Vol 28 No 12 November 2016

TAX INFORMATION Bulletin

CONTENTS

Inland Revenue
Te Tari Taake

Classified Inland Revenue - Public
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.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **www.ird.govt.nz/public-consultation**

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 at **www.ird.govt.nz/public-consultation** to receive regular email updates when we publish new draft items for comment.

Below is a list of recent items out for consultation. You can get copies from **www.ird.govt.nz/public-consultation/** or by emailing **public.consultation@ird.govt.nz**

Ref	Draft type	Title	Comment deadline
ED0190	SPS	Retrospective adjustments to salaries paid to shareholder-employees	27 January 2017
PUB00284	Public Ruling	Income tax – treatment of unclaimed amounts of $100 or less	27 January 2017
PUB00263	Public Ruling	Income Tax – treatment of alteration to rights attached to shares under section CB 4; Income Tax – treatment of a disposal of shares with altered rights under section CB 4	27 January 2017
PUB00211	Public Ruling	Goods and Services Tax – traffic enforcement activities by local authorities - GST output tax on infringement fees retained - treatment of fines – GST input tax on acquisition of goods and services	27 January 2017
PUB00229	Public Ruling	Fringe Benefit Tax - Charitable and Other Donee Organisations and Fringe Benefit Tax	23 January 2017

IN SUMMARY

IN SUMMARY

BINDING RULINGS

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

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

Product ruling – BR Prd 16/06

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Smartshares Limited in its capacity as Manager of the NZX Mid Cap Index Fund.

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CB 4, CD 8, CX 56C, DB 23, and FC 2.

The Arrangement to which this Ruling applies

The Arrangement is the resettlement of the NZX Mid Cap Index Fund (the Existing Fund) onto the NZ Mid Cap Fund (the New Fund) by redeeming units held by unitholders (Unitholders), applying the redemption proceeds to acquire units in the New Fund on behalf of Unitholders, and transferring the assets of the Existing Fund to the New Fund. However, the New Fund will not issue units to Unitholders whose address on the register of Unitholders is outside New Zealand (Offshore Unitholders). The redemption proceeds that Offshore Unitholders will receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming unitholders in the New Fund.

Prior to the resettlement Unitholder's units in the Existing Fund will be subdivided and the Manager of the Existing Fund will resolve that the subdivision of units is a dividend that will be fully imputed.

The New Fund was established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013 (FMCA)) in relation to which units will be issued that are managed investment products (as defined in the FMCA).

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

The Existing Fund

1. The Existing Fund was established by a trust deed dated 15 April 1997 (the Trust Deed), as subsequently amended by:
   (a) first supplemental deed to the Trust Deed dated 29 June 2001;
   (b) second deed of modification to the Trust Deed dated 17 March 2005;
   (c) third deed of modification to the Trust Deed dated 30 September 2005;
   (d) fourth deed of modification to the Trust Deed dated 1 October 2007;
   (e) fifth deed of modification to the Trust Deed dated 30 March 2010;
   (f) sixth deed of modification to the Trust Deed dated 21 September 2010;
   (g) deed of amendment to Trust Deeds dated 16 September 2015; and
   (h) deed of amendment to the Trust Deed to be dated 2016 (Amendment Deed).
2. The Trust Deed established the Existing Fund as a group investment fund in accordance with the Trustee Companies Act 1967.
3. The Existing Fund elected into the portfolio investment entity (PIE) regime and is a "listed PIE" as defined in s YA 1.
4. The Manager of the Existing Fund is Smartshares Limited (the Manager), and the trustee of the Existing Fund is Trustees Executors Limited.

5. The Existing Fund invests in financial products listed on the NZX Main Board and is designed to track the S&P/NZX Mid Cap Index. The Existing Fund's investment objective is to provide a return that closely matches the return on the S&P/NZX Mid Cap Index. The Existing Fund measures and tracks the performance of New Zealand's core middle capitalisation equity market. Investments are diversified across a broad range of medium sized New Zealand entities and comprise all constituents of the S&P/NZX 50 Index, excluding entities for which their NZX listing is not their primary listing and excluding entities that are in the S&P/NZX 10 Index.

The New Fund

6. The New Fund is a fund established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units will be issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013).
7. The New Fund was established under and by virtue of a trust deed dated 24 June 2014 and amended and restated on 9 September 2016 (the Master Trust Deed), and an Establishment Deed dated 9 September 2016 executed by the Manager and Public Trust.
8. The manager of the New Fund is Smartshares Limited (the Manager) and the supervisor and trustee of the New Fund is Public Trust.
9. The New Fund will elect into the PIE regime and will become a "listed PIE" (as defined in s YA 1).
10. The investment policy of the New Fund is and will be similar in all material respects to that of the Existing Fund.

Steps to be undertaken to resettle the Existing Fund

11. The resettlement of the Existing Fund onto the New Fund will be achieved by utilising the resettlement mechanism contained in the Trust Deed.
12. The material provisions in the Trust Deed are as follows:

ARTICLE 18 – TERMINATION OF THE FUND

18.1 Termination

18.1.1 The Fund shall terminate if it has not previously terminated on the day that is the first of the following days to occur:

(a) the day that is one day less than 80 years from the date of this Deed;

(b) the day nominated by Unitholders pursuant to clause 18.2.1;

(c) the day appointed by the Manager pursuant to clause 18.2.2; or

(d) the day on which the Trustee retires under clause 13.11 if on the date of retirement no successor Trustee has been appointed;

(e) within 60 days of Unitholders by Extraordinary Resolution terminating the Manager's authority under clause 15.9.

18.2 Termination by Unitholder or Manager

18.2.1 Unitholders may terminate Fund: Unitholders may resolve by Extraordinary Resolution to terminate the Fund on a date not earlier than two months after the passage of the resolution, but no such resolution to terminate may be made if during a period of 3 months or more prior to the date of the deposit of the requisition:

(i) holders of Basket Numbers of Units would have been able, if they so wished, to redeem a Basket or more on at least 20 Business Days during that period, at their Current Unit Value; and

(ii) the reported weighted average price for sales of units in parcels of less than a Basket on at least 20 Business Days during that period has been higher than 1% below Current Unit Value at the time of sale.

18.2.2 Manager may terminate Fund: The Manager may terminate the Fund for any reason whatsoever, including (but without limitation) if in the opinion of the Manager the Fund is not sufficiently profitable for the Manager. The date of termination shall be a day appointed by the Manager by giving not less than two months' written notice to the Unitholders and to the Trustee.

18.2.3 No redemption once a termination date is determined: Upon Unitholders pursuant to clause 18.2.1, or the Manager pursuant to clause 18.2.2, determining a date of termination of the Fund the rights of Unitholders with respect to the redemption of Units shall cease.

18.3 Termination Procedure

18.3.1 Distribution of Assets: Upon the Fund being terminated subject to clause 13.13 (*successor trustee*), the Trustee shall discharge the liabilities and Expenses of the Fund and distribute to each Unitholder that Unitholder's share of the net Assets of the Fund proportionately to the Unitholders in such manner and within such period after the termination of the Fund as the Trustee considers advisable.

18.3.2 Form of distribution: Such distribution may be made in cash or in kind or partly in both, all as the Trustee in its sole discretion may determine.

18.3.3 Certificates and release: Any Certificates shall in the case of the final distribution be surrendered to the Trustee and such final distribution shall only be made against delivery to the Trustee of such form of release as the Trustee shall in its sole discretion require.

18.3.4 Resettlement: If Unitholders resolve by Extraordinary Resolution to resettle all or part of the income or capital of the Fund and the Trustee is satisfied that it is not, nor is it likely to become, materially prejudicial to the interests of Unitholders generally, the Trustee shall, :

(a) **Compulsory redemption:** Require Unitholders to accept repayment in respect of all or any of the Unitholders' Units for the purposes of the application of the proceeds referred to in clause 18.3.1; or

(b) **Apply Proceeds toward a New Fund:** Apply the proceeds of repayment towards the issue price for Units in an alternative Fund, being a New Fund ("the New Fund") with an investment policy similar in all material respects to those of the Fund ("the Existing Fund"), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

(c) **Transfer of GIF Assets:** Sell or otherwise transfer all or any GIF Assets of the Existing Fund to the New Fund.

(d) **Resettle New Fund:** Resettle by irrevocable deed (without infringing the rule against perpetuities) all or part of the income or capital of the Fund on the trusts and with the powers of any New Fund, or other trust approved by the Trustee.

(e) **Lend to New Fund:** Lend any sum to the trustee or trustees of that New Fund, with or without security, at an interest rate (if any) and on such other terms as in each respect the Trustee thinks fit.

(f) **Assume Liabilities:** Assume liabilities of the Existing Fund on behalf of the New Fund.

(g) **New Manager or Trustee:** Arrange any of the foregoing with another manager and/or trustee for the New Fund;

(h) **Terminate Fund:** Terminate the Existing Fund.

13. Other relevant provisions of the Trust Deed are as follows:

ARTICLE 1 - INTERPRETATION

1.1 Definitions

In this Deed, unless the subject matter or context otherwise requires:

…

"**Fund**" means the NZ Mid Cap Index Fund, a group investment fund constituted under this Deed and as the context requires refers also the Trustee in its capacity as trustee of that group investment fund;

ARTICLE 4 – REGISTERS, TRANSFERS, CERTIFICATES

…

4.11 Consolidation and Split of Units

4.11.1 Notice: The Manager may at any time, by notice in writing to the Trustee, cause Units in existence on a date specified in that notice to be consolidated or subdivided. Each such notice shall

(a) specify the date on which such consolidation or subdivision is to take place (the "Operative Date"); and

(b) specify the ratio ("the Ratio") which the number of Units in existence after the consolidation or subdivision will bear to the number of Units in existence before the consolidation or subdivision.

4.11.2 New number of Units: As from the Operative Date, each Unitholder of the Fund shall be deemed to hold a number of Units of the Fund equivalent to the number held by him before the Operative Date multiplied or divided (as the case may be) by the Ratio. For this purpose, at the option of the Manager in each case, fractions may be disregarded or may be rounded upwards or downwards.

4.11.3 Arrangement at Manager's discretion: The Manager shall make such arrangements (if any) as it deems appropriate, following a consolidation or subdivision, for the cancellation of existing Certificates and the issue of new Certificates.

ARTICLE 16 - AMENDMENTS

16.1 Amendments to Deed or Issue Terms

The Trustee may at any time make any alteration, modification, variation or addition to the Trust Deed or any Issue Term, with the concurrence of the Manager, in any of the following cases:

…

16.1.6 If it is authorised by an Extraordinary Resolution of the Unitholders under Clause 17.10.

14. Prior to the resettlement of the Existing Fund, the Trust Deed will be amended as follows by the Amendment Deed:

(a) A new definition will be added to clause 1.1 that reads as follows:

"**Resettlement Fund**" means a fund (other than the Fund) established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units are issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013) and that, at the date of any resettlement pursuant to Clause 18.3.4, has or will have Smartshares Limited as its manager.

(b) The second sentence of clause 18.2.2 will be amended to read as follows:

The date of termination shall be a day appointed by the Manager by giving not less than:

(i) one week's written notice if all of the income and capital of the Fund is to be resettled in accordance with clause 18.3.4 and an Extraordinary Resolution approving that resettlement has been passed; or

(ii) two months' written notice in all other cases,

to the Unitholders and the Trustee.

(c) Clause 18.3.4(b) will be deleted and the following inserted in its place:

(b) **Apply Proceeds towards a Resettlement Fund:** Apply the proceeds of repayment towards the issue price for units in a Resettlement Fund ("the New Fund") with an investment policy similar in all material respects to those of the Fund ("The Existing Fund"), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

15. Prior to the resettlement, the Manager will provide written notice to the Trustee (in accordance with clause 4.11 of the Trust Deed) requiring that each unit in the Existing Fund is subdivided so as to become two units (the Subdivision). Unitholders will not be given an option whether to receive a bonus issue (being the Subdivision of units) or money or money's worth (other than money's worth that is a bonus issue). The Subdivision will occur immediately prior to the Existing Fund being resettled. When it makes the bonus issue (being the subdivision of units), the Manager will resolve:

(a) that it is a "dividend" for the purposes of the Act;

(b) the amount to be treated as a dividend (which must be more than zero); and

(c) that imputation credits are attached at the maximum permitted ratio.

16. The Manager of the Existing Fund will give notice to the Commissioner under s 63 of the Tax Administration Act 1994 of the election to treat the Subdivision as a dividend under s CD 8, and the amount to be treated as a dividend.

17. The effect of the Subdivision and related resolutions summarised above is that the Existing Fund is unlikely to have any imputation credits at the time the resettlement occurs.

18. The following steps will be undertaken to achieve the resettlement of the Existing Fund on the New Fund:

(a) A notice of meeting will be issued to Unitholders of the Existing Fund in accordance with the requirements of Article 17 of the Trust Deed. The notice of meeting will advise Unitholders of:

(i) the following proposed amendments to the Trust Deed:

- the amendment contained in the Amendment Deed (such amendment allowing the power of resettlement in clause 18.3.4 to be used to resettle the assets of the Existing Fund onto the New Fund notwithstanding that the New Fund is not a group investment fund); and

- the amendment of the notice period required for the termination of the Existing Fund by the Manager under clause 18.2.2 from two months to one week;

(ii) the intention to seek authorisation of the resettlement of the Existing Fund on the New Fund (as required by clause 18.3.4 of the Trust Deed).

(b) At the meeting, the Manager will give notice of the intended termination of the Existing Fund pursuant to clause 18.2.2 of the Trust Deed. Such notice will be conditional on the Unitholders passing extraordinary resolutions approving:

(i) the amendments to the Trust Deed referred to in [18(a)(i)] above; and

(ii) the resettlement described in [18(a)(ii)] above.

(c) Formal written notice will be provided in compliance with the provisions of clause 18.2.2 of the Trust Deed (as amended) immediately following the passage of the extraordinary resolutions referred to in [18(b)].

(d) If the Unitholders approve the amendments to the Trust Deed referred to in [18(a)(i)] above, and approve the resettlement described in [18(a)(ii)] above, the Trustee will:

(i) discharge the liabilities and expenses of the Existing Fund (clause 18.3.1);

(ii) redeem the Unitholders' units in the Existing Fund (clause 18.3.4(a));

(iii) apply the proceeds of redemption to acquire units in the New Fund on behalf of Unitholders (clause 18.3.4(b));

(iv) transfer the assets of the Existing Fund to the New Fund (to be held and invested subject to a statement of investment policy and objectives identical in all material respects to the investment policy to which the Existing Fund is subject) (clause 18.3.4(c)); and

(v) wind up the Existing Fund (clause 18.3.4(h)).

19. Accordingly, the Arrangement will comprise a redemption of Unitholders' units in the Existing Fund and a resettlement on the New Fund. At conclusion of the resettlement process:

(a) Unitholders will hold interests in the New Fund of the same value and on substantially similar terms as the interests they held in the Existing Fund;

(b) the New Fund will hold the same assets as the Existing Fund and will continue to invest on the same basis and in the same manner in which the Existing Fund invested prior to resettlement.

20. To ensure that the resettlement process does not result in the New Fund inadvertently breaching foreign securities laws, the New Fund will not issue units to any Unitholders in the Existing Fund whose address on the register of Unitholders (established and maintained under clause 4.1 of the Trust Deed) is outside New Zealand (Offshore Unitholders). Accordingly the redemption proceeds that Offshore Unitholders receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming unitholders in the New Fund.

21. The trustees of the Existing Fund and the New Fund will enter into a Deed of Resettlement and Related Matters pursuant to which the trustee of the New Fund will undertake to issue units to Unitholders (excluding Offshore Unitholders) in proportion to the units that they each held on resettlement in the Existing Fund and to receive funds which are unallocated at the time of resettlement (if any) and to pay such amounts to the persons lawfully entitled to those funds. This ruling is based on a draft of the Deed of Resettlement and Related Matters provided to the Commissioner on 21 October 2016.

22. The Existing Fund will not at the time of its resettlement onto the New Fund be a party to a "returning share transfer" as that term is defined in the Act.

23. Immediately prior to its resettlement, the assets of the Existing Fund will include cash held in short term interest bearing bank accounts (the Bank Accounts) by the Existing Fund. Such amounts of the Bank Accounts that form part of the net assets of the Existing Fund at the time of redemption will be distributed to Unitholders on redemption of their units under the Arrangement.

24. An amount equal to the interest derived on such accounts is paid by the Existing Fund to the Manager as a management fee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Existing Fund:

- is not a "designated group investment fund" (as defined in s HR 3(6));
- results from investments made into it that are not from a "designated source" (as defined in s HR 3(5));
- does not derive any "category B income" (as defined in s YA 1); and
- is a "listed PIE" (as defined in s YA 1).

How the Taxation Laws apply to the Arrangement

Subject in all respects to any conditions stated above, the Taxation Laws apply to the Arrangement as follows:

(a) Any units received by the Unitholders under the Subdivision will be a "taxable bonus issue" that is a dividend under s CD 8.

(b) The amount derived by Unitholders of the Existing Fund on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income under s CX 56C(1) if they:

(i) are resident; and

(ii) are a natural person or a trustee; and

(iii) do not include the amount as income in a return of income for the income year.

(c) If any one or more of the criteria listed in subparagraphs (i) to (iii) above does not apply to the Unitholder, the amount derived by the Unitholder on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income to the extent to which the redemption proceeds is more than the amount that is fully credited as described in s CD 43(26).

(d) Unitholders (other than Offshore Unitholders or PIEs) will:

(i) derive income under s CB 4 from the disposal of the redemption proceeds to the New Fund;

(ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and

(iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(e) Unitholders which are PIEs will derive excluded income under s CX 55 from the disposal of the redemption proceeds to the New Fund to the extent that:

(i) the redemption proceeds consist of shares issued by a company referred to in s CX 55(3)(a);

(ii) the Unitholders are not assured under an arrangement with another person of having a gain on the disposal; and

(iii) the shares are not fixed-rate shares within the meaning of paragraphs (a) to (d) of the definition of "fixed-rate share".

(f) To the extent that Unitholders which are PIEs dispose of redemption proceeds that do not satisfy one or more of the criteria listed in subparagraphs (i) to (iii) of paragraph (e), those Unitholders will:

(i) derive income under section CB 4 from the disposal of the redemption proceeds to the New Fund;

(ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and

(iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(g) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2016 and ending on 30 September 2017.

This Ruling is signed by me on the 25th day of October 2016.

Howard Davis
Director (Taxpayer Rulings)

Product ruling – BR Prd 16/07

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Smartshares Limited in its capacity as Manager of the NZX 10 Fund.

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CB 4, CD 8, CX 56C, DB 23, and FC 2.

The Arrangement to which this Ruling applies

The Arrangement is the resettlement of the NZX 10 Fund (the Existing Fund) onto the NZ Top 10 Fund (the New Fund) by redeeming units held by unitholders (Unitholders) in the Existing Fund, applying the redemption proceeds to acquire units in the New Fund on behalf of Unitholders, and transferring the assets of the Existing Fund to the New Fund.

However, the New Fund will not issue units to Unitholders whose address on the register of Unitholders is outside New Zealand (Offshore Unitholders). The redemption proceeds that Offshore Unitholders will receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming unitholders in the New Fund.

Prior to the resettlement Unitholder's units in the Existing Fund will be subdivided and the Manager of the Existing Fund will resolve that the subdivision of units is a dividend that will be fully imputed.

The New Fund was established as part of a managed investment scheme as defined in the Financial Markets Conduct Act 2013 (FMCA) in relation to which units will be issued that are managed investment products (as defined in the FMCA).

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

The Existing Fund

1. The Existing Fund was established by a trust deed dated 7 May 1996 (the Trust Deed), as subsequently amended by:
    (a) first Deed of Modification to the Trust Deed dated 7 November 1996;
    (b) second Deed of Modification to the Trust Deed dated 14 December 2000;
    (c) third Deed of Modification to the Trust Deed dated 29 May 2001;
    (d) fourth Deed of Modification to the Trust Deed dated 17 December 2003;
    (e) fifth Deed of Modification to the Trust Deed dated 17 March 2005;
    (f) sixth Deed of Modification to the Trust Deed dated 9 December 2005;
    (g) seventh Deed of Modification to the Trust Deed dated 1 October 2007;
    (h) eighth Deed of Modification to the Trust Deed dated 30 March 2010;
    (i) ninth Deed of Modification to the Trust Deed dated 3 September 2010;
    (j) deed of amendment to the Trust Deed to be dated 2016 (the Amendment Deed).
2. The Trust Deed established the Existing Fund as a group investment fund in accordance with the Trustee Companies Act 1967.
3. The Existing Fund elected into the portfolio investment entity (PIE) regime and is a "listed PIE" as defined in s YA 1.
4. The Manager of the Existing Fund is Smartshares Limited (the Manager), and the trustee of the Existing Fund is The New Zealand Guardian Trust Company Limited.
5. The Existing Fund invests in financial products listed on the NZX Main Board and is designed to track the S & P / NZX 10 Index. The S & P / NZX 10 Index is made up of ten of the largest financial products listed on the NZX Main Board, but excludes products issued by non-New Zealand issuers. The Existing Fund's investment objective is to provide a return that closely matches the return on the S & P / NZX 10 Index.

The New Fund

6. The New Fund is a fund established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units will be issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013).
7. The New Fund was established under and by virtue of a trust deed dated 24 June 2014 and amended and restated on 9 September 2016 (the Master Trust Deed), and an Establishment Deed dated 9 September 2016 executed by the Manager and Public Trust.
8. The manager of the New Fund is Smartshares Limited (the Manager) and the supervisor and trustee of the New Fund is Public Trust.
9. The New Fund will elect into the PIE regime and will become a "listed PIE" (as defined in s YA 1).
10. The investment policy of the New Fund is and will be similar in all material respects to that of the Existing Fund.

Steps to be undertaken to resettle the Existing Fund

11. The resettlement of the Existing Fund onto the New Fund will be achieved by utilising the resettlement mechanism which will, at the time of resettlement, be contained in the Trust Deed.
12. The material provisions in the Trust Deed are as follows:

ARTICLE 20 – TERMINATION OF A FUND

20.1 Termination

20.1.1 Each Fund shall terminate if it has not previously terminated on the day that is the first of the following days to occur:

(a) the day that is one day less than 80 years from the date of this Deed;

(b) the day appointed by the Manager for that Fund by giving not less than two months' written notice to the Unitholders and to the Trustee; or

(c) the day nominated by Unitholders pursuant to clause 20.2.1;

(d) the day on which the Fund is terminated pursuant to the terms of this Deed or law; or

(e) the day on which the Trustee retires under clause 15.11 if on the date of retirement no successor Trustee has been appointed.

20.2 Termination by Unitholder

20.2.1 Unitholders may resolve by Extraordinary Resolution to terminate the Fund on a date not earlier than two months after the passage of the resolution, but no such resolution to terminate may be made if during a period of 3 months or more prior to the date of the deposit of the requisition:

(i) holders of Basket Numbers of Units would have been able, if they so wished, to redeem a Basket or more on at least 20 Business Days during that period, at their Current Unit Value; and

(ii) the reported weighted average price for sales of units in parcels of less than a Basket on at least 20 Business Days during that period has been higher than 1% below Current Unit Value at the time of sale.

