015
Act(s)	Income Tax Act 2004, Tax Administration Act 1994
Keywords	Hearing de novo, dividend, employment income, income under ordinary concepts

Summary

This was a decision of the Taxation Review Authority ("the Authority") confirming that the Commissioner of Inland Revenue ("the Commissioner") had made an honest appraisal of the disputant's 2006 income tax. The Authority agreed with the Commissioner that amounts deposited into various business and personal bank accounts were the disputant's assessable income as dividends, employment income or income under ordinary concepts.

Facts

During the 2006 tax year the disputant was a director, shareholder and employee of three companies in the same industry sector. In addition, the disputant was the trustee of a property owning trust.

At the time the Commissioner commenced her review of the disputant's tax affairs he had not filed an income tax return for six years. The companies and trust were also in default of their tax obligations. Following a lengthy period of unsatisfied information requests, the Commissioner made a default assessment of the disputant's income tax and subsequently made an amended assessment following completion of the disputes process.

The Commissioner's assessments were made on the basis that amounts deposited into various business and personal bank accounts were the disputant's assessable income as dividends, employment income or income under ordinary concepts.

The disputant claimed that the amended assessment was incorrect and that the Commissioner had ignored business expenses, wrongly treated certain deposits and transfers as assessable income, and had failed to rely upon information provided by the disputant.

Decision

Assessments an honest appraisal and genuine exercise of judgement

The Authority held that while the Commissioner is required to make a genuine attempt to ascertain the taxpayer's assessable income, that obligation cannot be elevated into a requirement that the Commissioner is not to assess unless and until she is fully informed of the taxpayer's affairs. Rather, the Commissioner must do the best she can on the information in her possession and it is only when the Commissioner acts arbitrarily or in disregard of the law or facts known that the purported assessment will be set aside.

The disputant contended that the Commissioner failed to uphold an agreement to obtain an independent review from a qualified accountant, investigate an alternative method of calculation mentioned in an internal email and consider whether another legal connection (contractual arrangement) existed between the disputant and each company. The Authority held there was no merit in the disputant's arguments.

The Authority held that with respect to any alleged breaches of s 6 of the Tax Administration Act 1994 and/or of procedure or unfairness in the dispute process, a hearing before the Authority is a hearing de novo. The focus is not therefore on attacking the process, as the nature of the hearing will cure any breaches of natural justice, procedural unfairness and other procedural defects. Instead it is on calling evidence to enable the Authority to make an appropriate assessment or set the assessment aside.

The Authority was satisfied that the Commissioner's assessments were an honest appraisal of the disputant's tax position and a genuine exercise of her judgement.

Dividends, employment income and income under ordinary concepts

It was accepted that income from the companies was deposited into the companies' accounts and into personal accounts. However, the disputant denied any transfer of value occurred by virtue of his shareholding. The disputant claimed that as funds in personal accounts were used for business expenditure, another legal connection existed between himself and each company. The Authority held that the disputant's argument was without merit. Firstly, because there was no evidence to support another legal connection, and secondly, because business-related expenditure was not included in the amended assessment.

Additionally, the disputant contended that there was no transfer of value from each company to the disputant caused by the disputant's shareholding, because the disputant in fact received drawings which he was required to repay. After referring to the disputant's failure to produce contemporaneous evidence that he had borrowed money from the companies and that interest was charged, the Authority held that there did not appear to be any reason for the companies to have made transfers of value other than because of the disputant's shareholding. The Authority found that the disputant could be taken to have derived as dividend income an amount equal to his private expenditure.

The Authority agreed with the Commissioner that the disputant's declared salary was not commensurate with the work he had done. To the extent the funds the companies made available to the disputant were not dividends, the Authority held they would be included in the disputant's income as employment income.

The Commissioner submitted that the companies' incomes went into a variety of personal and business accounts that the disputant controlled and had access to. The Commissioner contended that it was reasonable to conclude that income "came in" to the disputant when the companies incurred personal expenditure on his behalf or when the disputant used the companies' incomes for his private benefit. The disputant depended on that income (quantified by expenditure) for his and his family's living expenses. The disputant was the companies' sole director, and sole or majority shareholder and received employment income. Accordingly, there was an element of reciprocity

involved between the amounts that the companies either spent on the disputant's behalf or which the disputant spent himself. The Commissioner claimed this supported the conclusion that these amounts have the quality of income in the disputant's hands.

The Authority agreed with the Commissioner and found that to the extent that the amounts are not dividend payments or employment income, they are income under ordinary concepts. Rent was also deposited into the disputant's joint personal bank account on a weekly basis by tenants of various properties owned by the trust. The Authority agreed with the Commissioner that the rent had the quality of income in the disputant's hands and is also assessable to him as income under ordinary concepts.

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy and Strategy

Policy advises the Government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

GET YOUR TAX INFORMATION BULLETIN ONLINE

The *Tax Information Bulletin (TIB)* is available online as a PDF at **www.ird.govt.nz** (search keywords: Tax Information Bulletin). You can subscribe to receive an email alert when each issue is published. Simply go to **www.ird.govt.nz/technical-tax/tib** and complete the subscription form.

An index to the TIB is also available at **www.ird.govt.nz/aboutir/newsletters/tib/** (scroll down the page to "Volume indexes"). This is updated about twice a year.

Our website has other Inland Revenue information you may find useful, including draft binding rulings and interpretation statements.