20.2.2 As and from the date of termination of a Fund so fixed by the Manager the rights of Unitholders with respect to the redemption of Units shall cease.

20.3 Termination Procedure

20.3.1 Upon a Fund being terminated subject to clause 15.14 (*successor trustee*), the Trustee shall discharge the liabilities and Expenses of that Fund and distribute to each Unitholder that Unitholder's share of the net Assets of the Fund proportionately to the Unitholders in such manner and within such period after the termination of the Fund as the Trustee considers advisable.

20.3.2 Such distribution may be made in cash or in kind or partly in both, all as the Trustee in its sole discretion may determine.

20.3.3 Any Certificates shall in the case of the final distribution be surrendered to the Trustee and such final distribution shall only be made against delivery to the Trustee of such form of release as the Trustee shall in its sole discretion require.

13. Other relevant provisions of the Trust Deed are as follows:

ARTICLE 1 - INTERPRETATION

1.1 Definitions

In this Deed, unless the subject matter or context otherwise requires, in respect of each Fund:

…

"**Fund**" means a group investment fund governed by this Deed;

ARTICLE 4 – REGISTERS, TRANSFERS, CERTIFICATES

4.10 Consolidatixon and Split of Units

4.10.1 The Manager may at any time, by notice in writing to the Trustee, cause Units in existence at a Record Date specified in that notice to be consolidated or subdivided. Each such noticed shall:

(a) specify the date on which such consolidation or subdivision is to take place (the "Operative Date"); and

(b) specify the ratio ("the Ratio") which the number of Units in existence after the consolidation or subdivision will bear to the number of Units in existence before the consolidation or subdivision.

4.10.2 As from the Operative Date, each Unitholder of the Fund shall be deemed to hold a number of Units of the Fund equivalent to the number held by him before the Operative Date multiplied or divided (as the case may be) by the Ratio. For this purpose, at the option of the Manager in each case, fractions may be disregarded or may be rounded upwards or downwards.

4.10.3 The Manager shall make such arrangements (if any) as it deems appropriate, following a consolidation or subdivision, for the cancellation of existing Certificates and the issue of new Certificates.

ARTICLE 18 - AMENDMENTS

18.1 Amendments to Deed

The Trustee may at any time make any alteration, modification, variation or addition to the Trust Deed or any Issue Term, with the concurrence of the Manager, in any of the following cases:

…

18.1.5 If it is authorised by an Extraordinary Resolution of the Unitholders under Clause 19.10 (Effect of a resolution).

14. Prior to the resettlement of the Existing Fund, the Trust Deed will be amended as follows by the Amendment Deed:

(a) Clause 20.1.1(b) will be amended to read as follows:

(b) the day appointed by the Manager for that Fund by giving not less than:

(i) one week's written notice if all of the income and capital of the Fund is to be resettled in accordance with clause 20.3.4 and an Extraordinary Resolution approving that resettlement has been passed; or

(ii) two months' written notice in all other cases,

to the Unitholders and the Trustee.

(b) Clause 20.3 will be amended by the insertion of the following:

20.3.4 Resettlement: If Unitholders resolve by Extraordinary Resolution to resettle all or part of the income or capital of the Fund and the Trustee is satisfied that it is not, nor is it likely to become, materially prejudicial to the interests of Unitholders generally, the Trustee shall:

(a) Require Unitholders to accept repayment of all or any of the Unitholders' Units for the purposes of the application of the proceeds referred to in clause 20.3.1.

(b) Apply the proceeds of repayment towards the issue price for units in a Resettlement Fund ("the New Fund") with an investment policy similar in all material respects to those of the Fund ("the Existing Fund"), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

(c) Sell or otherwise transfer all or any GIF Assets of the Existing Fund to the New Fund.

(d) Resettle by irrevocable deed (without infringing the rule against perpetuities) all or part of the income or capital of the Fund on the trusts and with the powers of any New Fund, or other trust approved by the Trustee.

(e) Lend any sum to the trustee or trustees of that New Fund, with or without security, at an interest rate (if any) and on such other terms as in each respect the Trustee thinks fit.

(f) Assume liabilities of the Existing Fund on behalf of the New Fund.

(g) Arrange any of the foregoing with another manager and/or trustee for the New Fund.

(h) Terminate the Existing Fund.

(c) A new definition will be added to clause 1.1 that reads as follows:

"**Resettlement Fund**" means a fund (other than the Fund) established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units are issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013) and that, at the date of any resettlement pursuant to Clause 20.3.4, has or will have Smartshares Limited as its manager.

15. Prior to the date of resettlement, the Manager will provide written notice to the Trustee (in accordance with clause 4.10 of the Trust Deed) requiring that each unit in the Existing Fund is subdivided so as to become two units (the Subdivision). Unitholders will not be given an option whether to receive a bonus issue (being the Subdivision) or money or money's worth (other than money's worth that is a bonus issue).

16. The Subdivision will occur immediately prior to the Existing Fund being resettled. When it makes the Subdivision, the Manager will resolve:

(a) that it is a "dividend" for purposes of the Act;

(b) the amount to be treated as a dividend (which must be more than zero); and

(c) that imputation credits are attached at the maximum permitted ratio.

17. The Manager of the Existing Fund will give notice to the Commissioner under s 63 of the Tax Administration Act 1994 of the election to treat the Subdivision as a dividend under s CD 8, and the amount to be treated as a dividend.

18. The effect of the Subdivision and related resolutions summarised above is that the Existing Fund is unlikely to have any imputation credits at the time the resettlement occurs.

19. The following steps will be undertaken to achieve the resettlement of the Existing Fund on the New Fund:

(a) A notice of meeting will be issued to Unitholders in the Existing Fund in accordance with the requirements of Article 19 of the Trust Deed. The notice of meeting will advise Unitholders of:

(i) the following proposed amendments to the Trust Deed:

- the amendment contained in the Amendment Deed (such amendment introducing the ability to resettle the assets of the Existing Fund on a New Fund with an investment policy similar in all material respects to that of the Existing Fund); and
- the amendment of the notice period required for the termination of the Existing Fund by the Manager under clause 20.1.1(b) from two months to one week;

(ii) the intention to seek authorisation of the resettlement of the Existing Fund on the New Fund (as required by (new) clause 20.3.4 of the Trust Deed).

(b) At the meeting, the Manager will give notice of the intended termination of the Existing Fund pursuant to clause 20.2.2 of the Trust Deed. Such notice will be conditional on the Unitholders passing extraordinary resolutions approving:

(i) the amendments to the Trust Deed referred to in [19(a)(i)] above; and

(ii) the resettlement described in [19(a)(ii)] above.

(c) Formal written notice will be provided in compliance with the provisions of clause 20.2.2 of the Trust Deed (as amended) immediately following the passage of the extraordinary resolutions referred to in [19(b)].

(d) If the Unitholders approve the amendments to the Trust Deed referred to in [19(a)(i)] above, and approve the resettlement described in [19(a)(ii)] above, the Trustee will:

(i) discharge the liabilities and expenses of the Existing Fund (clause 20.3.1);

(ii) redeem the Unitholders' units in the Existing Fund (clause 20.3.4(a));

(iii) apply the proceeds of redemption to acquire units in the New Fund on behalf of the Unitholders (clause 20.3.4(b));

(iv) transfer the assets of the Existing Fund to the New Fund (to be held and invested subject to a statement of investment policy and objectives identical in all material respects to the investment policy to which the Existing Fund is subject (clause 20.3.4(c)); and

(v) wind up the Existing Fund (clause 20.3.4(h)).

20. Accordingly, the Arrangement will comprise a redemption of Unitholders' units in the Existing Fund and a resettlement on the New Fund. At conclusion of the resettlement process:

(a) Unitholders will hold interests in the New Fund of the same value and on substantially similar terms as the interests they held in the Existing Fund;

(b) the New Fund will hold the same assets as the Existing Fund and will continue to invest on the same basis and in the same manner in which the Existing Fund invested prior to resettlement.

21. To ensure that the resettlement process does not result in the New Fund inadvertently breaching foreign securities laws, the New Fund will not issue units to any Unitholders in the Existing Fund whose address on the register of Unitholders (established and maintained under clause 4.1 of the Trust Deed) is outside New Zealand (Offshore Unitholders). Accordingly the redemption proceeds that Offshore Unitholders receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming Unitholders in the New Fund.

22. The trustees of the Existing Fund and the New Fund will enter into a Deed of Resettlement and Related Matters pursuant to which the trustee of the New Fund will undertake to issue units to Unitholders (excluding Offshore Unitholders) in proportion to the units that they each held on resettlement in the Existing Fund and to receive funds which are unallocated at the time of resettlement (if any) and to pay such amounts to the persons lawfully entitled to those funds. This ruling is based on a draft of the Deed of Resettlement and Related Matters provided to the Commissioner on 21 October 2016.

23. The Existing Fund will not at the time of its resettlement onto the New Fund be a party to a returning share transfer as defined in s YA 1.

24. Immediately prior to its resettlement, the assets of the Existing Fund will include cash held in short term interest bearing bank accounts (the Bank Accounts) by the Existing Fund. Such amounts of the Bank Accounts that form part of the net assets of the Existing Fund at the time of redemption will be distributed to Unitholders on redemption of their units under the Arrangement.

25. An amount equal to the interest derived on the Bank Accounts is paid by the Existing Fund to the Manager as a management fee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

This Ruling is made subject to the following conditions:

(a) The Existing Fund:

- is not a "designated group investment fund" (as defined in s HR 3(6));
- results from investments made into it that are not from a "designated source" (as defined in s HR 3(5));
- does not derive any "category B income" (as defined in s YA 1); and
- is a "listed PIE" (as defined in s YA 1).

How the Taxation Laws apply to the Arrangement

Subject in all respects to any conditions stated above, the Taxation Laws apply to the Arrangement as follows:

(a) Any units received by the Unitholders under the Subdivision will be a "taxable bonus issue" that is a dividend under s CD 8.

(b) The amount derived by Unitholders of the Existing Fund on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income under s CX 56C(1) if they:

- (i) are resident; and
- (ii) are a natural person or a trustee; and
- (iii) do not include the amount as income in a return of income for the income year.

(c) If any one or more of the criteria listed in subparagraphs (i) to (iii) above does not apply to the Unitholder, the amount derived by the Unitholder on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income to the extent to which the redemption proceeds is more than the amount that is fully credited as described in s CD 43(26).

(d) Unitholders (other than Offshore Unitholders or PIEs) will:

- (i) derive income under s CB 4 from the disposal of the redemption proceeds to the New Fund;
- (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and
- (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(e) Unitholders which are PIEs will derive excluded income under s CX 55 from the disposal of the redemption proceeds to the New Fund to the extent that:

- (i) the redemption proceeds consist of shares issued by a company referred to in s CX 55(3)(a);
- (ii) the Unitholders are not assured under an arrangement with another person of having a gain on the disposal; and
- (iii) the shares are not fixed-rate shares within the meaning of paragraphs (a) to (d) of the definition of "fixed-rate share".

(f) To the extent that Unitholders which are PIEs dispose of redemption proceeds that do not satisfy one or more of the criteria listed in subparagraphs (i) to (iii) of paragraph (e), those Unitholders will:

- (i) derive income under section CB 4 from the disposal of the redemption proceeds to the New Fund;
- (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and
- (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(g) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2016 and ending on 30 September 2017.

This Ruling is signed by me on the 25th day of October 2016.

Howard Davis
Director, Taxpayer Rulings

Product ruling – BR Prd 16/08

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Smartshares Limited in its capacity as Manager of the NZX Australian 20 Leaders Index Fund.

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CB 4, CD 8, CX 56C, DB 23, and FC 2.

The Arrangement to which this Ruling applies

The Arrangement is the resettlement of the NZX Australian 20 Leaders Index Fund (the Existing Fund) onto the Australian Top 20 Fund (the New Fund) by redeeming units held by unitholders (Unitholders) in the Existing Fund, applying the redemption proceeds to acquire units in the New Fund on behalf of Unitholders, and transferring the assets of the Existing Fund to the New Fund.

However, the New Fund will not issue units to Unitholders whose address on the register of Unitholders is outside New Zealand (Offshore Unitholders). The redemption proceeds that Offshore Unitholders will receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming unitholders in the New Fund.

Prior to the resettlement Unitholder's units in the Existing Fund will be subdivided and the Manager of the Existing Fund will resolve that the subdivision of units is a dividend that will be fully imputed.

The New Fund was established as part of a managed investment scheme as defined in the Financial Markets Conduct Act 2013 (FMCA) in relation to which units will be issued that are managed investment products (as defined in the FMCA).

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

The Existing Fund

1. The Existing Fund was established by a trust deed dated 20 January 1997 (the Trust Deed), as subsequently amended by:
   (a) first supplemental deed to the Trust Deed dated 14 September 2001;
   (b) second supplemental deed to the Trust Deed dated 30 June 2006;
   (c) third deed of modification to the Trust Deed dated 1 October 2007;
   (d) fourth deed of modification to the Trust Deed dated 30 March 2010;
   (e) fifth deed of modification to the Trust Deed dated 21 September 2010;
   (f) deed of amendment to the Trust Deed to be dated 2016 (the Amendment Deed).
2. The Trust Deed established the Existing Fund as a group investment fund in accordance with the Trustee Companies Act 1967.
3. The Existing Fund elected into the portfolio investment entity (PIE) regime and is a "listed PIE" as defined in s YA 1.
4. The Manager of the Existing Fund is Smartshares Limited (the Manager), and the trustee of the Existing Fund is Trustees Executors Limited.
5. The Existing Fund invests in financial products listed on the ASX Main Board and is designed to track the S & P / ASX 20 Index. The Existing Fund's investment objective is to provide a return that closely matches the return on the S & P / ASX 20 Index. The S & P / ASX 20 Index is comprised of the 20 largest financial products by market capitalisation in Australia.

The New Fund

6. The New Fund is a fund established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units will be issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013).
7. The New Fund was established under and by virtue of a trust deed dated 24 June 2014 and amended and restated on 9 September 2016 (the Master Trust Deed), and an Establishment Deed dated 9 September 2016 executed by the Manager and Public Trust.

8. The manager of the New Fund is Smartshares Limited (the Manager) and the supervisor and trustee of the New Fund is Public Trust.
9. The New Fund will elect into the PIE regime and will become a "listed PIE" (as defined in s YA 1).
10. The investment policy of the New Fund is and will be similar in all material respects to that of the Existing Fund.

Steps to be undertaken to resettle the Existing Fund

11. The resettlement of the Existing Fund onto the New Fund will be achieved by utilising the resettlement mechanism contained in the Trust Deed.
12. The material provisions in the Trust Deed are as follows:

ARTICLE 18 – TERMINATION OF A FUND

18.1 Termination

18.1.1 The Fund shall terminate if it has not previously terminated on the day that is the first of the following days to occur:

(a) the day that is one day less than 80 years from the date of this Deed;

(b) the day appointed by the Manager by giving not less than two months' written notice to the Unitholders and to the Trustee; or

(c) the day nominated by Unitholders pursuant to clause 18.2.1;

(d) the day on which the Trustee retires under clause 13.11 if on the date of retirement no successor Trustee has been appointed;

(e) within 60 days of the Trustee terminating the Manager's authority under clause 15.8.

18.2 Termination by Unitholder

18.2.1 Unitholders may terminate Fund: Unitholders may resolve by Extraordinary Resolution to terminate the Fund on a date not earlier than two months after the passage of the resolution, but no such resolution to terminate may be made if during a period of 3 months or more prior to the date of the deposit of the requisition:

(i) holders of Basket Numbers of Units would have been able, if they so wished, to redeem a Basket or more on at least 20 Business Days during that period, at their Current Unit Value; and

(ii) the reported weighted average price for sales of units in parcels of less than a Basket on at least 20 Business Days during that period has been higher than 1% below Current Unit Value at the time of sale.

18.2.2 No redemption once a termination date is determined: Upon the Manager determining a date of termination of the Fund the rights of Unitholders with respect to the redemption of Units shall cease.

18.3 Termination Procedure

18.3.1 Distribution of Assets: Upon the Fund being terminated subject to clause 13.13 (*successor trustee*), the Trustee shall discharge the liabilities and Expenses of the Fund and distribute to each Unitholder that Unitholder's share of the net Assets of the Fund proportionately to the Unitholders in such manner and within such period after the termination of the Fund as the Trustee considers advisable.

18.3.2 Form of distribution: Such distribution may be made in cash or in kind or partly in both, all as the Trustee in its sole discretion may determine.

18.3.3 Certificates and release: Any Certificates shall in the case of the final distribution be surrendered to the Trustee and such final distribution shall only be made against delivery to the Trustee of such form of release as the Trustee shall in its sole discretion require.

18.3.4 Resettlement: If Unitholders resolve by Extraordinary Resolution to resettle all or part of the income or capital of the Fund and the Trustee is satisfied that it is not, nor is it likely to become, materially prejudicial to the interests of Unitholders generally, the Trustee shall, :

(a) **Compulsory redemption:** Require Unitholders to accept repayment in respect of all or any of the Unitholders' Units for the purposes of the application of the proceeds referred to in clause 18.3.1; or

(b) **Apply Proceeds toward a New Fund:** Apply the proceeds of repayment towards the issue price for Units in an alternative Fund, being a New Fund ("the New Fund") with an investment policy similar in all material respects to those of the Fund ("the Existing Fund"), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

(c) **Transfer of GIF Assets:** Sell or otherwise transfer all or any GIF Assets of the Existing Fund to the New Fund.

(d) **Resettle New Fund:** Resettle by irrevocable deed (without infringing the rule against perpetuities) all or part of the income or capital of the Fund on the trusts and with the powers of any New Fund, or other trust approved by the Trustee.

(e) **Lend to New Fund:** Lend any sum to the trustee or trustees of that New Fund, with or without security, at an interest rate (if any) and on such other terms as in each respect the Trustee thinks fit.

(f) **Assume Liabilities:** Assume liabilities of the Existing Fund on behalf of the New Fund.

(g) **New Manager or Trustee:** Arrange any of the foregoing with another manager and/or trustee for the New Fund;

(h) **Terminate Fund:** Terminate the Existing Fund.

13. Other relevant provisions of the Trust Deed are as follows:

ARTICLE 1 - INTERPRETATION

1.1 Definitions

In this Deed, unless the subject matter or context otherwise requires:

.

"**Fund**" means the group investment fund constituted under this Deed;

ARTICLE 4 – REGISTERS, TRANSFERS, CERTIFICATES

4.11 Consolidation and Split of Units

4.11.1 Notice: The Manager may at any time, by notice in writing to the Trustee, cause Units in existence on a date specified in that notice to be consolidated or subdivided. Each such notice shall:

(a) specify the date on which such consolidation or subdivision is to take place (the "Operative Date"); and

(b) specify the ratio ("the Ratio") which the number of Units in existence after the consolidation or subdivision will bear to the number of Units in existence before the consolidation or subdivision.

4.11.2 New number of Units: As from the Operative Date, each Unitholder of the Fund shall be deemed to hold a number of Units of the Fund equivalent to the number held by him before the Operative Date multiplied or divided (as the case may be) by the Ratio. For this purpose, at the option of the Manager in each case, fractions may be disregarded or may be rounded upwards or downwards.

4.11.3 Arrangement at Manager's discretion: The Manager shall make such arrangements (if any) as it deems appropriate, following a consolidation or subdivision, for the cancellation of existing Certificates and the issue of new Certificates.

ARTICLE 17 – MEETINGS

17.10 Resolution binding on all: Except as provided for in clauses 17.10.2, 17.10.3, 18.2.1 (Unitholder's may terminate Fund) and 18.3.4 (Resettlement) a resolution passed at a meeting of Unitholders duly convened and held in accordance with this Article 17 shall be binding upon all Unitholders whether present or not present at the meeting, and the Manager and the Trustee shall be bound to give effect thereto accordingly and the passing of any such resolution shall as between the Trustee, the Manager and the Unitholders be conclusive evidence that the circumstances justify the passing thereof the intention being that it shall rest with the meeting to determine without appeal whether or not the circumstances justify the passing of such resolution.

17.10.2 Resolution amending this Deed: Other than as provided for in Article 16 (Amendments) only an Extraordinary Resolution can amend, alter, modify, vary or add to this Deed.

14. Prior to the resettlement of the Existing Fund, the Trust Deed will be amended by the Amendment Deed as follows:

(a) A new definition will be added to clause 1.1 that reads as follows:

"**Resettlement Fund**" means a fund (other than the Fund) established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units are issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013) and that, at the date of any resettlement pursuant to clause 18.3.4, has or will have Smartshares Limited as its manager.

(b) Clause 18.1.1(b) will be amended to read as follows:

the day appointed by the Manager by giving not less than:

(i) one week's written notice if all of the income and capital of the Fund is to be resettled in accordance with clause 18.3.4 and an Extraordinary Resolution approving that resettlement has been passed; or

(ii) two months' written notice in all other cases,

to the Unitholders and the Trustee.

(c) Clause 18.3.4(b) will be deleted and the following inserted in its place:

(b) **Apply Proceeds towards a Resettlement Fund**: Apply the proceeds of repayment towards the issue price for units in a Resettlement Fund ("the New Fund") with an investment policy similar in all material respects to those of the Fund ("the Existing Fund"), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

15. Prior to the date of resettlement, the Manager will provide written notice to the Trustee (in accordance with clause 4.11 of the Trust Deed) requiring that each unit in the Existing Fund is subdivided so as to become two units (the Subdivision). Unitholders will not be given an option whether to receive a bonus issue (being the Subdivision) or money or money's worth (other than money's worth that is a bonus issue).

16. The Subdivision will occur immediately prior to the Existing Fund being resettled. When it makes the Subdivision, the Manager will resolve:

(a) that it is a "dividend" for purposes of the Act;

(b) the amount to be treated as a dividend (which must be more than zero); and

(c) that imputation credits are attached at the maximum permitted ratio.

17. The Manager of the Existing Fund will give notice to the Commissioner under s 63 of the Tax Administration Act 1994 of the election to treat the Subdivision as a dividend under s CD 8, and the amount to be treated as a dividend.

18. The effect of the Subdivision and related resolutions summarised above is that the Existing Fund is unlikely to have any imputation credits at the time the resettlement occurs.

19. The following steps will be undertaken to achieve the resettlement of the Existing Fund on the New Fund:

(a) A notice of meeting will be issued to Unitholders in the Existing Fund in accordance with the requirements of Article 19 of the Trust Deed. The notice of meeting will advise Unitholders of:

(i) the following proposed amendments to the Trust Deed:

- the amendment contained in the Amendment Deed (such amendment allowing the power of resettlement in clause 18.3.4 to be used to resettle the assets of the Existing Fund onto the New Fund notwithstanding that the New Fund is not a group investment fund); and
- the amendment of the notice period required for the termination of the Existing Fund by the Manager under clause 18.1.1(b) from two months to one week;

(ii) the intention to seek authorisation of the resettlement of the Existing Fund on the New Fund (as required by clause 18.3.4 of the Trust Deed).

(b) At the meeting, the Manager will give notice of the intended termination of the Existing Fund pursuant to clause 18.1.1(b) of the Trust Deed. Such notice will be conditional on the Unitholders passing extraordinary resolutions approving:

(i) the amendments to the Trust Deed referred to in [19(a)(i)] above; and

(ii) the resettlement described in [19(a)(ii)] above.

(c) Formal written notice will be provided in compliance with the provisions of clause 18.1.1(b) of the Trust Deed (as amended) immediately following the passage of the extraordinary resolutions referred to in [19(b)] above.

(d) If the Unitholders approve the amendments to the Trust Deed referred to in [19(a)(i)] above, and approve the resettlement described in [19(a)(ii)] above, the Trustee will:

(i) discharge the liabilities and expenses of the Existing Fund (clause 18.3.1);

(ii) redeem the Unitholders' units in the Existing Fund (clause 18.3.4(a));

(iii) apply the proceeds of redemption towards the issue price of units in the New Fund on behalf of the Unitholders (clause 18.3.4(b));

(iv) transfer the assets of the Existing Fund to the New Fund (to be held and invested subject to a statement of investment policy and objectives identical in all material respects to the investment policy to which the Existing Fund is subject) (clause 18.3.4(c)); and

(v) wind up the Existing Fund (clause 18.3.4(h)).

20. Accordingly, the Arrangement will comprise a redemption of Unitholders' interests in the Existing Fund and a resettlement on the New Fund. At conclusion of the resettlement process:

(a) Unitholders will hold interests in the New Fund of the same value and on substantially similar terms as the interests they held in the Existing Fund;

(b) the New Fund will hold the same assets as the Existing Fund and will continue to invest on the same basis and in the same manner in which the Existing Fund invested prior to resettlement.

21. To ensure that the resettlement process does not result in the New Fund inadvertently breaching foreign securities laws, the New Fund will not issue units to any Unitholders in the Existing Fund whose address on the register of Unitholders (established and maintained under clause 4.1 of the Trust Deed) is outside New Zealand (Offshore Unitholders). Accordingly the redemption proceeds that Offshore Unitholders receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming Unitholders in the New Fund.

22. The trustees of the Existing Fund and the New Fund will enter into a Deed of Resettlement and Related Matters pursuant to which the trustee of the New Fund will undertake to issue units to Unitholders (excluding Offshore Unitholders) in proportion to the units that they each held on resettlement in the Existing Fund and to receive funds which are unallocated at the time of resettlement (if any) and to pay such amounts to the persons lawfully entitled to those funds. This ruling is based on a draft of the Deed of Resettlement and Related Matters provided to the Commissioner on 21 October 2016.

23. The Existing Fund will not at the time of its resettlement onto the New Fund be a party to a "returning share transfer" as defined in s YA 1.

24. Immediately prior to its resettlement, the assets of the Existing Fund will include cash held in short term interest bearing bank accounts (the Bank Accounts) by the Existing Fund. Such amounts of the Bank Accounts that form part of the net assets of the Existing Fund at the time of redemption will be distributed to Unitholders on redemption of their units under the Arrangement.

25. An amount equal to the interest derived on the Bank Accounts is paid by the Existing Fund to the Manager as a management fee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Existing Fund:

- is not a "designated group investment fund" (as defined in s HR 3(6));
- results from investments made into it that are not from a "designated source" (as defined in s HR 3(5));
- does not derive any "category B income" (as defined in s YA 1); and
- is a "listed PIE" (as defined in s YA 1).

How the Taxation Laws apply to the Arrangement

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

(a) Any units received by the Unitholders under the Subdivision will be a "taxable bonus issue" that is a dividend under s CD 8.

(b) The amount derived by Unitholders of the Existing Fund on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income under s CX 56C(1) if they:

(i) are resident; and

(ii) are a natural person or a trustee; and

(iii) do not include the amount as income in a return of income for the income year.

(c) If any one or more of the criteria listed in subparagraphs (i) to (iii) above does not apply to the Unitholder, the amount derived by the Unitholder on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income to the extent to which the redemption proceeds is more than the amount that is fully credited as described in s CD 43(26).

(d) Unitholders (other than Offshore Unitholders or PIEs) will:
   (i) derive income under s CB 4 from the disposal of the redemption proceeds to the New Fund;
   (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and
   (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(e) Unitholders which are PIEs will derive excluded income under s CX 55 from the disposal of the redemption proceeds to the New Fund to the extent that:
   (i) the redemption proceeds consist of shares issued by a company referred to in s CX 55(3)(b);
   (ii) the Unitholders are not assured under an arrangement with another person of having a gain on the disposal; and
   (iii) the shares are not fixed-rate shares within the meaning of paragraphs (a) to (d) of the definition of "fixed-rate share".

(f) To the extent that Unitholders which are PIEs dispose of redemption proceeds that do not satisfy one or more of the criteria listed in subparagraphs (i) to (iii) of paragraph (e), those Unitholders will:
   (i) derive income under section CB 4 from the disposal of the redemption proceeds to the New Fund;
   (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and
   (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(g) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2016 and ending on 30 September 2017.

This Ruling is signed by me on the 25th day of October 2016.

Howard Davis
Director (Taxpayer Rulings)

Product ruling – BR Prd 16/09

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Smartshares Limited in its capacity as Manager of the NZX 50 Portfolio Index Fund.

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CB 4, CD 8, CX 56C, DB 23, and FC 2.

The Arrangement to which this Ruling applies

The Arrangement is the resettlement of the NZX 50 Portfolio Index Fund (the Existing Fund) onto the NZ Top 50 Fund (the New Fund) by redeeming units held by unitholders (Unitholders) in the Existing Fund, applying the redemption proceeds to acquire units in the New Fund on behalf of Unitholders, and transferring the assets of the Existing Fund to the New Fund.

However, the New Fund will not issue units to Unitholders whose address on the register of Unitholders is outside New Zealand (Offshore Unitholders). The redemption proceeds that Offshore Unitholders will receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming unitholders in the New Fund.

Prior to the resettlement Unitholder's units in the Existing Fund will be subdivided and the Manager of the Existing Fund will resolve that the subdivision of units is a dividend that will be fully imputed.

The New Fund will be established as part of a managed investment scheme as defined in the Financial Markets Conduct Act 2013 (FMCA) in relation to which units are issued that are managed investment products (as defined in the FMCA).

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

The Existing Fund

1. The Existing Fund was established by a trust deed dated 15 October 2004 (the Trust Deed), as subsequently amended by:
   (a) first deed of modification to the Trust Deed dated 9 December 2005;
   (b) second deed of modification to the Trust Deed dated 1 October 2007;
   (c) third deed of modification to the Trust Deed dated 30 March 2010;
   (d) fourth deed of modification to the Trust Deed dated 3 September 2010; and
   (e) deed of amendment to the Trust Deed to be dated 2016 (the Amendment Deed).
2. The Trust Deed established the Existing Fund as a group investment fund in accordance with the Trustee Companies Act 1967.
3. The Existing Fund elected into the portfolio investment entity (PIE) regime and is a "listed PIE" as defined in s YA 1.
4. The Manager of the Existing Fund is Smartshares Limited (the Manager), and the trustee of the Existing Fund is The New Zealand Guardian Trust Company Limited.
5. The Existing Fund invests in financial products listed on the NZX Main Board and is designed to track the S & P / NZX 50 Portfolio Index. The Existing Fund's investment objective is to provide a return that closely matches the return on the S & P / NZX 50 Portfolio Index. The S & P / NZX 50 Portfolio Index is comprised of the 50 largest financial products listed on the NZX Main Board. The S & P / NZX 50 Portfolio Index is made up of the same financial products as the S & P / NZX 50 Index, but with a 5% cap on the float-adjusted market capitalisation.

The New Fund

6. The New Fund is a fund established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units will be issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013).
7. The New Fund was established under and by virtue of a trust deed dated 24 June 2014 and amended and restated on 9 September 2016 (the Master Trust Deed), and an Establishment Deed dated 9 September 2016 executed by the Manager and Public Trust.

8. The manager of the New Fund is Smartshares Limited (the Manager) and the supervisor and trustee of the New Fund is Public Trust.
9. The New Fund will elect into the PIE regime and will become a "listed PIE" (as defined in s YA 1).
10. The investment policy of the New Fund is and will be similar in all material respects to that of the Existing Fund.

Steps to be undertaken to resettle the Existing Fund

11. The resettlement of the Existing Fund onto the New Fund will be achieved by utilising the resettlement mechanism contained in the Trust Deed.
12. The material provisions in the Trust Deed are as follows:

ARTICLE 19 – TERMINATION OF THE FUND

19.1 Termination

(a) The Fund shall terminate if it has not previously terminated on the day that is the first of the following days to occur:

(i) the day that is one day less than 80 years from the date of this Deed;

(ii) the day nominated by Unitholders pursuant to clause 19.2(a) (*Unitholders may terminate Fund*);

(iii) the day appointed by the Manager pursuant to clause 19.2(b) (*Manager may terminate Fund*); or

(iv) the day on which the Trustee retires under clause 14.9 (*Retirement of Trustee*) or clause 14.10 (*Trustee's retirement of Manager's request*) if on the date of retirement no successor Trustee has been appointed; and

(v) if NZX Funds Management Limited (or any related company of that company as defined in section 2(3) of the Companies Act 1993) is the manager of the Fund, within 60 days of Unitholders by Extraordinary Resolution terminating the Manager's authority under clause 16.9 (*Removal of Manager by Extraordinary Resolution of Unitholders*).

19.2 Termination by Unitholder or Manager

(a) **Unitholders may terminate Fund:** Unitholders may resolve by Extraordinary Resolution to terminate the Fund on a date not earlier than two months after the passage of the resolution, but no such resolution to terminate may be made if during a period of 3 months or more prior to the date of the deposit of the requisition of the meeting setting out the terms of such Extraordinary Resolution:

(i) holders of Basket Numbers of Units would have been able, if they so wished, to redeem a Basket or more on at least 20 Business Days during that period, at their Current Unit Value; and

(ii) the reported weighted average price for sales of Units in parcels of less than a Basket on at least 20 Business Days during that period has been higher than 1% below Current Unit Value at the time of sale.

(b) **Manager may terminate Fund:** The Manager may terminate the Fund for any reason whatsoever, including (but without limitation) if in the opinion of the Manager the Fund is not sufficiently profitable for the Manager. The date of termination shall be a day appointed by the Manager by giving not less than two months' written notice to the Unitholders and to the Trustee.

(c) **No redemption once a termination date is determined:** Upon Unitholders pursuant to clause 19.2(a) (*Unitholders may terminate Fund*), or the Manager pursuant to clause 19.2(b) (*Manager may terminate Fund*) determining a date of termination of the Fund the rights of Unitholders with respect to the redemption of Units shall cease.

19.3 Termination Procedure

(a) **Distribution of Assets:** Upon the Fund being terminated subject to clause 14.12 (*Successor Trustee*), the Trustee shall discharge the liabilities and Expenses of the Fund (and the provisions of Article 12 (Custodial arrangement for Securities), to the extent, if any, they prohibit the payment of Expenses out of the Fund, shall cease to apply) and distribute to each Unitholder that Unitholder's Share of the net Assets of the Fund proportionately to the Unitholders in such manner and within such period after the termination of the Fund as the Trustee considers advisable.

(b) **Form of distribution:** Such distribution may be made in cash or in kind or partly in both, all as the Trustee in its sole discretion may determine.

(c) **Certificates and release:** Any Certificates shall in the case of the final distribution be surrendered to the Trustee and such final distribution shall only be made against delivery to the Trustee of such form of release as the Trustee shall in its sole discretion require.

(d) **Resettlement:** If Unitholders resolve by Extraordinary Resolution to resettle all or part of the income or capital of the Fund and the Trustee is satisfied that it is not, nor is it likely to become, materially prejudicial to the interests of Unitholders generally, the Trustee shall:

(i) **Compulsory redemption:** Require Unitholders to accept repayment in respect of all or any of the Unitholder's Units for the purposes of the application of the proceeds referred to in clause 19.3(a) (Distribution of Assets); or

(ii) **Apply Proceeds toward a New Fund:** Apply the proceeds of repayment towards the issue price for Units in an alternative Fund, being a New Fund (the New Fund) with an investment policy similar in all material respects to those of the Fund (the Existing Fund), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund;

(iii) **Transfer of GIF Assets:** Sell or otherwise transfer all or any GIF Assets of the Existing Fund to the New Fund;

(iv) **Resettle New Fund:** Resettle by irrevocable deed (without infringing the rule against perpetuities) all or part of the income or capital of the Fund on the trusts and with the powers of any New Fund, or other trust approved by the Trustee;

(v) **Lend to New Fund:** Lend any sum to the trustee or trustees of that New Fund, with or without security, at an interest rate (if any) and on such other terms as in each respect the Trustee thinks fit;

(vi) **Assume Liabilities:** Assume liabilities of the Existing Fund on behalf of the New Fund;

(vii) **New Manager or Trustee:** Arrange any of the foregoing with another manager and/or trustee for the New Fund;

(viii) **Terminate Fund:** Terminate the Existing Fund.

13. Other relevant provisions of the Trust Deed are as follows:

ARTICLE 1 - INTERPRETATION

1.1 Definitions

In this Deed, unless the subject matter or context otherwise requires:

…

Fund means The NZX 50 Portfolio Index Fund, which is a group investment fund (GIF) governed by this Deed and as the context requires refers also to the Trustee in its capacity as trustee of that group investment fund;

ARTICLE 4 – REGISTERS, TRANSFERS, CERTIFICATES

4.11 Consolidation and split of Units

(a) **Notice:** The manager may at any time, by notice in writing to the Trustee, cause Units in existence on a date specified in that notice to be consolidated or subdivided. Each such notice shall:

(i) specify the date on which such consolidation or subdivision is to take place (the "*Operative Date*"); and

(ii) specify the ratio (the "*Ratio*") which the number of Units in existence after the consolidation or subdivision will bear to the number of Units in existence before the consolidation or subdivision.

(b) **New number of Units:** As from the Operative Date, each Unitholder of the Fund shall be deemed to hold a number of Units of the Fund equivalent to the number held by him before the Operative Date multiplied or divided (as the case may be) by the Ratio. For this purpose, at the option of the Manager in each case, fractions may be disregarded or may be rounded upwards or downwards.

(c) **Arrangement at Manager's discretion:** The Manager shall make such arrangements (if any) as it deems appropriate, following a consolidation or subdivision, for the cancellation of existing Certificates and the Issue of new Certificates, if Certificates are required by law.

ARTICLE 17 - AMENDMENTS

17.1 Amendments to Deed or Issue Terms

The Trustee may at any time make any alteration, modification, variation or addition to the Trust Deed or any Issue Term (excluding any applicable Rule), with the concurrence of the Manager, in any of the following cases:

…

(f) If it is authorised by an Extraordinary Resolution of the Unitholders under Clause 18.10 (*Effect of a resolution*).

14. Prior to the resettlement of the Existing Fund, the Trust Deed will be amended by the Amendment Deed as follows:

(a) A new definition will be added to clause 1.1 that reads as follows:

"**Resettlement Fund**" means a fund (other than the Fund) established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units are issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013) and that, at the date of any resettlement pursuant to Clause 19.3(d), has or will have Smartshares Limited as its manager.

(b) The second sentence of clause 19.2(b) will be amended to read as follows:

The date of termination shall be a day appointed by the Manager by giving not less than:

(i) one week's written notice if all of the income and capital of the Fund is to be resettled in accordance with clause 19.3(d) and an Extraordinary Resolution approving that resettlement has been passed; or

(ii) two months' written notice in all other cases,

to the Unitholders and the Trustee.

(c) Clause 19.3(d)(ii) will be deleted and the following inserted in its place:

(ii) **Apply Proceeds towards a Resettlement Fund:** Apply the proceeds of repayment towards the issue price for units in a Resettlement Fund (the *New Fund*) with an investment policy similar in all material respects to those of the Fund (the *Existing Fund*), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

15. Prior to the date of resettlement, the Manager will provide written notice to the Trustee (in accordance with clause 4.11 of the Trust Deed) requiring that each unit in the Existing Fund is subdivided so as to become two units (the Subdivision). Unitholders will not be given an option whether to receive a bonus issue (being the Subdivision) or money or money's worth (other than money's worth that is a bonus issue).

16. The Subdivision will occur immediately prior to the Existing Fund being resettled. When it makes the Subdivision, the Manager will resolve:

(a) that it is a "dividend" for purposes of the Act;

(b) the amount to be treated as a dividend (which must be more than zero); and

(c) that imputation credits are attached at the maximum permitted ratio.

17. The Manager of the Existing Fund will give notice to the Commissioner under s 63 of the Tax Administration Act 1994 of the election to treat the Subdivision as a dividend under s CD 8, and the amount to be treated as a dividend.

18. The effect of the Subdivision and related resolutions summarised above is that the Existing Fund is unlikely to have any imputation credits at the time the resettlement occurs.

19. The following steps will be undertaken to achieve the resettlement of the Existing Fund on the New Fund:

(a) A notice of meeting will be issued to Unitholders in the Existing Fund in accordance with the requirements of Article 18 of the Trust Deed. The notice of meeting will advise Unitholders of:

(i) the following proposed amendments to the Trust Deed:

- the amendment contained in the Amendment Deed (such amendment allowing the power of resettlement in clause 19.3(d) to be used to resettle the assets of the Existing Fund onto the New Fund notwithstanding that the New Fund is not a group investment fund); and
- the amendment of the notice period required for the termination of the Existing Fund by the Manager under clause 19.2(b) from two months to one week;

(ii) the intention to seek authorisation of the resettlement of the Existing Fund on the New Fund (as required by clause 19.3(d) of the Trust Deed).

(b) At the meeting, the Manager will give notice of the intended termination of the Existing Fund pursuant to clause 19.2(b) of the Trust Deed. Such notice will be conditional on the Unitholders passing extraordinary resolutions approving:

(i) the amendments to the Trust Deed referred to in [19(a)(i)] above; and

(ii) the resettlement described in [19(a)(ii)] above.

(c) Formal written notice will be provided in compliance with the provisions of clause 19.2(b) of the Trust Deed (as amended) immediately following the passage of the extraordinary resolutions referred to in [19(b)] above.

(d) If the Unitholders approve the amendments to the Trust Deed referred to in [19(a)(i) above, and approve the resettlement described in [19(a)(ii)] above, the Trustee will:

(i) discharge the liabilities and expenses of the Existing Fund (clause 19.3(a))

(ii) redeem the Unitholders' units in the Existing Fund (clause 19.3(d)(i));

(iii) apply the proceeds of redemption towards the issue price of units in the New Fund on behalf of the Unitholders (clause 19.3(d)(ii));

(iv) transfer the assets of the Existing Fund to the New Fund (to be held and invested subject to a statement of investment policy and objectives identical in all material respects to the investment policy to which the Existing Fund is subject) (clause 19.3(d)(iii)); and

(v) wind up the Existing Fund (clause 19.3(d)(viii)).

20. Accordingly, the Arrangement will comprise a redemption of Unitholders' interests in the Existing Fund and a resettlement on the New Fund. At conclusion of the resettlement process:

(a) Unitholders will hold interests in the New Fund of the same value and on substantially similar terms as the interests they held in the Existing Fund;

(b) the New Fund will hold the same assets as the Existing Fund and will continue to invest on the same basis and in the same manner in which the Existing Fund invested prior to resettlement.

21. To ensure that the resettlement process does not result in the New Fund inadvertently breaching foreign securities laws, the New Fund will not issue units to any Unitholders in the Existing Fund whose address on the register of Unitholders (established and maintained under clause 4.1 of the Trust Deed) is outside New Zealand (Offshore Unitholders). Accordingly the redemption proceeds that Offshore Unitholders receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming Unitholders in the New Fund.

22. The trustees of the Existing Fund and the New Fund will enter into a Deed of Resettlement and Related Matters pursuant to which the trustee of the New Fund will undertake to issue units to Unitholders (excluding Offshore Unitholders) in proportion to the units that they each held on resettlement in the Existing Fund and to receive funds which are unallocated at the time of resettlement (if any) and to pay such amounts to the persons lawfully entitled to those funds. This ruling is based on a draft of the Deed of Resettlement and Related Matters provided to the Commissioner on 21 October 2016.

23. The Existing Fund will not at the time of its resettlement onto the New Fund be a party to a "returning share transfer" as defined in s YA 1.

24. Immediately prior to its resettlement, the assets of the Existing Fund will include cash held in short term interest bearing bank accounts (the Bank Accounts) by the Existing Fund. Such amounts of the Bank Accounts that form part of the net assets of the Existing Fund at the time of redemption will be distributed to Unitholders on redemption of their units under the Arrangement.

25. An amount equal to the interest derived on the Bank Accounts is paid by the Existing Fund to the Manager as a management fee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Existing Fund:

- is not a "designated group investment fund" (as defined in s HR 3(6));
- results from investments made into it that are not from a "designated source" (as defined in s HR 3(5));
- does not derive any "category B income" (as defined in s YA 1); and
- is a "listed PIE" (as defined in s YA 1).

How the Taxation Laws apply to the Arrangement

Subject in all respects to any conditions stated above, the Taxation Laws apply to the Arrangement as follows:

(a) Any units received by the Unitholders under the Subdivision will be a "taxable bonus issue" that is a dividend under s CD 8.

(b) The amount derived by Unitholders of the Existing Fund on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income under s CX 56C(1) if they:

  (i) are resident; and

  (ii) are a natural person or a trustee; and

  (iii) do not include the amount as income in a return of income for the income year.

(c) If any one or more of the criteria listed in subparagraphs (i) to (iii) above does not apply to the Unitholder, the amount derived by the Unitholder on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income to the extent to which the redemption proceeds is more than the amount that is fully credited as described in s CD 43(26).

(d) Unitholders (other than Offshore Unitholders or PIEs) will:

  (i) derive income under s CB 4 from the disposal of the redemption proceeds to the New Fund;

  (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and

  (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(e) Unitholders which are PIEs will derive excluded income under s CX 55 from the disposal of the redemption proceeds to the New Fund to the extent that:

  (i) the redemption proceeds consist of shares issued by a company referred to in s CX 55(3)(a);

  (ii) the Unitholders are not assured under an arrangement with another person of having a gain on the disposal; and

  (iii) the shares are not fixed-rate shares within the meaning of paragraphs (a) to (d) of the definition of "fixed-rate share".

(f) To the extent that Unitholders which are PIEs dispose of redemption proceeds that do not satisfy one or more of the criteria listed in subparagraphs (i) to (iii) of paragraph (e), those Unitholders will:

  (i) derive income under section CB 4 from the disposal of the redemption proceeds to the New Fund;

  (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and

  (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(g) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2016 and ending on 30 September 2017.

This Ruling is signed by me on the 25th day of October 2016.

Howard Davis
Director (Taxpayer Rulings)

Product ruling – BR Prd 16/10

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Smartshares Limited in its capacity as Manager of NZX Australian Mid Cap Index Fund.

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CB 4, CD 8, CX 56C, DB 23, and FC 2.

The Arrangement to which this Ruling applies

The Arrangement is the resettlement of the NZX Australian Mid Cap Index Fund (the Existing Fund) onto the Australian Mid Cap Fund (the New Fund) by redeeming units held by unitholders (Unitholders) in the Existing Fund, applying the redemption proceeds to acquire units in the New Fund on behalf of Unitholders, and transferring the assets of the Existing Fund to the New Fund.

However, the New Fund will not issue units to Unitholders whose address on the register of Unitholders is outside New Zealand (Offshore Unitholders). The redemption proceeds that Offshore Unitholders will receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming unitholders in the New Fund.

Prior to the resettlement Unitholder's units in the Existing Fund will be subdivided and the Manager of the Existing Fund will resolve that the subdivision of units is a dividend that will be fully imputed.

The New Fund will be established as part of a managed investment scheme as defined in the Financial Markets Conduct Act 2013 (FMCA) in relation to which units are issued that are managed investment products (as defined in the FMCA).

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

The Existing Fund

1. The Existing Fund was established by a trust deed dated 10 August 2004 (the Trust Deed), as subsequently amended by:
   (a) first deed of modification to the Trust Deed dated 10 February 2005;
   (b) second deed of modification to the Trust Deed dated 9 December 2005;
   (c) third deed of modification to the Trust Deed dated 1 October 2007;
   (d) fourth deed of modification to the Trust Deed dated 30 March 2010;
   (e) fifth deed of modification to the Trust Deed dated 3 September 2010;
   (f) deed of amendment to the Trust Deed to be dated 2016 (the Amendment Deed).
2. The Trust Deed established the Existing Fund as a group investment fund in accordance with the Trustee Companies Act 1967.
3. The Existing Fund elected into the portfolio investment entity (PIE) regime and is a "listed PIE" as defined in s YA 1.
4. The Manager of the Existing Fund is Smartshares Limited (the Manager), and the trustee of the Existing Fund is The New Zealand Guardian Trust Company Limited.
5. The Existing Fund invests in financial products listed on the ASX Main Board and is designed to track the S & P / ASX Mid Cap 50 Index. The Existing Fund's investment objective is to provide a return that closely matches the return on the S & P / ASX Mid Cap 50 Index. The S & P / ASX Mid Cap 50 Index comprises financial products listed on the ASX and included in the S & P / ASX 100 Index, but excludes products included in the S & P / ASX 50 Index.

The New Fund

6. The New Fund is a fund established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units will be issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013).
7. The New Fund was established under and by virtue of a trust deed dated 24 June 2014 and amended and restated on 9 September 2016 (the Master Trust Deed), and an Establishment Deed dated 9 September 2016 executed by the Manager and Public Trust.

8. The manager of the New Fund is Smartshares Limited (the Manager) and the supervisor and trustee of the New Fund is Public Trust.
9. The New Fund will elect into the PIE regime and will become a "listed PIE" (as defined in s YA 1).
10. The investment policy of the New Fund is and will be similar in all material respects to that of the Existing Fund.

Steps to be undertaken to resettle the Existing Fund

11. The resettlement of the Existing Fund onto the New Fund will be achieved by utilising the resettlement mechanism contained in the Trust Deed.
12. The material provisions in the Trust Deed are as follows:

ARTICLE 18 – TERMINATION OF THE FUND

18.1 Termination

(a) The Fund shall terminate if it has not previously terminated on the day that is the first of the following days to occur:

(i) the day that is one day less than 80 years from the date of this Deed;

(ii) the day nominated by Unitholders pursuant to clause 18.2(a);

(iii) the day appointed by the Manager pursuant to clause 18.2(b); or

(iv) the day on which the Trustee retires under clause 13.10 if on the date of retirement no successor Trustee has been appointed;

(v) if NZX Funds Manager Limited (or any related company of that company as defined in section 2(3) of the Companies Act 1993) is the manager of the Fund, within 60 days of Unitholders by Extraordinary Resolution terminating the Manager's authority under clause 15.9.

18.2 Termination by Unitholder or Manager

(a) **Unitholders may terminate Fund:** Unitholders may resolve by Extraordinary Resolution to terminate the Fund on a date not earlier than two months after the passage of the resolution, but no such resolution to terminate may be made if during a period of 3 months or more prior to the date of the deposit of the requisition of the meeting setting out the terms of the Extraordinary Resolution:

(i) holders of Basket Numbers of Units would have been able, if they so wished, to redeem a Basket or more on at least 20 Business Days during that period, at their Current Unit Value; and

(ii) the reported weighted average price for sales of Units in parcels of less than a Basket on at least 20 Business Days during that period has been higher than 1% below Current Unit Value at the time of sale.

(b) **Manager may terminate Fund:** The Manager may terminate the Fund for any reason whatsoever, including (but without limitation) if in the opinion of the Manager the Fund is not sufficiently profitable for the Manager. The date of termination shall be a day appointed by the Manager by giving not less than two months' written notice to the Unitholders and to the Trustee.

(c) **No redemption once a termination date is determined:** Upon Unitholders pursuant to clause 18.2(a), or the Manager pursuant to clause 18.2(b), determining a date of termination of the Fund the rights of Unitholders with respect to the redemption of Units shall cease.

18.3 Termination Procedure

(a) **Distribution of Assets:** Upon the Fund being terminated, subject to clause 13.12 (successor trustee), the Trustee shall discharge the liabilities and Expenses of the Fund (and the provisions of clause 12, to the extent (if any) they prohibit the payment of Expenses out of the Fund, shall cease to apply) and distribute to each Unitholder that Unitholder's share of the net Assets of the Fund proportionately to the Unitholders in such manner and within such period after the termination of the Fund as the Trustee considers advisable.

(b) **Form of distribution:** Such distribution may be made in cash or in kind or partly in both, all as the Trustee in its sole discretion may determine.

(c) **Certificates and release:** Any Certificates shall in the case of the final distribution be surrendered to the Trustee and such final distribution shall only be made against delivery to the Trustee of such form of release as the Trustee shall in its sole discretion require.

(d) **Resettlement:** If Unitholders resolve by Extraordinary Resolution to resettle all or part of the income or capital of the Fund and the Trustee is satisfied that it is not, nor is it likely to become, materially prejudicial to the interests of Unitholders generally, the Trustee shall:

(i) **Compulsory redemption:** Require Unitholders to accept repayment in respect of all or any of the Unitholders' Units for the purposes of the application of the proceeds referred to in clause 18.3(a); or

(ii) **Apply Proceeds toward a New Fund:** Apply the proceeds of repayment towards the issue price for Units in an alternative Fund, being a New Fund ("the New Fund") with an investment policy similar in all material respects to those of the Fund ("the Existing Fund"), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund;

(iii) **Transfer of GIF Assets:** Sell or otherwise transfer all or any GIF Assets of the Existing Fund to the New Fund;

(iv) **Resettle New Fund:** Resettle by irrevocable deed (without infringing the rule against perpetuities) all or part of the income or capital of the Fund on the trusts and with the powers of any New Fund, or other trust approved by the Trustee;

(v) **Lend to New Fund:** Lend any sum to the trustee or trustees of that New Fund, with or without security, at an interest rate (if any) and on such other terms as in each respect the Trustee thinks fit;

(vi) **Assume Liabilities:** Assume liabilities of the Existing Fund on behalf of the New Fund;

(vii) **New Manager or Trustee:** Arrange any of the foregoing with another manager and/or trustee for the New Fund;

(viii) **Terminate Fund:** Terminate the Existing Fund.

13. Other relevant provisions of the Trust Deed are as follows:

ARTICLE 1 - INTERPRETATION

1.1 Definitions

In this Deed, unless the subject matter or context otherwise requires:

…

Fund means The NZX Australian Mid Cap Index Fund, which is a group investment fund (GIF) governed by this Deed and as the context requires refers also to the Trustee in its capacity as trustee of that group investment fund;

GIF means a group investment fund;

ARTICLE 4 – REGISTERS, TRANSFERS, CERTIFICATES

4.11 Consolidation and Split of Units

(a) **Notice:** The Manager may at any time, by notice in writing to the Trustee, cause Units in existence on a date specified in that notice to be consolidated or subdivided. Each such notice shall:

(i) specify the date on which such consolidation or subdivision is to take place (the "Operative Date"); and

(ii) specify the ratio ("the Ratio") which the number of Units in existence after the consolidation or subdivision will bear to the number of Units in existence before the consolidation or subdivision.

(b) **New number of Units:** As from the Operative Date, each Unitholder of the Fund shall be deemed to hold a number of Units of the Fund equivalent to the number held by him before the Operative Date multiplied or divided (as the case may be) by the Ratio. For this purpose, at the option of the Manager in each case, fractions may be disregarded or may be rounded upwards or downwards.

(c) **Arrangement at Manager's discretion:** The Manager shall make such arrangements (if any) as it deems appropriate, following a consolidation or subdivision, for the cancellation of existing Certificates and the issue of new Certificates, if Certificates are required by law.

ARTICLE 16 - AMENDMENTS

16.1 Amendments to Deed or Issue Terms

The Trustee may at any time make any alteration, modification, variation or addition to the Trust Deed or any Issue Term (excluding any applicable Rule), with the concurrence of the Manager, in any of the following cases:

…

16.1(f) If it is authorised by an Extraordinary Resolution of the Unitholders under Clause 17.10.

14. Prior to the resettlement of the Existing Fund, the Trust Deed will be amended by the Amendment Deed as follows:
    (a) A new definition will be added to clause 1.1 that reads as follows:

    "Resettlement Fund" means a fund (other than the Fund) established as part of a managed investment scheme (as defined in the Financial Markets Conduct Act 2013) in relation to which units are issued that are managed investment products (as defined in the Financial Markets Conduct Act 2013) and that, at the date of any resettlement pursuant to clause 18.3(d), has or will have Smartshares Limited as its manager.

    (b) The second sentence of clause 18.2(b) will be amended to read as follows:

    The date of termination shall be a day appointed by the Manager by giving not less than:

    (i) one week's written notice if all of the income and capital of the Fund is to be resettled in accordance with clause 18.3(d) and an Extraordinary Resolution approving that resettlement has been passed; or

    (ii) two months' written notice in all other cases,

    to the Unitholders and the Trustee.

    (c) Clause 18.3(d)(ii) will be deleted and the following inserted in its place:

    (ii) **Apply Proceeds towards a Resettlement Fund:** Apply the proceeds of repayment towards the issue price for units in a Resettlement Fund (the New Fund) with an investment policy similar in all material respects to those of the Fund (the Existing Fund), as if the Unitholder had redeemed units in the Existing Fund and reinvested the proceeds from those units in the New Fund.

15. Prior to the date of resettlement, the Manager will provide written notice to the Trustee (in accordance with clause 4.11 of the Trust Deed) requiring that each unit in the Existing Fund is subdivided so as to become two units (the Subdivision). Unitholders will not be given an option whether to receive a bonus issue (being the Subdivision) or money or money's worth (other than money's worth that is a bonus issue).

16. The Subdivision will occur immediately prior to the Existing Fund being resettled. When it makes the Subdivision, the Manager will resolve:
    (a) that it is a "dividend" for purposes of the Act;
    (b) the amount to be treated as a dividend (which must be more than zero); and
    (c) that imputation credits are attached at the maximum permitted ratio.

17. The Manager of the Existing Fund will give notice to the Commissioner under s 63 of the Tax Administration Act 1994 of the election to treat the Subdivision as a dividend under s CD 8, and the amount to be treated as a dividend.

18. The effect of the Subdivision and related resolutions summarised above is that the Existing Fund is unlikely to have any imputation credits at the time the resettlement occurs.

19. The following steps will be undertaken to achieve the resettlement of the Existing Fund on the New Fund:
    (a) A notice of meeting will be issued to Unitholders in the Existing Fund in accordance with the requirements of Article 17 of the Trust Deed. The notice of meeting will advise Unitholders of:
    (i) the following proposed amendments to the Trust Deed:
    - the amendment contained in the Amendment Deed (such amendment allowing the power of resettlement in clause 18.3(d) to be used to resettle the assets of the Existing Fund onto the New Fund notwithstanding that the New Fund is not a group investment fund); and
    - the amendment of the notice period required for the termination of the Existing Fund by the Manager under clause 18.2(b) from two months to one week;

    (ii) the intention to seek authorisation of the resettlement of the Existing Fund on the New Fund (as required by clause 18.3(d) of the Trust Deed).

(b) At the meeting, the Manager will give notice of the intended termination of the Existing Fund pursuant to clause 18.2(b) of the Trust Deed. Such notice will be conditional on the Unitholders passing extraordinary resolutions approving:

(i) the amendments to the Trust Deed referred to in [19(a)(i)] above; and

(ii) the resettlement described in [19(a)(ii)] above.

(c) Formal written notice will be provided in compliance with the provisions of clause 18.2(b) of the Trust Deed (as amended) immediately following the passage of the extraordinary resolutions referred to in [19(b)] above.

(d) If the Unitholders approve the amendments to the Trust Deed referred to in [19(a)(i)] above, and approve the resettlement described in [19(a)(ii)] above, the Trustee will:

(i) discharge the liabilities and expenses of the Existing Fund (clause 18.3(a));

(ii) redeem the Unitholders' units in the Existing Fund (clause 18.3(d)(i));

(iii) apply the proceeds of redemption towards the issue price of units in the New Fund on behalf of the Unitholders (clause 18.3(d)(ii);

(iv) transfer the assets of the Existing Fund to the New Fund (to be held and invested subject to a statement of investment policy and objectives identical in all material respects to the investment policy to which the Existing Fund is subject) (clause 18.3(d)(iii)); and

(v) wind up the Existing Fund (clause 18.3(d)(viii)).

20. Accordingly, the Arrangement will comprise a redemption of Unitholders' interests in the Existing Fund and a resettlement on the New Fund. At conclusion of the resettlement process:

(a) Unitholders will hold interests in the New Fund of the same value and on substantially similar terms as the interests they held in the Existing Fund;

(b) the New Fund will hold the same assets as the Existing Fund and will continue to invest on the same basis and in the same manner in which the Existing Fund invested prior to resettlement.

21. To ensure that the resettlement process does not result in the New Fund inadvertently breaching foreign securities laws, the New Fund will not issue units to any Unitholders in the Existing Fund whose address on the register of Unitholders (established and maintained under clause 4.1 of the Trust Deed) is outside New Zealand (Offshore Unitholders). Accordingly the redemption proceeds that Offshore Unitholders receive from the Existing Fund will be cash only and the resettlement process will not result in them becoming Unitholders in the New Fund.

22. The trustees of the Existing Fund and the New Fund will enter into a Deed of Resettlement and Related Matters pursuant to which the trustee of the New Fund will undertake to issue units to Unitholders (excluding Offshore Unitholders) in proportion to the units that they each held on resettlement in the Existing Fund and to receive funds which are unallocated at the time of resettlement (if any) and to pay such amounts to the persons lawfully entitled to those funds. This ruling is based on a draft of the Deed of Resettlement and Related Matters provided to the Commissioner on 21 October 2016.

23. The Existing Fund will not at the time of its resettlement onto the New Fund be a party to a "returning share transfer" as defined in s YA 1.

24. Immediately prior to its resettlement, the assets of the Existing Fund will include cash held in short term interest bearing bank accounts (the Bank Accounts) by the Existing Fund. Such amounts of the Bank Accounts that form part of the net assets of the Existing Fund at the time of redemption will be distributed to Unitholders on redemption of their units under the Arrangement.

25. An amount equal to the interest derived on the Bank Accounts is paid by the Existing Fund to the Manager as a management fee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Existing Fund:

- is not a "designated group investment fund" (as defined in s HR 3(6));
- results from investments made into it that are not from a "designated source" (as defined in s HR 3(5));
- does not derive any "category B income" (as defined in s YA 1); and
- is a "listed PIE" (as defined in s YA 1).

How the Taxation Laws apply to the Arrangement

Subject in all respects to any conditions stated above, the Taxation Laws apply to the Arrangement as follows:

(a) Any units received by the Unitholders under the Subdivision will be a "taxable bonus issue" that is a dividend under s CD 8.

(b) The amount derived by Unitholders of the Existing Fund on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income under s CX 56C(1) if they:

- (i) are resident; and
- (ii) are a natural person or a trustee; and
- (iii) do not include the amount as income in a return of income for the income year.

(c) If any one or more of the criteria listed in subparagraphs (i) to (iii) above does not apply to the Unitholder, the amount derived by the Unitholder on redemption of their units in the Existing Fund, and any units received by Unitholders under the Subdivision, are excluded income to the extent to which the redemption proceeds is more than the amount that is fully credited as described in s CD 43(26).

(d) Unitholders (other than Offshore Unitholders or PIEs) will:

- (i) derive income under s CB 4 from the disposal of the redemption proceeds to the New Fund;
- (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and
- (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(e) Unitholders which are PIEs will derive excluded income under s CX 55 from the disposal of the redemption proceeds to the New Fund to the extent that:

- (i) the redemption proceeds consist of shares issued by a company referred to in s CX 55(3)(b);
- (ii) the Unitholders are not assured under an arrangement with another person of having a gain on the disposal; and
- (iii) the shares are not fixed-rate shares within the meaning of paragraphs (a) to (d) of the definition of "fixed-rate share".

(f) To the extent that Unitholders which are PIEs dispose of redemption proceeds that do not satisfy one or more of the criteria listed in subparagraphs (i) to (iii) of paragraph (e), those Unitholders will:

- (i) derive income under section CB 4 from the disposal of the redemption proceeds to the New Fund;
- (ii) be entitled to a deduction under s DB 23 (calculated with reference to s FC 2) for an amount at least the same as the amount of any income under s CB 4; and
- (iii) have no overall income tax liability as a result of their disposal of the redemption proceeds to the New Fund.

(g) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2016 and ending on 30 September 2017.

This Ruling is signed by me on the 25th day of October 2016.

Howard Davis
Director (Taxpayer Rulings)

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.

Interpretation statement: IS 16/04

Income tax - treatment of the receipt of lump sum settlement payments

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

Summary

1. The focus of this statement is setting out how the Commissioner will treat a lump sum payment received under a settlement agreement for claims that (if successful) would have resulted in receipts of both a capital and revenue nature.
2. Whether a settlement payment is taxable depends on what it is paid for – in this case, what was given up in return for the payment – and its nature in the hands of the recipient. It is essential to first determine what a payment is for before determining whether apportionment is necessary.
3. It has been suggested that two High Court of Australia decisions: *McLaurin v FCT* (1961) 12 ATD 273 and *Allsop v FCT* (1965) 14 ATD 62 ("McLaurin and Allsop ") are authority for the proposition that, if an undissected settlement payment includes both capital and revenue amounts, the whole amount will be treated as capital. To the extent that *McLaurin and Allsop* stand for this proposition, the Commissioner's view is that they would not be followed in New Zealand. Rather, where possible, New Zealand courts would seek a reasonable basis for apportioning a lump sum.
4. Given this, where a single undissected sum is received, it should be apportioned between its capital and revenue elements where possible. Any apportionment must be made on an objective basis. The starting point for determining an appropriate apportionment will be the settlement agreement and any related documents (for example, the statement of claim (if there is one)). Where necessary, the circumstances surrounding the agreement and other relevant evidence (such as evidence of any negotiations between the parties) should be considered. The onus of proof is on the taxpayer to show the apportionment is appropriate.
5. In the rare circumstance where the payment **cannot** be appropriately apportioned, the whole amount should be treated the same. Where the lump sum includes an amount that is taxable under a provision in Part C, the taxpayer has the burden of proving what part of the amount is not taxable. If a taxpayer is unable to show what part of a lump sum payment is capital, the Commissioner's view is that generally the whole amount should be treated as income.

Introduction

6. We have been asked to clarify the Commissioner's position on how to treat lump sum payments made to settle claims partly capital and partly revenue in nature. There has been uncertainty as to how such payments should be treated. In particular, some people have taken the view that the lump sum should be treated as always wholly capital and, therefore, not subject to income tax. This is based on an interpretation of two High Court of Australia decisions: *McLaurin v FCT* (1961) 12 ATD 273 and *Allsop v FCT* (1965) 14 ATD 62. This item sets out the Commissioner's view on this issue.

Analysis

How to determine whether an amount is capital or revenue

7. To decide whether a payment is capital or revenue, it is necessary to determine what the payment is for (*Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)). The character of a cause of action discharged by a payment will determine the nature of the payment (*Federal Coke Pty Ltd v FCT* 77 ATC 4255 (FCA)). Therefore, where a payment is received in return for settling claims, it is necessary to consider what the nature of any payment received would have been if those claims

had been successful. A payment received to settle claims of a revenue nature would be revenue. A payment received to settle claims of a capital nature would be capital (*Case V8* (2001) 20 NZTC 10,092). This is regardless of the nature of the legal rights to make the claims for payment – that is, whether made in contract or tort or under statute or in any other way in which a right to claim may arise (*London & Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124 at 134 per Diplock LJ).

8. Sometimes a payment will be made to settle claims of both a capital and revenue nature. As discussed below, in the Commissioner's view, generally such payments should be apportioned. An exception to this is where one of the advantages sought is ancillary or incidental to the other. In such a case it may be proper to characterise the payment as wholly capital or wholly revenue (*Buckley & Young* (at 61,275):

> Difficulties of characterisation may arise where the director or employee agrees to resign and to give a restrictive covenant. **The proper conclusion may be that the payment secures one advantage and the other provision is merely ancillary or incidental, not affecting the character of the payment** (cf. *Anglo-Persian Oil Company Limited v Dale (H.M. Inspector of Taxes)* [1932] 1 K.B. 124, 139-140). In other cases distinct and separately identifiable advantages may be gained by the payment. There the payment is of a dual character. The statement of the problem highlights the importance of identifying the true character of the payment for which deduction is sought. [Emphasis added]

In that case, it would not be necessary to go on and consider apportionment.

9. For an amount to be taxable, it must be "income" under a provision in Part C (and not exempt or excluded income). In the context of settlement payments, common provisions that could apply include s CB 1 (amounts derived from business) and s CE 1 (amounts derived in connection with employment). Unless the context otherwise requires, references to "revenue" amounts in this statement assume that a provision in Part C would apply to treat the amount as assessable income.

10. At issue is the tax treatment of a lump sum paid to settle claims of **both** a capital and revenue nature.

Apportionment

New Zealand approach

11. The Commissioner considers the approach of the New Zealand courts is to seek to apportion a payment into its capital and revenue elements wherever possible. This is demonstrated in Richardson J's judgment in *Buckley & Young* – one of the leading New Zealand cases on apportionment. Although *Buckley & Young* considered the apportionment of expenditure rather than income, in the Commissioner's view the same principles are relevant to both. *Buckley & Young* shows the approach of the New Zealand courts is to apportion where possible, rather than applying an all-or-nothing approach. However, an all-or-nothing approach can arise where the taxpayer fails to provide a reasonable basis for apportionment.

12. *Buckley & Young* concerned a series of agreements aimed at removing an unsatisfactory employee. The payments made were for both capital (restrictive covenant) and revenue (payment made to remove employee) elements. The contract did not specify how the amounts paid were to be apportioned.

13. Richardson J noted that the purpose of apportionment is to determine how much of an amount the parties have attributed to a particular item. This is done by considering the terms of the contract and, where relevant, the context and background to the agreement. Richardson J took the view that a situation where apportionment was impossible was likely to be rare and the fact an apportionment might be difficult was not, of itself, a reason not to apportion.

14. He also noted that "absolute precision" was not required, nor was it necessary that the apportionment could be "calculated by some kind of scientific process". Apportionment cannot, however, be based on mere speculation and there must be sufficient evidence to justify the result. Ultimately, apportionment was not possible on the facts of that case as the taxpayer had not put forward any argument as to how apportionment should be made.

15. *Case V8* considered the characterisation of a lump sum settlement payment. In that case, the taxpayer (the operator of a kiwifruit packhouse and storage facility) had filed a statement of claim alleging breach of contract by the supplier and manufacturer of an allegedly defective fruit-processing machine, misrepresentation and negligence. The taxpayer claimed compensation of $1,050,561.25. Mediation resulted in an out of court settlement under which the taxpayer received $170,000 from the designer of the machine and $100,000 from the manufacturer. The agreement included a denial of liability by all parties. It was also entered into in "full and final settlement of all issues between the parties in or in connection with" the proceedings.

16. Judge Barber considered that in determining the character of the settlement payment it was necessary to consider the statement of claim, the mediation agreement, the settlement agreement and the circumstances surrounding the case. As the mediation agreement referred to the attached settlement agreement and the statement of claim, these documents were intended to be read together. Judge Barber considered that the settlement payment was made to compensate the taxpayer for the losses specified in the statement of claim.

17. The taxpayer argued that, because the payment was received as a lump sum, it could not be apportioned between the ingredients of the original claim made by the taxpayer. Judge Barber held that, as the payment was made to compensate the taxpayer for loss of profits and for repair costs as per the statement of claim, the settlement payment was income, being compensation for revenue losses. The judgment suggests that if it had been established that the settlement payment was compensation for losses of both a capital and revenue nature, apportionment would have been required. Unlike in *Allsop* (considered in more detail below), the fact that the agreement included a general clause settling all issues between the parties was not seen as relevant – even though there may have been capital claims that the taxpayer could have (but did not) bring. Foregoing the right to sue was an incident of settlement; it did not characterise the payment.
18. *Case S96* (1996) 17 NZTC 7,603 related to personal grievance proceedings against an employer. The settlement agreement had been lost so the Taxation Review Authority had to consider whether (and how) a lump sum settlement payment should be apportioned (between revenue amounts (for loss of income) and capital amounts (for humiliation, loss of dignity and hurt feelings)). The taxpayer argued that the entire settlement payment was compensation for injury to feelings.
19. Judge Barber considered all of the available evidence and circumstances and chose to apportion the payments on a pro rata basis of the amounts claimed in the original proceedings. In his view, this was a fair apportionment (at 7,608):

    > I consider that the non taxable element of the settlements needs to be now fixed by this Authority because it has heard the available evidence, and **regardless of what limit may have been imposed by the Settlement Agreement**. **The issue must be what, in commercial and personal reality, was a fair apportionment of each settlement to compensation for feelings injury**. [Emphasis added]

20. *Sayer v CIR* (1999) 19 NZTC 15,249 involved an employment court award for wrongful dismissal. The Employment Court awarded Mr Sayer compensation including $62,142 as compensation for lost remuneration, $50,000 for humiliation, loss of dignity and injury to feelings and $5,000 for costs (a total of $117,142). Mr Sayer applied to wind up the company and also took action against the directors and shareholders of the company for any shortfall that he might suffer as a result of the company's liability to him, as well as interest and exemplary damages.
21. Mr Sayer entered into a deed of settlement and assignment with the directors and shareholders of the company. At that time, the company owed Mr Sayer $130,944.30. Under the deed of settlement, in consideration of the amount of $100,000, Mr Sayer agreed to assign to a second company all claims that he might have against the company and to release the directors and shareholders from any claims that he had against them. The deed provided that $99,999 of the settlement amount (together with interest less withholding tax) was attributable to the consideration for the assignment of Mr Sayer's claim against the company.
22. The Commissioner had assessed $50,000 as monetary remuneration and had attributed the other $50,000 to compensation for humiliation (capital). Mr Sayer argued that no part of the $100,000 was monetary remuneration as it was paid to bring about the discontinuance of his proceedings against the directors and shareholders (rather than to settle his dispute with the company). However, Doogue J considered that the deed of settlement made it clear that $99,999 of the settlement amount (together with interest less withholding tax) was attributable to the consideration paid for the assignment of the claim against the company and that it was not possible to go behind the deed.
23. The taxpayer also argued that the $100,000 could not be apportioned and must be considered as a whole. This was on the basis of *McLaurin* and *Allsop* (which are considered below). Doogue J rejected the taxpayer's argument on the basis that it was not supported by the facts and distinguished *McLaurin* and *Allsop* on the basis that the settlement agreement in *Sayer* involved settling a claim for liquidated damages (which was squarely within one of the exceptions noted in *McLaurin*).
24. In *Henwood v CIR* (1995) 17 NZTC 12,271 the majority of the Court of Appeal (Richardson J and Hardie Boys J) held that payments received under a contract for services were partly capital in character as the payments were received in return for both acting services (income) and for the restraint of trade (capital). The majority also held the payments could be apportioned.
25. In determining an appropriate apportionment, Richardson J was willing to take into account the TRA's finding as to what level of fee would have been commercial in the circumstances (ie attributing a value to that element of the contract). This, in conjunction with implications from the contract, provided the basis for Richardson J's conclusion that the TRA's apportionment was appropriate.
26. On the other hand, Hardie Boys J appears to have been trying to work out from the contract how much the **parties intended** to allocate to each element (which he found in clause 11 of their contract). In the absence of any indication to this effect, Hardie Boys J suggested that apportionment may have been impossible.

Conclusion on New Zealand approach

27. The New Zealand courts have tended to take a broad approach to apportionment. The default position is that the courts will apportion where there is a reasonable basis for doing so. In determining an appropriate apportionment, the courts have looked at the documentation between the parties, as well as the relevant context and background.

United Kingdom case law

28. Two United Kingdom cases directly on point are *Wales v Tilley* [1943] 1 All ER 280 (HL) and *Carter v Wadman* (1946) 28 TC 41 (UKCA). Both cases considered the apportionment of undissected lump sum settlement payments.

29. *Wales v Tilley* was a decision of the House of Lords (which was followed by the House of Lords more recently in *Mairs (Inspector of Taxes) v Haughey* [1993] 3 All ER 801). It concerned the managing director of a company. The company had agreed to pay Mr Tilley a salary of £6,000 a year and had also agreed to pay him a pension of £4,000 a year for 10 years after he ceased to be managing director. Mr Tilley agreed to release the company from the obligation to pay the pension and agreed to a reduced salary of £2,000 a year in consideration for a lump sum payment of £40,000 in two equal instalments.

30. The House of Lords held that, to the extent the payment was received for surrendering a right to a pension, it was capital and, to the extent the payment was made in consideration of a reduction of salary, it was income. There was nothing in the agreement that apportioned the amount between the two rights that had been surrendered. Nor was there any other evidence of agreement between the parties as to how the amount was calculated.

31. Viscount Simon noted that if the court considered tax was due under one head but not the other, the Attorney-General, on behalf of the Crown, had accepted the amount should be treated as apportionable. On the same point, Lord Thankerton commented that, on the issue of practicability, Mr Tilley's accountants had provided a basis for apportionment. Lord Porter considered that although there were difficulties in determining the amount attributable to each component (which depended, for example, on when Mr Tilley's employment ceased), it was not impossible to do so (at 285):

> It only remains, therefore, to see whether the sum attributable to the release of the pension can be separated from that payable for the reduction of salary. It was only faintly argued on behalf of the Crown that such a division was not possible; but it was said that there were no materials **upon which such a calculation could be made** inasmuch as the cessation of the salary and the commencement of the pension were dependent on many unascertainable matters, amongst others on the Appellant's choice of the time of his retirement. No doubt there are difficulties but the resultant figure **seems no more incalculable** than, say, the length of time during which an injured workman would have continued to earn wages had he not received his injury, a period difficult no doubt to ascertain, but one which has constantly **to be estimated** in dealing with cases of personal injury. [Emphasis added]

32. Therefore, in considering whether an apportionment was possible, Lord Porter considered whether it was possible to objectively calculate the respective values of the rights given up in return for the lump sum payment. The fact the respective amounts would have to be estimated (as they could not be calculated exactly) did not mean apportionment was not possible. The case was referred back to the Special Commissioners to determine the appropriate apportionment.

33. A similar issue was considered by the UK Court of Appeal in *Carter v Wadman*. In that case, the taxpayer (Mr Carter) was employed as the resident manager of a public house for a salary of £10 per week plus a quarter share of the net profits of the business. The term of the agreement began on 30 January 1942 and ended on 24 June 1949. In 1942 the employer (Mrs Pierce) wished to assign the lease and the licence for the premises and to sell the goodwill, chattels and stock relating to the premises. Mr Carter's consent to the assignment was required as it was a term of Mr Carter's agreement with Mrs Pierce that she could not, without his consent, sublet or part with possession of any part of the premises or the goodwill or assets of the business, except in the ordinary course of business.

34. Mr Carter and Mrs Pierce entered into an agreement under which Mrs Pierce agreed to pay Mr Carter £2,000 in consideration of his agreeing to the transfer of the licence to the purchaser and in full settlement of "all past, present and future claims" he might have against her under the management contract. At the time the agreement was made Mr Carter had been paid his salary up to the cancellation date (2 December 1942), but his share of the profits for the 1942 year had not been calculated. In view of the agreement, Mr Carter could no longer make any claim against Mrs Pierce for a share of the profits. Subsequently, it was determined that Mr Carter's share of the profits would have been £1,090.

35. The Court of Appeal had to determine whether any part of the £2,000 was employment income. It considered the payment was, in part, the price for the cancellation of the agreement and, in part, paid in settlement of past and present claims. One of the possible claims was for the taxpayer's share of the profits up to 2 December 1942 (this would be employment income). The court considered it was possible to determine the value of the unexpired term of the agreement, at 52-53:

INTERPRETATION STATEMENTS

> Mr. Mustoe sought to argue that, as the consideration was one lump sum of £2,000, it was impossible to point to any portion of the £2,000 and say that it was a profit arising from his employment: but the Crown might equally well have argued that, as it was impossible to fix any sum which represented a capital payment, the whole must be income. … **But we respectfully agree with their Lordships** [in *Wales v Tilley*] **that in principle there must be apportionment, and we think that on the facts of the present case, though the calculation of the value to the Appellant of the unexpired portion of the agreement must be a matter of estimate, there is no insuperable difficulty in estimating its value.** [Emphasis added]

36. It can be seen from this that the court was concerned with apportioning the lump sum based on the values of the respective elements. Consistent with *Wales v Tilley*, there was no consideration given to trying to determine any agreement between the parties as to how the amount was made up. This emphasis on valuation is consistent with the order the court gave regarding apportionment when referring the case back to the General Commissioners.

37. The court found apportionment should be made on the basis of the proportion the sum of £1,090 (the share of the profits to which the taxpayer would have been entitled) bore to the aggregate of £1,090 and the sum the taxpayer would have been entitled to recover from Mrs Pierce as damages for breach of the employment contract, if he had been paid his salary and a share of profits up to cancellation date and had then repudiated the contract.

Australian case law

38. The leading Australian cases on this issue are the High Court of Australia decisions in *McLaurin* and *Allsop*. The taxpayer in *McLaurin* had made claims for a total amount of £30,240 as compensation for damage to property as a result of a fire that had spread from a property owned by the Commissioner of Railways. Some of the claims were for amounts that were capital in nature and some for amounts that were revenue in nature. The Commissioner of Railways made a settlement offer of £12,350 and the taxpayer accepted it "in full settlement of all claims for damage arising out of" the fire.

39. The £12,350 lump sum offer was based on a valuation of the items of property for which the claims had been made, as carried out by a valuer employed by the Commissioner of Railways. There had been various discussions between the valuer and the taxpayer in the course of the valuer arriving at his valuation. However, the court found no information was given to the taxpayer as to how the amount was arrived at.

40. The Commissioner considered £11,000 of the compensation was income, being compensation for the revenue items claimed, determined on the basis of the valuation. The court accepted the valuation was based on a list of items supplied by the taxpayer and the taxpayer could make a confident guess as to the amount allowed by the valuer for each item claimed. However, the court considered the character of the payment in the hands of the recipient could not be determined by the payer's (the Commissioner of Railways) uncommunicated reasons for agreeing to pay the amount. The court considered the offer made and accepted was for a single undissected amount (not payments for each individual item claimed).

41. The court accepted that it may be appropriate to apportion a single payment of a mixed nature made in settlement of specific claims where at least some of the claims are for liquidated amounts or are amounts that are "otherwise ascertainable by calculation". In this context, the court referred to *Carter v Wadman* and *Wales v Tilley*. It gave *Carter v Wadman* as an example of a case that included liquidated claims and *Wales v Tilley* as an example of a case where some of the distinct claims were ascertainable by calculation.

42. However, the court considered apportionment was not appropriate where a payment is made only for claims for unliquidated damages under a compromise that treats the payment as a single undissected payment. In such circumstances, the amount must be considered as a whole. The court considered the damage caused by the fire (whether included in the taxpayer's claim or not) was compensated for by one entire sum. There was no factual basis for the Commissioner's argument that the settlement payment was income on the basis it had the same character as the profits the taxpayer would otherwise have derived. The court, therefore, held the entire sum was capital in nature.

43. The court was concerned with establishing what the parties had **agreed** the amount was paid for. It was not relevant what one party had originally claimed was payable. It was also not relevant what the other party was willing to pay for (ie the uncommunicated reasons of the payer for making the payment were not relevant). Further, there was no discussion of the possibility of valuing the respective claims given up and apportioning on that basis. This may be because the parties had not argued the case on this basis.

44. *Allsop* concerned a taxpayer who was in the transport business. The taxpayer had paid the Commissioner for Motor Transport permit fees totalling £54,868 and had been allowed deductions for the permit fees. Following a decision by the Privy Council that the fees were not legally payable, the taxpayer sought recovery of the fees paid on the basis that the amounts had been improperly demanded under the colour of office. A settlement was negotiated under which the taxpayer was paid £37,500.

45. The settlement deed was made without any admission of liability on the part of the Government and the Commissioner for Motor Transport. The deed provided that, in consideration of the payment, the taxpayer released the Government and the Commissioner for Motor Transport from all actions, suits, proceedings, causes of action, arbitrations, debts, dues, demands, costs, charges and expenses the taxpayer had in connection with or arising out of anything done or omitted to be done under the relevant legislation.

46. The High Court of Australia rejected the Commissioner's argument that, as the payment was a refund of expenditure for which a deduction had been allowed, the amount was income. The court considered there was no factual basis for the Commissioner's argument.

47. Barwick CJ and Taylor J considered the taxpayer would have had valid claims against the Commissioner for unlawful interference with the taxpayer's vehicles and his business (even though no such claims had been made by the taxpayer). As the settlement deed provided the amount was paid for the release of all potential claims, Barwick CJ and Taylor J considered the entire payment was made by way of compromise of all claims the taxpayer had. No part of the payment was attributable solely to the refund of the fees paid.

48. Windeyer J held the consideration for the payment was the release of a variety of claims the taxpayer had or might be thought to have had against the Government. No part of the payment was received as a refund of permit fees paid by the taxpayer. In particular, Windeyer J appears to have been seeking evidence as to how the parties had calculated the amount before he would have been willing to apportion (at 65):

> It does not appear from the material before us that the sum of £37,000, or any definite part of it, was computed, paid and received as a refund of particular amounts that had been paid by the appellant for road charges and which had been allowed as deductions in the assessment of his taxable income.

49. The court did not consider attempting to value the respective claims given up. Rather the court seems to have been looking for evidence as to how the parties calculated the amount (ie what they agreed the amount was paid for). As the agreement contained (and, in that case, was limited to) a general release clause covering all potential claims, it was not possible to determine that any specific amount was paid for any specific claim. The court, therefore, found the whole amount should be treated as capital.

50. *McLaurin* and *Allsop* have also been followed in later Australian decisions. In determining whether apportionment is possible, the courts have sought evidence of agreement between the parties as to how the amount was calculated. See, for example, *FCT v Spedley Securities Ltd* 88 ATC 4126 (FCA) at 4128:

> After negotiation, an entire sum of $200,000 was accepted. Its payment was the subject of agreement, **but there was no agreement as to the way in which it was made up**. The evidence as to the way the settlement was seen, from one side or another is scant. [Emphasis added]

51. The Court held that the entire amount was capital as the payment was received as a lump sum, the ingredients of which were not identified, so there was no basis for apportionment.

Conclusion on apportionment

52. In the Commissioner's view, the Australian and UK courts have taken different approaches to apportioning lump sum settlement payments. The courts in *Wales v Tilley* and *Carter v Wadman* were willing to accept apportionments based on objectively estimated values for different elements of the agreements. On the other hand, the High Court of Australia in *McLaurin* and *Allsop* seemed concerned with trying to find evidence of agreement between the parties as to how the lump sum was made up. In the absence of this, the courts found that no apportionment was possible.

53. Although *McLaurin* distinguished *Wales v Tilley* and *Carter v Wadman*, this, arguably, does not fully explain the different approaches to apportionment. The fact the agreement in *Carter v Wadman* included a liquidated amount did not appear to assist the court with determining any agreement between the parties. It was not a case where the court concluded an amount equal to the amount of the liquidated damages (in that case £1,090) was allocated to that head. In such a situation, it would be easier to argue that the parties had implicitly agreed on the amount to be allocated. However, the court found the £2,000 was paid as a lump sum to cover all of the rights given up. It found that £2,000 had to be apportioned according to the respective values of the different claims. In this regard, the fact there was an amount of liquidated damages was of no more assistance to the court than any other right that could be valued.

54. Similarly, the amounts making up the lump sum in *Wales v Tilley* do not seem to be any more easily "ascertainable by calculation" than the amounts in *McLaurin* or *Allsop*.

55. Neither *McLaurin* and *Allsop* nor *Wales v Tilley* and *Carter v Wadman* have been applied in New Zealand. The court in *Sayer* did suggest that, if the facts had been different, the taxpayer would have been able to argue that *McLaurin* and *Allsop* applied – however, this does not mean that such an argument would necessarily have been accepted. Rather, in

INTERPRETATION STATEMENTS

the Commissioner's view, the broad approach taken in New Zealand apportionment cases is more consistent with the UK approach than the Australian one. It has been suggested that *McLaurin* and *Allsop* are authority for the proposition that, if an undissected settlement payment includes both capital and revenue amounts, the whole amount will be treated as capital. To the extent that *McLaurin* and *Allsop* stand for this proposition, the Commissioner's view is that they would not be followed in New Zealand. Rather, where possible, New Zealand courts would seek a reasonable basis for apportioning a lump sum.

56. It is noted that *McLaurin* and *Allsop* have also been judicially criticised by the High Court of Australia (see *FCT v CSR Ltd* No S278 of 2000, 23 November 2001). In that case, the Commissioner was seeking leave to appeal to the High Court. He argued that *McLaurin* and *Allsop* should be overturned despite their longevity. Ultimately, although critical of *McLaurin* and *Allsop*, the High Court denied the application for leave to appeal. This was because the cases had stood for (at that time) 40 years and Parliament had not chosen to overturn them by legislation. This was despite a recommendation by the Asprey Committee in 1975 that specific legislation be introduced to apportion on a valuation basis. As *McLaurin* and *Allsop* have never been applied in New Zealand, the High Court's reasons for not considering overturning *McLaurin* and *Allsop* are not relevant. However, their criticisms are equally valid in New Zealand as in Australia.

How should an appropriate apportionment be determined?

57. Any apportionment must be undertaken on an objective basis. The ultimate aim of apportionment is to determine what the amount was paid for and to split it into its capital and revenue parts. As well as considering any settlement agreement, it is likely to be necessary to look at the surrounding circumstances and other, related documentation.

58. Where it can be established that the parties to the settlement have agreed how the payment is made up, this will generally be an appropriate basis for determining the apportionment between capital and revenue amounts. However, the Commissioner may not accept such an apportionment where taking into account the relevant circumstances, the amount allocated to the capital element is excessive, the agreement is a sham, or the agreement is part of a tax avoidance arrangement (see *Case S96* at 7,606).

59. Often there will be no agreement between the parties as to how the lump sum was made up. The nature of settlement agreements is that they represent a compromise between parties with competing interests. For example, an employee may want a higher payment for hurt and humiliation, but their employer may prefer a higher payment for lost wages. Other times, the parties may care only about the total amount of the payment and may not have given any thought as to how it is made up.

60. Where there is no (or insufficient) evidence of how the parties intended the amount to be apportioned, it may be appropriate to calculate (or estimate) the value of the respective claims given up in return for the payment.

61. The terms of any statement of claim should be considered. How helpful a statement of claim is will depend on the particular circumstances. For example, a statement of claim is likely to be highly relevant where there is an express link to it in the settlement agreement (as in *Case V8*). At the other end of the spectrum, if the dispute was settled on a different basis to the statement of claim, it may be of little or no relevance in determining an appropriate apportionment (see *du Cros v Ryall* (1935) 19 TC 444 (KBD)). In situations in between, it is likely to be of some assistance along with evidence of later negotiations between the parties.

62. Evidence of negotiations between the parties prior to settlement and other background facts may also be relevant if they help determine what the payment was made for.

63. The relevance of a general clause releasing a party from all liability will be similarly fact dependent. In some circumstances, it will be included as an incidental element of a settlement agreement (as in *Case V8* and *Sayer*). In other cases, it may be intended to cover one or more claims (as in *Carter v Wadman*). This will generally be a question of characterisation, rather than apportionment. As discussed above, it is essential to work out what the payment is for before considering apportionment. In *Allsop* the agreement consisted entirely of a general release clause. In the Commissioner's view, no apportionment would be required on the facts of *Allsop* as the full payment was made to settle a claim by the taxpayer of a revenue nature.

64. All relevant factors need to be considered when determining a reasonable basis for apportionment.

Amounts that cannot be apportioned

65. In the Commissioner's view, it will be possible to find an appropriate basis for apportionment in most situations. The taxpayer has the burden of proving that any apportionment is reasonable. Where a taxpayer does not make an apportionment, the Commissioner may, depending on the relevant facts and the information available, make an apportionment that the Commissioner considers is fair and reasonable.

66. There may be rare situations where **no apportionment is possible**. In these cases, the whole amount received should be treated the same. As noted above, for an amount to be taxable, it must be "income" under a provision in Part C. Where no part of the amount comes within a provision in Part C, none of the amount will be taxable.

67. However, where the lump sum includes an amount that is taxable under a provision in Part C, the taxpayer has the burden of proving what part of the amount is not taxable. If a taxpayer is unable to show what part of a lump sum payment is capital, the Commissioner's view is that generally the whole amount should be treated as income. This is consistent with *Buckley & Young* (at 61,283):

> If there is insufficient evidence to arrive at a conclusion, any answer must be mere speculation and the taxpayer will have failed to discharge the onus of proof upon him …

68. See also *Case S96* at 7,606:

> Where the Commissioner has some doubt about the amount attributed to humiliation, loss of dignity, or injury to feelings, he may ask the parties to an agreement what steps they took to evaluate objectively what would be a reasonable amount to attribute to humiliation, loss of dignity, or injury to feelings. This would be so regardless of whether the payment was made as a result of an out of court settlement and whether or not the agreement is settled by the Human Rights Commissioner under the Human Rights Act. **The onus of proof regarding the taxability of any such payment would be on the taxpayer**. [Emphasis added]

References

Subject references

Income Tax

Lump sum

Settlement payment

Case references

Allsop v FCT (1965) 14 ATD 62 (HCA)

Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)

Carter v Wadman (1946) 28 TC 41 (UKCA)

Case S96 (1996) 17 NZTC 7,603

Case V8 (2001) 20 NZTC 10,092

du Cros v Ryall (1935) 19 TC 444 (KBD)

FCT v CSR Ltd No S278 of 2000, 23 November 2001

Federal Coke Pty Ltd v FCT 77 ATC 4255 (FCA)

Henwood v CIR (1995) 17 NZTC 12,271 (CA)

McLaurin v FCT (1961) 12 ATD 273 (HCA)

FCT v Spedley Securities Ltd 88 ATC 4126 (FCA)

Wales v Tilley [1943] 1 All ER 280 (HL)

Interpretation statement: IS 16/05

Income tax – foreign tax credits – how to claim a foreign tax credit where the foreign tax paid is covered by a double tax agreement

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

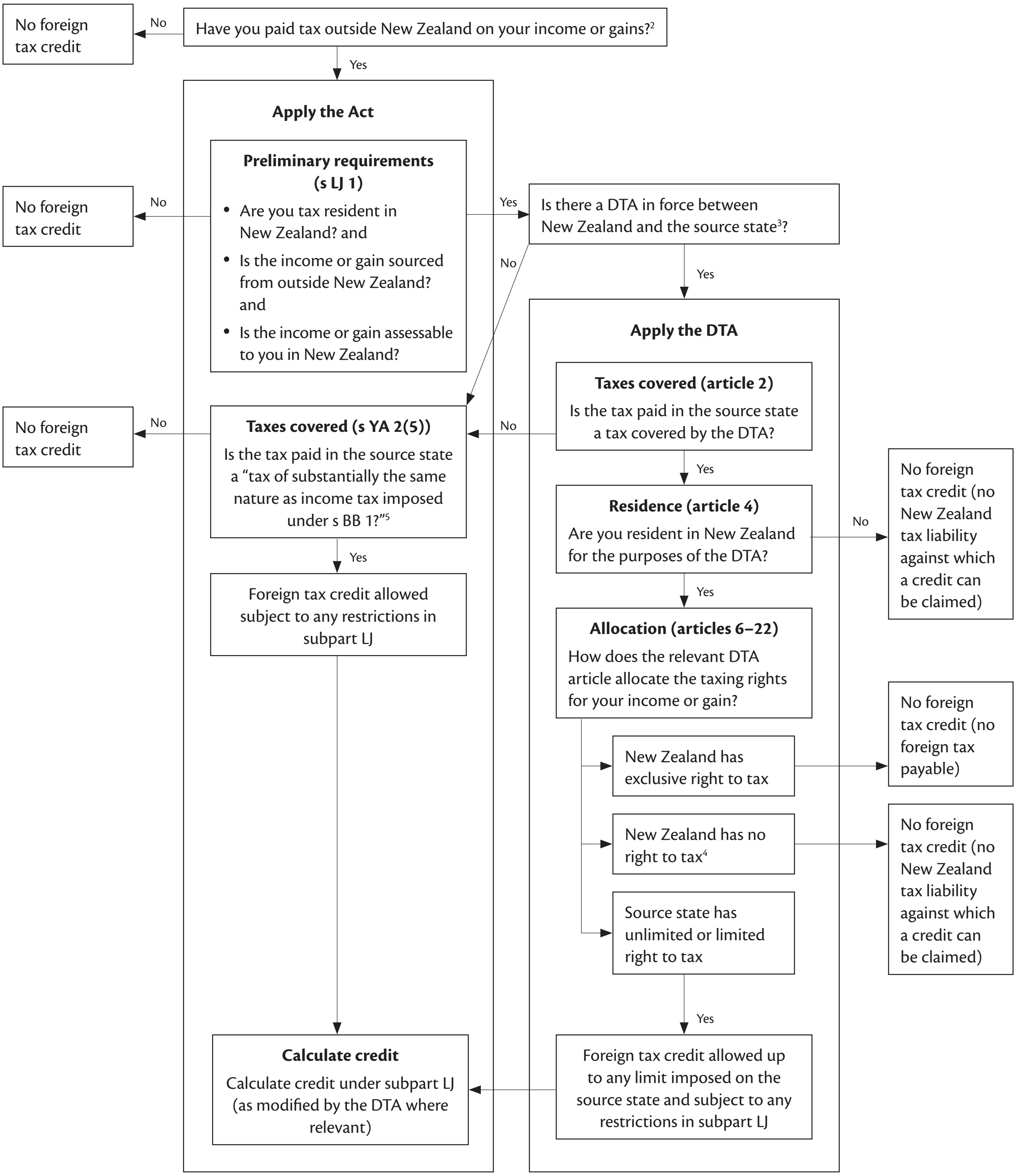
Scope of this statement

1. Double taxation occurs when two or more countries or territories (referred to as "states" for the purposes of this Interpretation Statement) tax the same taxpayer on the same income or gains. Many states tax residents on their worldwide income, including income sourced in a foreign state. States also tax non-residents on income sourced in that state. This can result in the same income being taxable under the tax laws of both states, based on residence and source respectively.
2. To relieve double taxation, a New Zealand tax resident taxpayer may be entitled to claim a foreign tax credit against their New Zealand income tax liability for any foreign income tax paid. There are two circumstances where a taxpayer may be entitled to claim a foreign tax credit:
    - if the foreign tax is covered by a Double Tax Agreement (DTA), a credit may be allowed under, and in accordance with, the terms of that DTA; or
    - if the foreign tax is not covered by a DTA, a foreign tax credit may be allowed directly under subpart LJ.
3. This Interpretation Statement explains how to claim a foreign tax credit where a foreign tax **is** covered by a DTA. A foreign tax **is** covered by a DTA if it is:
    - expressly listed in the "Taxes covered" article of the DTA (typically art 2); or
    - a tax on income or capital as defined in art 2(1) and (2) of the DTA; or
    - a subsequently enacted tax that is "identical or substantially similar" to one of the taxes covered by the DTA (typically art 2(4)).
4. If a tax **is** covered by a DTA, then the DTA will determine whether a foreign tax credit is available. If a foreign tax credit is available, the amount of that credit will be calculated under subpart LJ. If a foreign tax credit is not available, then there will be no foreign tax credit relief.
5. A foreign tax is **not** covered by a DTA if:
    - New Zealand does not have a DTA with the state imposing the foreign tax; or
    - there is a DTA between New Zealand and the state imposing the foreign tax, but the foreign tax is not a tax that the DTA applies to.
6. Where a tax is **not** covered by a DTA, a taxpayer may still be entitled to a foreign tax credit under subpart LJ. Taxpayers should refer to Interpretation Statement IS 14/02: "Income tax – foreign tax credits – what is a tax of substantially the same nature as income tax imposed under s BB 1?" in *Tax Information Bulletin* Vol 26, No 5 (June 2014): 3, for further guidance.

Introduction

7. The following flowchart is intended as a useful framework for analysing a foreign tax credit issue. However, the flowchart is not meant to be a replacement for carefully reading and applying the relevant legislation.

Can I claim a foreign tax credit?[1]



[1] All legislative references are to the Income Tax Act 2007.
[2] Different rules exist if a tax-sparing article applies.
[3] "Source state" refers to a country or a territory.
[4] This only occurs when article 20 (students) applies.
[5] See IS 14/02: "What is a tax of substantially the same nature as income tax imposed under s BB 1?" cited above.

8. After confirming that a taxpayer has paid tax outside New Zealand on their income or gains, the flowchart then looks at the domestic law preliminary requirements for foreign tax credits (ss LJ 1 and LJ 2) before considering the potential application of the DTA. In the Commissioner's opinion, this is the most logical place to start. If you do not apply domestic law first, then you will not know if you have a New Zealand income tax liability. Without this knowledge you will not be able to determine if you are subject to double taxation.
9. This approach is consistent with most international tax law commentary. However, the Commissioner accepts there may be other approaches to analysing foreign tax credit issues.
10. This Interpretation Statement does not attempt to explain every element of the flowchart. Instead, it focuses on how the foreign tax credit rules work where a foreign tax is covered by a DTA. If a taxpayer has paid foreign tax that is not covered by a DTA, they should refer to IS 14/02 for further guidance.
11. This Interpretation Statement does not consider how the foreign tax credit rules apply to trusts, controlled foreign companies, foreign investment funds, partnerships or fiscally transparent (look-through) entities.

Analysis

12. This Interpretation Statement is set out in two parts. The first part explains how the foreign tax credit rules work when a foreign tax is covered by a DTA and follows the structure set out in the flowchart. The second part contains worked examples that illustrate some of the issues discussed.

Have you paid tax outside New Zealand on your income or gains?

13. The first step in the flowchart asks: have you paid tax outside New Zealand on your income or gains? This is a question of fact. If tax has not been paid outside New Zealand on income or a gain, there will be no double taxation requiring foreign tax credit relief. Different rules exist if a tax sparing article applies.

Apply the Act - preliminary requirements – subpart LJ

14. Section LJ 2(1) provides that a person is entitled to a foreign tax credit for an amount of foreign income tax paid on a segment of foreign-sourced income:

    LJ 2 Tax credits for foreign income tax

    Amount of credit

    (1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.

15. A person described in s LJ 1(2)(a) is a person who is resident in New Zealand and derives assessable income that is sourced from outside New Zealand.
16. Section LJ 1(2)(b) provides that a foreign tax credit will not be allowed for any unrecognised taxes listed in sch 27 (there are currently none listed).
17. Based on ss LJ 1(2) and LJ 2(1), to be eligible for a foreign tax credit a taxpayer must:
    - be tax resident in New Zealand, and
    - have derived foreign-sourced income, and
    - have that foreign-sourced income assessable under the Act, and
    - have paid foreign income tax on that foreign-sourced income.
18. Each requirement must be satisfied positively. Failure to satisfy any one of the requirements will mean that a taxpayer will not be eligible for foreign tax credit relief, as there will be no New Zealand tax liability against which a credit can be claimed. These requirements are domestic law requirements and should first be determined without reference to the DTA.
19. The first three preliminary requirements are considered below. The fourth requirement is considered separately at [167].

Are you tax resident in New Zealand?

20. The rules for determining tax residence status for individuals (including transitional residents) and companies are summarised below. Interpretation Statement IS 16/03: "Tax residence" *Tax Information Bulletin* Vol 28, No 10 (October 2016) comprehensively explains these rules. Taxpayers should refer to this Interpretation Statement for further guidance.

Individuals

21. Section YD 1 determines the residence of natural persons (individuals). An individual is a New Zealand resident if they are personally present in New Zealand for more than 183 days in total in a 12-month period (s YD 1(3). The person will then be treated as resident from the first of those 183 days (s YD 1(4)). A person is also resident if they have a permanent place of abode in New Zealand, even if they also have a permanent place of abode elsewhere (s YD 1(2)). A person who is resident by virtue only of the 183-day rule will stop being a New Zealand resident if they are personally absent from New Zealand for more than 325 days in total in a 12-month period (s YD 1(5)). The person will then be treated as not resident from the first of those 325 days (s YD 1(6)).

22. However, the permanent place of abode test is the overriding residence rule for individuals. This means that a person who is absent from New Zealand for more than 325 days in a 12-month period will remain a New Zealand resident if they continue to have a permanent place of abode in New Zealand. Equally, a person who is present in New Zealand for less than 183 days in a 12-month period is still a New Zealand resident if they have a permanent place of abode in New Zealand. A person who is absent for more than 325 days in a 12-month period, but who has a permanent place of abode in New Zealand at any time during that period, cannot cease to be resident any earlier than the day they lose their permanent place of abode in New Zealand.

23. There are also special residence rules for government servants and seasonal workers (s YD 1(7) and (11)).

Transitional residents

24. Transitional residents are resident in New Zealand for tax purposes but are eligible for tax exemptions on certain income.

25. New migrants and returning New Zealanders may be transitional residents under s HR 8(2) if they meet the necessary requirements. If a person is a transitional resident they are temporarily entitled to tax exemptions (s CW 27) for all foreign-sourced income except for:

- employment income in connection with employment or service performed while the person is a transitional resident; and
- income from a supply of services.

26. IS 16/03 explains in more detail the requirements for transitional resident status and when this special status starts (on the date a person becomes a New Zealand tax resident under s YD 1 – either by acquiring a permanent place of abode or by meeting the requirements of the 183-day rule) and ends (usually at the end of the 48th month after the month in which the person acquired a permanent place of abode in New Zealand or satisfied the 183-day rule, (ignoring the back-dating rule in s YD 1(4)) whichever is earlier. Transitional resident status may also end on the day before the date where a person stops being a New Zealand resident or on the date on which they stop being a transitional resident because they elect not to be one under s HR 8(4) or (5).

27. Transitional residents will satisfy this preliminary requirement because they are tax resident in New Zealand. However, [43] below explains why transitional residents may ultimately be ineligible for foreign tax credit relief on their exempt income.

Companies

28. "Company" is defined in s YA 1. The definition is broad and extends to any entity with a legal existence separate from that of its members.

29. Section YD 2 sets out the tax residence tests for companies:

YD 2 Residence of companies

Four bases for residence

(1) A company is a New Zealand resident for the purposes of this Act if—

(a) it is incorporated in New Zealand:

(b) its head office is in New Zealand:

(c) its centre of management is in New Zealand:

(d) its directors, in their capacity as directors, exercise control of the company in New Zealand, even if the directors' decision-making also occurs outside New Zealand.

International tax rules

(2) Despite subsection (1), for the purpose of the international tax rules, a company is treated as remaining resident in New Zealand if it becomes a foreign company but is resident in New Zealand again within 183 days afterwards.

…

30. IS 16/03 considers the test for company tax residence in detail. Taxpayers should refer to that Interpretation Statement for further details.

Conclusion

31. Whether an individual or a company is tax resident in New Zealand will be a question of fact. If they are not tax resident in New Zealand, there will be no foreign tax credit relief available in New Zealand.

Is the income or gain sourced from outside New Zealand?

Source rules

32. To be eligible for a foreign tax credit, a taxpayer must have derived income sourced from outside New Zealand. "Income sourced from outside New Zealand" is not defined in the Act. However, s YA 1 does define "foreign-sourced amount" (which is a comparable term also used in s LJ 1(1)):

> **foreign-sourced amount** means an amount of income that is not treated as having a source in New Zealand under sections YD 4 (Classes of income treated as having New Zealand source) and YZ 1 (Source rule for interest)

33. Section YA 1 defines "foreign-sourced amount" by what it is not. If it is not one of the classes of income treated as having a source in New Zealand[1] under ss YD 4 or YZ 1, it will be a foreign-sourced amount.

34. Section YD 4 lists the classes of income that are treated as having a source in New Zealand. The list includes income derived from a business wholly carried on in New Zealand, income derived from a contract made in New Zealand, income earned in New Zealand, and pensions payable in New Zealand, to name a few. Section YD 4(18) is the catch-all provision that includes income derived directly or indirectly from any other source in New Zealand.

35. Section YZ 1 supplements the rules in s YD 4(11), which relate to income from debt instruments.

36. Income not treated as sourced in New Zealand under ss YD 4 and YZ 1 will be sourced from outside New Zealand. For ease of reference, this Interpretation Statement refers to this income as "foreign-sourced income".

Section LJ 1(4) – an additional source rule for dividends

37. Section LJ 1(4) is an additional source rule for dividends. It ensures that a New Zealand resident can claim a foreign tax credit for foreign withholding tax paid on a dividend received from a non-resident company. Section LJ 1(4) treats the dividend as being derived in that foreign territory.

Apportionment

38. Foreign-sourced income may also have a source in New Zealand. Section YD 5 permits certain classes of foreign-sourced income to be apportioned. Under s YD 5, if a business is partly carried on outside New Zealand, then the income derived outside New Zealand will be foreign-sourced income (to the extent it is apportioned to that source). Apportionment is also permitted under s YD 5 where income is derived under a contract made in New Zealand and performed in whole or in part by a person outside New Zealand (or alternatively, where a contract is made outside New Zealand and performed in whole or in part by a person in New Zealand). The apportionment is to be undertaken on an arm's length basis.

Conclusion

39. Income that is not deemed to have a source in New Zealand under ss YD 4, YD 5, YZ 1 or LJ 1(4), will be foreign-sourced income. If the income is not foreign-sourced income, foreign tax credit relief will be unavailable.

Is the income or gain assessable in New Zealand?

40. To be eligible for a foreign tax credit, the foreign-sourced income or gain (on which foreign income tax is paid) must also be assessable income in New Zealand. If the foreign-sourced income or gain is not assessable income in New Zealand, there will be no double taxation to relieve.

41. Section BD 1(1) provides that an amount is income of a person if it is their income under Part C of the Act. This amount will be assessable income under s BD 1(5) if it is not exempt income, excluded income or non-residents' foreign-sourced income. All relevant definitions are at s BD 1.

[1] "New Zealand" is defined in s YA 1 and includes the continental shelf and the water and air space above any part of the continental shelf that is beyond New Zealand's territorial sea, as defined in s 3 of the Territorial Sea, Contiguous Zone, and Exclusive Economic Zone Act 1977.

42. Taxpayers must work through Part C and the definitions in s BD 1 to determine whether the foreign-sourced income or gain is assessable income in New Zealand.

Transitional residents

43. A transitional resident will not be eligible for a foreign tax credit for any foreign-sourced income that is subject to the s CW 27 tax exemption. This is because the foreign-sourced income will not be assessable income in New Zealand.

44. However, not all of a transitional resident's income is exempt. Section CW 27(a) and (b) exclude from the tax exemption foreign-sourced employment income in connection with employment or services performed while the person is a transitional resident, and foreign-sourced income from a supply of services. Such income will be assessable income of the transitional resident and therefore potentially eligible for foreign tax credit relief. This is illustrated in the example at [47].

Conclusion

45. If the income or gain is not assessable in New Zealand, there will be no foreign tax credit relief because there will be no New Zealand income tax liability against which a credit can be claimed.

46. A taxpayer must satisfy all of the above preliminary requirements to be eligible for a foreign tax credit.

Example illustrating the application of the preliminary requirements for a transitional resident

47. The following example illustrates the application of the preliminary requirements for a transitional resident.

Example 1 – preliminary requirements and transitional residents

Lucy recently migrated to New Zealand and is a transitional resident under s HR 8(2). Lucy is therefore a New Zealand tax resident but is exempt from income tax on certain items of foreign-sourced income. Prior to migrating, Lucy had been tax resident in the United Kingdom for 10 years.

During her first tax year as a transitional resident, Lucy derives investment income from the United Kingdom. Lucy wants to know if she is entitled to claim a foreign tax credit for the United Kingdom income tax that she has paid on that investment.

Under s CW 27, Lucy's investment income is exempt from income tax in New Zealand. The investment income therefore fails the third preliminary requirement because the income is not assessable to Lucy in New Zealand. This means Lucy is not eligible for a foreign tax credit, as there is no New Zealand income tax liability against which a credit can be claimed.

During her first tax year as a transitional resident, Lucy returns to the United Kingdom and derives employment income while there. This income is taxed at source in the United Kingdom. Section CW 27(a) states that this income is not subject to the transitional resident exemption, so the income is also assessable to Lucy in New Zealand. Lucy will therefore suffer double taxation, although she may be entitled to a foreign tax credit under the New Zealand/ United Kingdom DTA. Example 9 of this Interpretation Statement considers whether Lucy would be entitled to a foreign tax credit under the DTA.

Is there a DTA in force between New Zealand and the source state?

48. The next step in the flowchart is to determine whether there is a DTA in force between New Zealand and the source state. This will decide whether any potential foreign tax credit arises under the DTA or under domestic law.

What is a DTA?

49. A DTA (also known as a double tax convention or tax treaty) is an international agreement entered into between the Government of New Zealand and the government of any state outside New Zealand (s BH 1(1)).

50. One of the main purposes of a DTA is to eliminate double taxation. Double taxation occurs when two or more states tax the same taxpayer on the same income or gains. Many states tax residents on their worldwide income, including income sourced in a foreign state. States also tax non-residents on income sourced in that state. This can result in the same income being taxable under the tax laws of both states, based on residence and source respectively.

51. A DTA may eliminate double taxation by allocating the right to tax in one of three ways. It could give New Zealand an exclusive right to tax the income, so that the source state must give up the right to tax that income. It could give the

source state the exclusive right to tax the income, so that New Zealand must give up the right to tax that income. Thirdly, it could give the source state an unlimited or limited right to tax while preserving New Zealand's right to tax. In the third scenario, New Zealand will provide a foreign tax credit up to any limit imposed on the source state. (The allocation articles are discussed in greater detail below from [139].)

52. Where double taxation arises, and it is not relieved by the application of an allocation article, a DTA will identify a method for relieving that double taxation. In New Zealand's DTAs, this is usually by way of a foreign tax credit.

53. Many of New Zealand's DTAs have one or more protocols that must be read alongside the DTA. A protocol is a treaty that clarifies, implements or modifies the provisions of the DTA. When reading a DTA, it is important to check for any protocols, as they may change the meaning of the DTA.

54. Most of New Zealand's DTAs follow a similar format, based on the OECD Model Tax Convention on Income and Capital[2] (the Model Convention). The Model Convention is accompanied by the OECD Model Tax Convention Commentary (the Model Commentary), which provides commentary on the articles of the Model Convention[3].

55. It is important to remember, however, that each DTA is negotiated separately and consequently no two DTAs are exactly the same. Care needs to be taken when applying a DTA to ensure that the actual words of the relevant article have been considered.

Does New Zealand have a DTA with the source state? Has that DTA entered into force and taken effect? Has the DTA been replaced or terminated?

56. Inland Revenue's website has a list of states that New Zealand has entered into DTAs with: www.ird.govt.nz/international/residency/dta/. Inland Revenue's Tax Policy website has more detailed DTA information, including the text of the DTAs and the related protocols: www.taxpolicy.ird.govt.nz/tax-treaties. This site also includes information such as:

- when the DTA was signed;
- the status of the DTA (ie, whether in force or not); and
- when the DTA became effective.

57. The site also lists DTAs that have been signed but are not yet in force, and includes a list of states that New Zealand is currently negotiating DTAs or protocols with.

58. All of New Zealand's DTAs contain an article that explains when the DTA will enter into force and when it has effect from (see art 30 of the Model Convention). A DTA typically enters into force once it has been incorporated into the domestic law of both states and each state has notified the other that this process has been completed.

59. Once a DTA has been signed, it needs to be incorporated into New Zealand law. This is done by an Order in Council. The Order in Council incorporates the text of the DTA and any protocols to the DTA into New Zealand's domestic law. For example, the New Zealand/United Kingdom DTA is part of New Zealand's domestic law by Order in Council: Double Taxation Relief (United Kingdom) Order 1984.

60. The DTA will also explain when it takes effect from. Once entered into force, a DTA usually takes effect from the next income year. For example, the New Zealand/United Kingdom DTA notes at art 27(1)(b) that the DTA shall have effect "in New Zealand: for any income year beginning on or after 1 April in the calendar year next following the date on which the Convention enters into force." Some DTAs may come into effect at different times for different taxes. It is therefore important to ensure not just that the DTA is in force, but that it has also taken effect.

61. Finally, taxpayers need to ensure that the DTA has not been replaced or terminated.

62. If there is no DTA between New Zealand and the source state, a taxpayer may still be eligible for foreign tax credit relief under subpart LJ, provided the foreign tax paid is of substantially the same nature as income tax imposed under s BB 1 (s YA 2(5)). IS 14/02 contains further guidance.

How to interpret a DTA

The Vienna Convention

63. A DTA is both an international treaty and part of New Zealand's domestic law. This unique dual nature means that it is interpreted differently from domestic legislation.

[2] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (OECD Publishing, Paris, 2014).
[3] The relevance of the Model Convention and the Model Commentary for interpreting DTAs is considered at [70].

64. Because it is an international treaty, a DTA is subject to the Vienna Convention on the Law of Treaties 1969[4], to which New Zealand is a signatory. Articles 31 and 32 of the Vienna Convention describe how a treaty shall be interpreted. Article 31(1) sets out the general rule of interpretation. It requires a holistic and integrated approach[5] that considers the ordinary meaning of the text in its context and in light of the object and purpose of the treaty. The ordinary meaning of the terms of the treaty is necessarily the starting point, but it is also mandatory to consider the context, object and purpose of the treaty[6]. It is from the combined effect of these elements that the legally relevant interpretation must be taken.

65. Article 31(2) and (3) describe the context that can be taken into account for the purposes of the general rule.

66. Despite the interpretation reached under the general rule, art 31(4) provides that a special meaning can be given to a term if it is established that the parties to the treaty so intended.

67. Article 32 relates to supplementary means of interpretation. Recourse to supplementary means of interpretation is restricted. It can only be had to confirm the meaning reached under art 31 or to determine the meaning when the interpretation under art 31 is ambiguous, manifestly absurd or unreasonable.

68. The courts have interpreted New Zealand's DTAs in a manner consistent with these international obligations, adopting a broad and purposive approach. McCarthy P, in *CIR v United Dominions Trust Ltd* [1973] 2 NZLR 555 (CA) at 558, held that when interpreting a DTA the starting point is "not to adopt a narrow interpretation but to interpret having regard to the broad intentions of the framers as they emerge from the text."

69. The Commissioner considers that a DTA must be interpreted in a holistic and integrated manner. A DTA must not be interpreted solely by reference to the ordinary meaning of the words used or, at the other extreme, solely by reference to the purpose of the DTA. What is required is that the terms are given their ordinary meaning taking into account their context and the object and purpose of the DTA.

Relevance of the Model Commentary

70. In *CIR v JFP Energy Inc* (1990) 12 NZTC 7,176 (CA), Richardson J stated that appropriate regard should be given to the Model Commentary. While the Model Commentary is not binding, the Commissioner considers it extremely influential and an important tool for interpreting DTAs.

71. The Commissioner considers the Model Commentary can form part of the legal context of a DTA under art 31(1) of the Vienna Convention, provided the DTA article is the same or similar to the Model Convention and the Model Commentary was in existence at the time the DTA was signed. The Model Commentary may still be relevant if it was written after the DTA was signed, provided the changes to the Model Commentary are for clarification only. Similarly, the Model Convention can be a relevant supplementary means of interpretation under art 32 of the Vienna Convention.[7]

Article 3 – definitions

Defined terms

72. When interpreting a DTA, it is important to consider the general definitions article (typically art 3). Article 3(1) lists definitions that apply for the purposes of the DTA, unless the context requires otherwise. The list of defined terms will vary between DTAs. The list is not exhaustive and definitions can also be found elsewhere in a DTA. For example, art 4 (the Resident article) defines "resident of a Contracting State".

Undefined terms

73. If a DTA does not define a term, that term is to be defined under the domestic law of that state, unless the context requires otherwise. Article 3(2) of the Model Convention provides:

> 2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

[4] Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, ratified by New Zealand on 4 August 1971) entered into force on 27 January 1980.

[5] See *CT v Lamesa Holdings BV* 97 ATC 4752 (FCA), *McDermott Industries Pty Ltd v FCT* 2005 ATC 4398 (FCAFC) and *R v Crown Forest Industries Ltd* 95 DTC 5389 (SCC).

[6] See *TD Securities (USA) LLC v R* 2010 TCC 186, 2010 DTC 1137 (Tax Court of Canada), *Crown Forest*, *Coblentz v R* (1996) 96 DTC 6,531 (Fed CA), *Weiser v HMRC* [2012] UKFTT 501 (TC), *Bayfine UK v Revenue and Customs Commissioners* [2011] EWCA Civ 304, [2011] STC 717, *CIR v JFP Energy Inc* (1990) 12 NZTC 7,176 (CA).

[7] See *Thiel v FCT* 90 ATC 4717 (HCA) and *Crown Forest*.

74. Article 3(2) confirms that the domestic law meaning to be used is the meaning at the time the DTA is applied, not the meaning that existed at the time the DTA was signed. The Model Commentary also explains that when trying to find a domestic law definition, a tax law definition will take precedence over a non-tax law definition. Furthermore, a tax law definition from a law that imposes the relevant DTA tax will take precedence over any other definitions, including other tax law definitions.[8]

75. Article 3(2) applies "unless the context requires otherwise". The Model Commentary explains how "context" should be determined[9]:

> 12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

76. The context might otherwise require an interpretation that is different from the domestic law meaning where, for example, the application of a domestic law meaning would render part of the treaty inoperable or if the domestic law would give the taxpayer unjustified treaty benefits or would lead to double taxation or non-taxation.[10]

Apply the DTA - Is the tax paid in the source state a tax covered by the DTA?

Introduction

77. If a DTA is in force and has taken effect between New Zealand and the source state, the next step is to work out whether the tax paid in the source state is a tax covered by the DTA. The "Taxes covered" article of a DTA is typically art 2.

78. Depending on how the DTA has been drafted, a tax is covered by a DTA if it is:

- expressly listed in art 2 as one of the taxes covered; or
- a tax on income or capital as defined in art 2(1) and (2) of the DTA; or
- a subsequently enacted tax that is "identical or substantially similar" to one of the taxes expressly covered (art 2(4)).

79. If a tax is covered by a DTA, the DTA will determine whether a foreign tax credit is available (the amount of the credit will be calculated under subpart LJ). However, if a tax is not covered by a DTA, relief may still be available under the domestic law foreign tax credit provisions.

Taxes covered under art 2(1), (2) and (3)

80. In most cases, it will be easy to determine whether a tax is covered by a DTA because art 2 of the DTA will expressly list those taxes covered. For example, art 2(1) of the New Zealand/Australia DTA[11] expressly lists the taxes covered by the DTA:

> 1. The taxes to which this Convention shall apply are:
>
> a) in the case of Australia:
>
> (i) the income tax, including the resource rent tax in respect of offshore projects relating to exploration for or exploitation of petroleum resources; and
>
> (ii) the fringe benefits tax
>
> imposed under the federal law of Australia (hereinafter referred to as "Australian tax");
>
> b) in the case of New Zealand: the income tax, including the fringe benefit tax (hereinafter referred to as "New Zealand tax").

81. Most of New Zealand's DTAs adopt this prescriptive approach to defining the taxes covered by the DTA. However, some DTAs follow the Model Convention structure. Article 2(1)-(3) of the Model Convention state:

> 1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
>
> 2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
>
> 3. The existing taxes to which the Convention shall apply are in particular:
>
> a) (in State A):..........
>
> b) (in State B):..........

[8] Model Commentary, [13.1] at 84.
[9] Model Commentary, [12] at 83.
[10] E Reimer and A Rust (eds), *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015) at 213.
[11] Double Taxation Relief (Australia) Order 2010.

82. Under the Model Convention structure, the list of taxes in art 2(3) is not considered to be an exhaustive list. Instead, the taxes listed in art 2(3) are illustrative of the types of taxes on income and capital described in arts 2(1) and 2(2). In these circumstances, a tax may be covered by a DTA even if it is not specifically listed in art 2(3), provided it is a tax on income or capital as defined by arts 2(1) and 2(2). This was the outcome in the Irish case *Kinsella v The Revenue Commissioners* [2007] IEHC 250. The Irish High Court held that Irish capital gains tax (introduced after the DTA had been entered into) was covered by art 2(2) of the Ireland/Italy DTA. Article 2(2) of the Ireland/Italy DTA did not follow the Model Convention article exactly. It applied the DTA to "all taxes imposed on total income or on elements of income, including taxes on gains from the alienation of moveable or immovable property."

83. The "Taxes covered" article can be drafted in a number of different ways, so it is important to check the exact wording used. For example, art 2(1) of the Model Convention states that the DTA "shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities…". However, art 2(1) of the New Zealand/United States DTA[12] omits the reference to political subdivisions or local authorities. This is because the United States has reserved its position on this part of art 2(1) of the Model Convention[13].

"Identical or substantially similar" taxes under art 2(4)

Introduction

84. A tax is also covered by a DTA if it is imposed after the DTA is signed and it is identical or substantially similar to one of the taxes covered. It may be imposed in addition to, or in place of, the existing taxes. Article 2(4) of the Model Convention provides:

> 4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

85. The Model Convention and the Model Commentary do not provide any guidance on how to apply the test of "substantially similar". The Commissioner's view on how to apply this test is therefore set out below.

Ordinary meaning

86. Article 3 of the Model Convention lists general definitions for the purpose of the DTA. Article 3 does not define "substantially similar". Article 3(2) notes that where a term is not defined in the DTA, it should be given the meaning it has at that time under the domestic law of that state, unless the context otherwise requires (see from [73] to [76] above).

87. As "substantially similar" is not defined under New Zealand domestic law, the ordinary meaning of the term should be considered. *The Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) defines "substantially" to mean:

> ▸adv. **1** to a great or significant extent. **2** for the most part; essentially.

88. "Similar" is defined as:

> ▸adj. **1** of the same kind in appearance, character, or quantity, without being identical: *a soft cheese similar to brie.*

89. Combining these definitions, the ordinary meaning of "substantially similar" suggests that the relevant tax need not be identical, as long as it is, for the most part, the same kind of tax as a tax covered by art 2 of the relevant DTA.

90. The definition of the phrase "substantially the same" was considered by the Employment Court in *National Distribution Union Inc v General Distributors Ltd* [2007] ERNZ 120 (EmpC). While the context was different, the court noted that "substantially the same" must mean more than "substantially similar". It was a higher and more precise standard. This suggests that "substantially similar" is a lesser standard than "substantially the same".

Case law on meaning of "substantially similar"

91. The meaning of "substantially similar" in a DTA context has not been considered by the courts in New Zealand. However, it has been considered in other jurisdictions. The main cases are discussed below.

92. The issue before the Federal Court of Australia in *Virgin Holdings SA v FC of T* [2008] FCA 1503, 2008 ATC 20-051 was whether the Australian Government could tax a capital gain made by a Swiss resident company (Virgin) on the sale of shares in Australia.

[12] Double Taxation Relief (United States of America) Order 1983.

[13] "Reservations" are recorded in the Model Commentary by article and indicate that a state disagrees with the text (or part of the text) of an article. "Observations" are also recorded in the Model Commentary and indicate where a state disagrees with an aspect of the Model Commentary (but not the article itself). See [31] and [32], Introduction, OECD Model Commentary, at 15.

93. Under the Australia/Switzerland DTA (entered into in 1980, before Australia had a capital gains tax), Australia was prevented from taxing Virgin's business profits. The Australian Government argued that the DTA did not apply to Australian capital gains tax, meaning Australia could tax the capital gains made by Virgin on the share sale.

94. In addition to the argument that the "Australian income tax" incorporated capital gains tax (discussed below at [116]), the taxpayer argued, in the alternative, that the capital gains tax was "substantially similar" to Australian income tax.

95. Edmonds J held that the term "Australian income tax" extended to the capital gains from the sale of shares. He noted that if he was wrong on this point, the capital gains tax would still be "substantially similar" to Australian income tax. He noted at [55] – [56]:

> 55. Where a tax on capital gains is effected, as it has been in this country, by the inclusion of the capital gains, or some figure computed therefrom, in the tax base upon which income tax is imposed on an annual basis, I have great difficulty in comprehending why the tax on the capital gain is not substantially similar, if not identical, to the income tax on the tax base not including the capital gain or the figure computed therefrom. In saying this, I am mindful that one should not be blinded by the mechanisms used to impose the tax in characterising the nature of the tax for a specific purpose: see *South Australia v Commonwealth* 174 CLR at 261 per Dawson J extracted in [46] above. But that does not mean that in deciding whether a tax is substantially similar to another tax the mechanisms of imposition are irrelevant.
>
> 56. Second, if the tax with respect to which the tax on capital gains is being compared for similarity, also taxes capital gains, albeit depending on circumstances (s 25A) and time (s 26AAA) of acquisition, the more readily will a conclusion of substantial similarity be reached. This harks back to Dixon J's observation in *Resch* 66 CLR that the distinction between profits of a capital nature and profits in the nature of income in the strict sense is not one which the 1930 Act maintained; nor, according to the majority joint judgment in *South Australia* v *Commonwealth* 174 CLR, does the ITAA 36.

96. In deciding that Australian capital gains tax is "substantially similar" to Australian income tax, Edmonds J considered it was significant that the income tax taxed the same tax base as the capital gains tax.

97. Edmonds J also observed that, prior to the introduction of the Australian capital gains tax, the Australian income tax taxed capital gains in certain situations. He noted that a finding of "substantially similar" is more likely to be reached where the new tax and the tax covered by the DTA both tax capital gains. He also considered that the mechanism used to impose the tax is relevant.

98. The same issue came before the Irish High Court in *Kinsella*. In this case, the taxpayer sold shares in an Irish company to a third party while tax resident in Italy. The taxpayer argued that, under the Ireland/Italy DTA, she was tax resident in Italy and the sale of shares was subject to Italian tax only. The Revenue Commissioners argued that the DTA did not apply to Irish capital gains tax (the DTA pre-dated the introduction of Irish capital gains tax), so the sale of shares was subject to Irish capital gains tax.

99. Kelly J held that the DTA did apply to Irish capital gains tax as it was a covered tax under art 2(2). However, he acknowledged that if he was wrong in that, the capital gains tax would fall within art 2(4) as a "substantially similar tax":

> As I have already pointed out CGT is a tax on gains or profits rather than a tax on capital wealth. Although introduced in 1975 it is now dealt with by the 1997 Act. That Act contains all of the provisions related to other direct taxes such as corporation tax and income tax. The rules for computing CGT are included in that legislation. True it is that the capital gains are taxed in a different way from other forms of income but the tax legislation regards the two as being very closely related. Section 4 of the Income Tax Act, 1967 which is now contained in S. 12 of the 1997 Act provides that income tax is to be charged in respect of all property, profits or gains respectively described in the schedules contained in the sections which are enumerated. Thus, although it is calculated in a different way from income tax, CGT is substantially similar.

100. Kelly J also specifically endorsed Vogel's approach to this exercise (discussed in more detail below at [107]):

> My view appears to be in keeping with that of Klaus Vogel in his book on Double Taxation Conventions (3rd edition 1998). He opines that new capital gains taxes will normally be considered as substantially similar to income tax. He says:
>
> > "What is necessary is a comprehensive comparison of the tax laws' constituent elements. In such a comparison, the new tax under review, rather than being compared merely with a solitary older one (to which it will always be similar in some respects and different in others), should be considered with reference to all types of taxes historically developed within the State in question – and of States with related legal systems – in order to determine which of such traditional taxes comes closest to the new tax law….Whether a tax is "substantially similar" to another can, consequently, not be decided otherwise than against the background of the entire tax system…"
>
> Later he says:
>
> > "Taxation of capital gains is normally dealt with in income tax laws, though in some instances separate legislation is devoted to that subject (see the National Reports of LX1BCDF 1129FF [1976]. Consequently, any new capital gains tax will, for Treaty purposes normally have to be considered as being at least similar to income taxes; the Danish Landskattereten (Danish Tax Court) 26 ET114 [1986]: DTC Denmark/France, differs, however."

> I have briefly carried out the exercise which he suggests, namely to consider all types of taxes historically developed within the State and I have reached a conclusion similar to his namely, that for the purposes of this Convention, CGT falls within the wording of Article 2.4.

101. In *Case 8/2014* [2014] AATA 961, 2014 ATC 1-070, the Australian Administrative Appeals Tribunal (AAT) considered whether Irish pay-related social insurance (PRSI) was identical or substantially similar to the Irish income tax for the purposes of art 2 of the Australia/Ireland DTA.

102. The taxpayer was an Australian tax resident who had been employed in Ireland. Income tax and PRSI had been deducted from his salary. PRSI is a compulsory contribution to the Social Insurance Fund used to pay social welfare benefits and pensions. The taxpayer argued that because he would not be entitled to receive any of the PRSI benefits, PRSI was substantially similar to Irish income tax and therefore he should be entitled to a foreign income tax offset (the Australian tax credit equivalent).

103. The AAT held that the PRSI was not an identical or substantially similar tax. The AAT referred to the Model Commentary and Vogel and concluded that social security charges, such as the PRSI, where there is a direct connection between the levy and the individual benefits, are not intended to fall within the ambit of taxes covered by a DTA. It was not relevant that the taxpayer did not actually receive any benefits. The AAT held that the characterisation of the PRSI could not be different for the taxpayer because of his particular circumstances.

104. In comparing the PRSI with the existing taxes covered by the DTA, how the PRSI was reflected in tax legislation was relevant. The PRSI was not imposed by the main income tax assessment legislation in Ireland and was not referred to as a "tax" in the Social Welfare Development Act 2005 (Ireland). It was calculated on a different basis from income tax and arose because of a contributor's employment status. It was not paid into the general revenue, but into the Social Insurance Fund.

105. The AAT also endorsed the decisions in *Virgin* and *Kinsella* by confirming that the mechanisms of imposition used are relevant but not determinative, as are the methods of calculation.

International tax commentary

106. As "substantially similar" is a term used in an international treaty, it is useful to look to international tax law experts for guidance.

107. In the recently published 4th edition of *Klaus Vogel on Double Taxation Conventions*, the text identifies "two potential and equally valid approaches" to undertaking this comparison – the "micro-approach" and "macro-approach"[14]. Under a micro-approach, a new tax is compared to a single tax or even a component of that tax. The approach requires a comprehensive comparison of the respective taxes' constituent elements. Under a macro-approach, the new tax is compared to a combination of several taxes. This approach requires an overall assessment of the place of the new tax in the tax system as a whole. The Commissioner considers that the two approaches reflect aspects of the earlier approach outlined in the 3rd edition[15] of Vogel set out at [100].

Test of "substantially similar"

108. Under art 2(4), a tax is covered by a DTA if it is imposed after the DTA is signed and it is identical or substantially similar to the taxes covered by the DTA. The case law and commentary have identified a number of factors that should be considered when determining whether a tax is substantially similar to a tax specifically covered by a DTA. Based on these factors, the Commissioner has formulated the following test.

109. When approaching this exercise, the Commissioner considers that the starting point should be to compare the new tax with a single covered tax (or component of that tax). If the taxes are "substantially similar", taking into account the essential elements of that tax, the tax will be covered under art 2(4). If the tax is not "substantially similar" under this approach, the macro-approach should also be considered. The new tax is then compared to a combination of covered taxes. Under this approach, the question of whether a tax is substantially similar has to be considered against the background of the entire tax system.

110. The Commissioner considers that, when undertaking the comparison, it may be useful to consider the following:
    - The formal arrangement of the tax should first be considered (Vogel).
    - The essential elements of the taxes should be comprehensively compared (Vogel).

[14] E Reimer and A Rust (eds), *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015) at 167.
[15] Klaus Vogel, *Klaus Vogel on Double Taxation Conventions*, (3rd ed, Kluwer Law International, The Netherlands, 1997).

- The new tax should be compared with all types of taxes historically developed within the overseas jurisdiction and jurisdictions with related legal systems to determine which traditional taxes come closest to the new law (Vogel).
- If the new tax taxes the same tax base as the DTA tax, it is likely to be "substantially similar" (*Virgin*).
- If the new tax taxes the same items of income/gains as the DTA tax (albeit in different circumstances – ie, a capital gains tax compared to an income tax that also taxes some capital gains), the new tax is likely to be "substantially similar" (*Virgin*).
- Even if the new tax is calculated in a different way from the DTA tax, it may still be "substantially similar" (*Kinsella*).
- How the tax is imposed is relevant, but not determinative (*Virgin*).
- How the tax is reflected in the legislation is relevant. For example, does the legislation regard the two taxes as being closely related? (*Kinsella*).
- The name of the tax, the rate and who it is imposed on is of little significance (Vogel).
- Taxes or charges paid where a direct connection exists between the levy and the individual benefits to be received are not intended to be covered by a DTA (*Case 8/2014*, Vogel, Model Convention).

Capital gains taxes

111. While the previous section discussed the creditability of capital gains taxes in the context of art 2(4) of the Model Convention, this section discusses the creditability of capital gains taxes more broadly. A capital gains tax may be covered by a DTA in one of three ways:
    - It may be one of the taxes covered by the DTA (either a specifically listed tax, or a tax that satisfies the definitions in art 2(1) and (2)).
    - It may be integrated into a specifically covered tax (for example, the inclusion of capital gains in the Australian Income Tax Assessment Act 1997).
    - It may be enacted subsequent to the signing of the DTA and be considered an identical or substantially similar tax to one of the taxes specifically covered by a DTA.

Capital gains taxes covered by DTA

112. In some cases, a DTA may specifically cover taxes on capital gains. For example, art 2(1) of the New Zealand/United Kingdom DTA[16] states that the DTA covers the United Kingdom capital gains tax:

> 1) The taxes which are the subject of this Convention are:
>
> (a) in the United Kingdom:
>
> (i) the income tax;
>
> (ii) the corporation tax;
>
> (iii) the capital gains tax; and
>
> (iv) the petroleum revenue tax;
>
> (hereinafter referred to as "United Kingdom tax");
>
> (b) in New Zealand:
>
> (i) the income tax; and
>
> (ii) the excess retention tax;
>
> (hereinafter referred to as "New Zealand tax").

113. A capital gains tax may also be included under art 2(1) or (2). In *Kinsella*, the Irish High Court held that Irish capital gains tax fell within the terms of art 2(2) of the Ireland/Italy DTA.

114. In the Commissioner's view, if a capital gains tax is specifically covered by a DTA, then, depending on how the taxing right is allocated, New Zealand will give a foreign tax credit for capital gains tax paid, provided the same income is also taxable in New Zealand. This might be the case, for example, where a gain on a foreign property disposal is subject to capital gains tax in the foreign jurisdiction and is also treated as taxable income in New Zealand under s CB 6.

[16] Double Taxation Relief (United Kingdom) Order 1984.

Capital gains taxes integrated into an income tax

115. The position is the same for capital gains taxes that are integrated into an income tax. For example, art 2(1)(a)(i) of the New Zealand/Australia DTA lists Australian income tax as a tax covered by the DTA. Australian capital gains tax is not a separate tax, but a component of Australian income tax. Because the DTA covers Australian income tax, New Zealand would (if required) allow a credit for Australian income tax imposed on capital gains, provided those same gains are also taxable in New Zealand.

116. The Commissioner's view is consistent with the conclusion reached by the Federal Court of Australia in *Virgin Holdings SA* and *Undershaft No 1 Ltd v FC of T; Undershaft No 2 BV v FC of T* 2009 ATC 20-091. In *Virgin*, Edmonds J considered the structure of the Australian Income Tax Assessment Act 1997 and did not accept that there was a separate Australian capital gains tax. He held that capital gains fell into, and formed part of, income subject to income tax under the Act.

117. It is therefore important to determine whether a tax (although not specifically listed as a covered tax) is included within the ambit of a specifically listed DTA tax.

Capital gains taxes as "substantially similar" taxes

118. Vogel also argues that if a country introduces a capital gains tax, it would most likely come within the DTA's scope as a result of art 2(4). Consequently, any new capital gains tax would normally have to be considered as being at least similar to income tax[17]:

> Taxation of capital gains is normally dealt with in income tax laws, though in some instances separate legislation is devoted to that subject (see National Reports of LX1BCDF 1129FF [1976]. Consequently, any new capital gains tax will, for Treaty purposes normally have to be considered as being at least similar to income taxes; the Danish Landskattereten (Danish Tax Court) 26 ET114 [1986]: DTC Denmark/France, differs, however.

119. While any such comparison will depend on the actual taxes covered by a DTA, if an income tax (as traditionally understood) is covered by a DTA, the Commissioner considers that any subsequently enacted capital gains tax that taxes realised capital gains, rather than increases in wealth, would likely be considered "substantially similar" to that income tax.

Does a DTA tax also need to satisfy the domestic law test in s YA 2(5)?

120. A tax covered by a DTA does not also need to satisfy the s YA 2(5) test by being "of substantially the same nature as income tax imposed under s BB 1". The s YA 2(5) test applies only to foreign taxes that are not covered by a DTA.

Does the test of "substantially similar" (art 2(4)) need to be interpreted consistently with the s YA 2(5) test of "substantially the same nature"?

121. As mentioned above, a tax that is covered by a DTA does not need to satisfy the s YA 2(5) test. However, it is worth noting that the two tests - "a tax of substantially the same nature" and "substantially similar" - are different tests. The s YA 2(5) test compares the foreign tax paid with New Zealand income tax to determine whether the foreign tax is "of substantially the same nature" as New Zealand income tax. The art 2(4) test compares the foreign tax paid to the taxes covered under the DTA to determine whether the foreign tax is "substantially similar" to the DTA taxes. The tests are different and the Commissioner's view is that there is no reason why the tests should be interpreted consistently.

Apply the DTA - are you resident in New Zealand for the purposes of the DTA?

Introduction

122. The "Persons covered" article of a DTA (typically art 1) explains that the DTA applies to persons who are "residents of one or both of the Contracting States". Article 4(1) of the Model Convention defines "resident of a Contracting State":

> 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

123. This means that, for a DTA to apply, a person needs to be a resident of a contracting state under the domestic laws of that state. As the flowchart has already determined domestic law residence (under preliminary requirements), this condition will have been satisfied.

[17] Klaus Vogel, *Klaus Vogel on Double Taxation Conventions*, (3rd ed, Kluwer Law International, The Netherlands, 1997) at 157.

INTERPRETATION STATEMENTS

124. However, an issue may arise if a person is a tax resident under the domestic laws of both New Zealand and the source state. This is known as dual residence. Dual residence issues are resolved by the DTA, typically under art 4. Article 4 contains a series of tie-breaker tests that are applied to allocate resident status to one of the two states for the purposes of the DTA. The tie-breaker tests for individuals and non-individuals (ie, companies) are summarised below. Taxpayers should refer to IS 16/03 for more information.

Dual resident tie-breaker tests

125. Article 4 of the Model Convention sets out the tie-breaker test for individuals and for persons other than individuals (ie, companies).

Tie-breaker tests - Individuals

126. Article 4(2) contains the tie-breaker tests for individuals. The tie-breaker tests are applied in order until residence can be determined under one of them. The main tie-breaker tests are outlined below. It is important to note that the tie-breaker tests may vary between DTAs. The order in which the tie-breaker tests apply may also vary. Taxpayers must ensure that they apply the correct tie-breaker tests in the order that they appear in the relevant DTA.

Permanent home test

127. The first test gives preference to the state in which the person "has a permanent home available to [them]". There are three elements to the test: there must be a home, it must be permanent, and it must be available for use (art 4(2)(a)).

128. If a person has a permanent home available in one state, they will be resident in that state, unless the person can establish that they also have a permanent home available in the other state.

129. Where a person has a permanent home available in both states, the next test will generally be the personal and economic relations test. Where a person does not have a permanent home available to them in either state, the next test for consideration will usually be the habitual abode test.

Personal and economic relations (centre of vital interests) test

130. The next test gives preference to the state "with which [the person's] personal and economic relations are closer (centre of vital interests)".

131. If a person's economic and personal relations are evenly balanced between New Zealand and another state (even if personal relations are stronger with one state and economic relations with the other), the person will have no centre of vital interests, as the factors are regarded as being of equal weight. In this situation, the habitual abode test will need to be considered.

Habitual abode test

132. A person will have a habitual abode in a state if they live there habitually or normally. A person may habitually live in more than one state; the enquiry is not about assessing the state in which the person's abode is more habitual, but about whether they have a habitual abode in New Zealand and/or the other state.

Nationality and mutual agreement

133. When a person has a habitual abode in both states or in neither of them, residence is generally determined on the basis of nationality or citizenship. In cases where nationality is the test, the concept of nationality (for individuals) is generally defined as a person who is a New Zealand citizen. A New Zealand citizen is someone who has citizenship here under the Citizenship Act 1977.

134. If residence cannot be resolved under the tie-breaker tests, it will need to be resolved by mutual agreement between the competent authorities of the two states.

Tie-breaker test - Companies

135. Article 4(3) of the Model Convention contains the residence tie-breaker test for dual-resident non-individuals. It allocates residence, for DTA purposes, to the state in which the person's "place of effective management" is situated.

136. However, New Zealand's DTAs contain a number of different rules for allocating company residence for DTA purposes. Under these rules, residence may be allocated according to the company's "place of effective management", its "day-to-day management", the "centre of its administrative or practical management" or the location of its "head office".

Conclusion

137. If a New Zealand resident is deemed to be a non-resident under the tie-breaker rules in the DTA (for the purposes of the DTA), there will be no basis for the DTA to allocate taxing rights to New Zealand (as the income is not sourced in New Zealand[18]). It follows that there will be no foreign tax credit available, as the person will not have a New Zealand tax liability for that segment of foreign-sourced income against which a foreign tax credit can be claimed.

138. A New Zealand tax resident who is deemed to be a non-resident under the DTA will only have that status for the purposes of the DTA. They will remain a New Zealand tax resident under the Act and for other tax purposes, for example, in relation to any New Zealand-sourced income.

Apply the DTA - allocation articles – how does the relevant DTA article allocate the taxing rights for your income or gain?

Introduction

139. Once residence status (for the purposes of the DTA) has been established, the next step is to determine which allocation article applies to the foreign-sourced income. The application of the relevant allocation article will decide which state or states have the right to tax that foreign-sourced income.

Which allocation article applies?

140. It is important to correctly identify which allocation article applies to the foreign-sourced income. Articles 6 to 21 of the Model Convention contain the allocation articles for income. Article 22 is the allocation article for capital.

141. Income not covered under any of the specific allocation articles is usually dealt with under art 21 (Other income) of the Model Convention. Article 21 also covers income that would normally be covered by another allocation article, but that article does not apply because the conditions for application are not met (for example, the income arises in a third state).

142. A DTA also contains specific priority rules that apply where the income satisfies more than one allocation article. For example, art 7 (Business profits) only applies to the extent that the business profits are not subject to any other allocation article (see art 7(4)). So, if a person's business profits include interest income, that interest income must be dealt with under art 11 (Interest) not art 7.

How does the allocation article allocate the right to tax?

143. Once the correct allocation article has been identified, it can be applied to the foreign-sourced income. There are three potential outcomes:

- New Zealand has the exclusive right to tax.
- The source state has either an unlimited or a limited right to tax.
- New Zealand has no right to tax.

These outcomes are discussed below.

New Zealand has the exclusive right to tax

144. Some allocation articles will prevent the source state from taxing the foreign-sourced income, giving New Zealand (as the state of residence) exclusive taxing rights. For example, art 19 of the New Zealand/United Kingdom DTA gives New Zealand (as the state of residence) the exclusive right to tax pension income:

> **Article 19 Pension and annuities**
>
> (1) Pensions (including pensions paid under the social security legislation of a Contracting State), and similar remuneration in consideration of past employment or services, paid to a resident of a Contracting State, and any annuity paid to a resident of a Contracting State, **shall be taxable only in that State**.
>
> [Emphasis added]

145. The phrase "shall be taxable only in that State" allocates an exclusive taxing right to the state of residence. This can be compared with the phrase "may be taxed", which allocates a shared right to tax (see [147] below).

146. If this type of allocation article applies, New Zealand (as the state of residence) will have the exclusive right to tax the foreign-sourced income and the source state will agree not to tax that income. Because of this exclusive right to tax,

[18] See from para [32] above, and subpart LJ, which requires the income to be sourced from outside New Zealand.

New Zealand does not have to provide a foreign tax credit for any foreign tax that may be incorrectly paid or withheld in the source state.[19]

Source state has an unlimited or limited right to tax

Unlimited right to tax in source state

147. Under this type of allocation article, both states have a shared right to tax the foreign-sourced income. The source state's taxing rights are not limited in any way. New Zealand's taxing rights (as the state of residence) are also unaffected, but under art 23 it will have to provide a foreign tax credit for the tax imposed by the source state (subject to the calculation provisions in subpart LJ – see from [165] below). An example of this type of allocation article is art 6 (Income from immovable property) of the New Zealand/Spain DTA[20]. Use of the words "may be taxed" in art 6(1) means that the taxing rights are shared:

Article 6 Income from immovable property

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

Limited right to tax in source state

148. Under this type of allocation article, both states have a shared right to tax the foreign-sourced income, but the source state's taxing right is limited. This type of allocation article is often applied to dividend income, interest income and royalty income. New Zealand's taxing rights (as the state of residence) are unaffected, but it will have to provide a foreign tax credit under art 23 for the tax imposed by the source state (subject to subpart LJ). Article 12 of the New Zealand/Australia DTA contains an example of this type of allocation rule:

Article 12 Royalties

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but the tax so charged shall not exceed 5 per cent of the gross amount of the royalties.

…

149. Use of the words "may be taxed" in art 12(1) mean that the taxing rights are shared. However, art 12(2) limits Australia's taxing rights (as the source state) to no more than 5% of the gross amount of the royalties. New Zealand also has the right to tax the royalty income. However, it will be required to provide relief by way of a foreign tax credit under art 23 for the amount of tax imposed by Australia (subject to subpart LJ).

150. New Zealand will not provide a foreign tax credit for any amounts incorrectly imposed by a foreign state. The taxpayer will only receive a foreign tax credit for the amount of foreign tax that was entitled to be paid or withheld under the DTA, which in this case is 5%.[21]

[19] For example, see QB 14/12: "Income tax – foreign tax credits for amounts withheld from United Kingdom pensions" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.

[20] Double Taxation Relief (Spain) Order 2006.

[21] See QB 14/12: "Income tax – foreign tax credits for amounts withheld from United Kingdom pensions" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.

Example illustrating a limited right to tax

Example 2 – limited right to tax

Scenario 1

In the 2015 income year, Toby derived NZD$100 of royalty income from Australia. Toby is a foreign resident under Australian tax law and resident in New Zealand for the purposes of the Act and the New Zealand/Australia DTA.

As Toby is defined as a "foreign resident" under Australian tax law, the royalty income is subject to withholding tax of 30%, or NZD$30. New Zealand is also entitled to tax that income at Toby's marginal tax rate of 30% as he is resident here. If there was no DTA between New Zealand and Australia, Toby would have to try and obtain a foreign tax credit under the domestic law foreign tax credit provisions for the tax withheld in Australia.

However, New Zealand and Australia have entered into a DTA. Under art 12(2) of the New Zealand/Australia DTA, Australia's right to tax royalty income is limited to 5% of the gross amount of the royalty, or NZD$5, which is what the Australian payer of the royalty withholds. New Zealand is also entitled to tax the royalty income, but under art 23 of the DTA it will need to provide a foreign tax credit for the Australian tax that has been withheld. In this scenario, the total notional New Zealand income tax liability for that segment of foreign-sourced income is NZD$30 (as calculated under s LJ 5(2)) and a credit of NZD$5 would be allowed to reduce that liability by reference to the Australian tax paid, giving an end result of NZD$25 for that royalty income.

Scenario 2

The facts are the same as in scenario 1, however in this scenario the Australian payer of the royalties is unaware of the New Zealand/Australia DTA. The Australian payer withholds NZD$30, rather than the NZD$5 permitted under the DTA. Toby tries to claim a foreign tax credit in New Zealand for the NZD$30 incorrectly withheld by the Australian payer.

New Zealand will not provide Toby with a foreign tax credit for the NZD$30 incorrectly withheld by the Australian payer. Under the DTA, the Australian payer should only have withheld NZD$5. New Zealand will therefore only give a credit for this amount. In this scenario, Toby has paid the $30 incorrectly withheld plus NZD$30 of New Zealand income tax, less the NZD$5 credit permitted under the DTA. Toby must go back to the Australian payer or the Australian Tax Office and seek a refund of the incorrectly withheld amount. This will ensure Toby is in the same position as in scenario 1.

New Zealand has no right to tax

151. Article 20 of the Model Convention is different from the other allocation articles under a DTA. It simply exempts the relevant income from tax in New Zealand:

> **Article 20 Students**
>
> Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

152. Where all of the conditions of this article are met, the DTA exempts from tax all foreign-sourced payments received by the student in New Zealand for his/her maintenance, education or training. However, a payment received by way of a scholarship or bursary for attendance at an educational institution will likely be exempt income under s CW 36 in any event. The student will remain subject to New Zealand tax on all other income.

153. This article also applies where a New Zealand student is studying overseas and satisfies the conditions of this article. Any payments for the purpose of the student's maintenance, education or training received by the New Zealand student will be exempt from tax in that foreign jurisdiction.

Apply the DTA - elimination of double taxation (art 23)

154. Where double taxation arises, and it is not relieved by the application of an allocation article[22], a DTA will identify a method for relieving that double taxation.

155. New Zealand's DTAs all include an elimination of double taxation article (typically art 23) that explains when New Zealand (and the other contracting state) will give a foreign tax credit. The details of how to calculate the foreign tax credit are contained in subpart LJ of the Act.

156. New Zealand's DTAs do not follow the structure of art 23 of the Model Convention (see para [10] of the Appendix to this Interpretation Statement). New Zealand takes the following approach, as illustrated by art 22(2)(a) of the New Zealand/United Kingdom DTA:

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

157. This article is important because it explains how the DTA and the domestic law will work together to relieve double taxation. In the context of the New Zealand/United Kingdom DTA, it has the following effect:

- A foreign tax credit is allowed against New Zealand tax for United Kingdom tax paid on the same income.
- The allowance of the foreign tax credit is subject to New Zealand's domestic laws (that is, as to the timing and the amount of the credit). However, New Zealand's domestic legislation must be interpreted so as to uphold the general principle that a foreign tax credit should be available to eliminate double taxation.
- Any foreign tax credit allowed under art 22 must be for United Kingdom tax that is paid not only under the law of the United Kingdom but also in accordance with the DTA. For example, if New Zealand has the exclusive right to tax that income and the United Kingdom withholds an amount on that income in error, United Kingdom tax has not been paid in accordance with the DTA. Therefore, art 22 will not give rise to any foreign tax credit entitlements. (See, for example, QB 14/12: "Income tax – foreign tax credits for amounts withheld from United Kingdom pensions" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.)

158. Where a DTA determines that New Zealand should provide a foreign tax credit, subpart LJ (as modified by the DTA where relevant) will determine how that foreign tax credit should be calculated.

Apply the Act and the DTA - how to calculate a foreign tax credit

Introduction

159. If New Zealand is required by the DTA to provide a foreign tax credit, that credit will be calculated under subpart LJ of the Act. However, the credit will not be calculated solely by reference to domestic law. The DTA must also be considered. This is because s BH 1 provides that the DTA is to have overriding effect. Where there is any inconsistency between the DTA and domestic law, the domestic law must be read subject to the DTA. The overriding effect of the DTA is discussed below from [161].

160. Subpart LJ explains how to calculate a foreign tax credit where "foreign income tax" has been paid. It does this in two steps. First, it requires the foreign-sourced income to be divided into segments (s LJ 4). It then allows a foreign tax credit for foreign income tax paid on each segment of that foreign-sourced income (s LJ 2(1)) up to the amount of New Zealand income tax payable on that same segment (as calculated under s LJ 5).

The overriding effect of a DTA

161. Section BH 1 provides that a DTA "has effect in relation to income tax", despite anything in the Act. The heading to s BH 1(4) explains that the DTA has an overriding effect. Richardson J in *CIR v E R Squibb & Sons (New Zealand) Ltd* (1992) 14 NZTC 9,146 (CA) explained the overriding effect at 9,154: "...wherever and to the extent that there is any difference between the domestic legislation and the double tax agreement provision, the agreement has overriding effect."

[22] For example, where an allocation article gives New Zealand an exclusive right to tax, meaning the other contracting state must not tax that income.

162. This means that the DTA has an overriding effect as to income tax imposed under the Act, including the income part of the Act (part C) and the foreign tax credit part of the Act (subpart LJ). Therefore, the income and foreign tax credit parts of the Act must always be read together with the relevant articles of a DTA. Where there is any inconsistency between the two, the domestic law must be read subject to the DTA.

163. However, when it comes to calculating the amount of the foreign tax credit and the timing of that credit, the DTA does not provide any guidance. These issues are determined solely under domestic law. A credit may arise under a DTA, but it will be calculated under subpart LJ. Subpart LJ provides that the amount of the foreign tax credit will not be able to exceed the amount of New Zealand tax payable on that segment of foreign-sourced income. As the DTA provides no guidance on how to calculate a foreign tax credit, there can be no inconsistency between the DTA and domestic law.

164. Likewise, the timing of the allowance of the foreign tax credit arising under the DTA will be subject to the rules in s 78B of the Tax Administration Act 1994. (See para [184] below.)

Subpart LJ – "foreign income tax"

165. As discussed at [17] above, to be entitled to a foreign tax credit, a taxpayer must:

- be tax resident in New Zealand;
- have derived foreign-sourced income;
- have that foreign-sourced income assessable under the Act; and
- have paid foreign income tax on that foreign-sourced income.

166. The first three bullet points have already been considered at [14] to [46]. The fourth bullet point is considered below.

Meaning of "foreign income tax"

167. Section LJ 2(1) requires that a taxpayer must have paid foreign income tax to be entitled to a foreign tax credit[23]. "Foreign income tax" is defined in s LJ 3 for the purposes of the foreign tax credit rules (subpart LJ).

168. Where a DTA applies, s BH 1(4) gives the DTA an overriding effect on the foreign tax credit rules. This means that the definition of "foreign income tax" in s LJ 3 (which is only used for the purpose of the foreign tax credit rules) must be read together with the DTA. Where there is any inconsistency between the two, the term "foreign income tax" in s LJ 3 must be read subject to the relevant articles in the DTA.

169. When a DTA applies, the definition in s LJ 3 must be interpreted as referring to those taxes that are covered by art 2 of the DTA and are paid in accordance with the DTA.

Proof of payment of foreign tax

170. The Commissioner will also require proof that the foreign income tax has been paid. Because of timing mismatches between jurisdictions, it may not always be possible for taxpayers to obtain a notice of assessment in time for filing their New Zealand tax return. A statement of account or a tax deduction certificate from a foreign revenue authority confirming that foreign tax has been paid will satisfy this proof requirement in the absence of a notice of assessment.

Foreign income and foreign tax to be converted to New Zealand dollars

171. Foreign income and foreign tax must be converted to New Zealand dollars. Taxpayers must convert the amounts using the close of trading spot exchange rate (s YF 1(2)) or an alternative method approved by the Commissioner.

Dividing foreign-sourced income into segments

172. Once the preliminary requirements have been satisfied, the next step in the calculation process is to divide the foreign-sourced income into segments (s LJ 2(1)).

173. Section LJ 4 defines "segment of foreign-sourced income":

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

174. To divide the foreign-sourced income into segments, the income must first be split up by country. After this, the foreign-sourced income is further split up by source or nature.

[23] Different rules exist if a tax sparing article applies.

Calculating the credit – s LJ 5

175. Once the foreign-sourced income has been segmented under s LJ 4, the New Zealand income tax payable on that segment must be calculated. This is required because under s LJ 2(2) the amount of the foreign tax credit must not be more than the amount of New Zealand income tax payable on that segment (as calculated under s LJ 5(2) and modified, if necessary, under s LJ 5(4B)). A separate calculation is required for each segment of foreign-sourced income. The first step is to calculate the taxpayer's notional New Zealand income tax liability under s LJ 5(5). This is done by multiplying the taxpayer's net income (minus losses[24]) by the appropriate tax rate.

176. The second step is to insert this information into the equation in s LJ 5(2). Under s LJ 5(2), the segment of foreign-sourced income (less any deductions) is divided by the taxpayer's total net income for the year and then multiplied by their notional New Zealand income tax liability (as calculated under s LJ 5(5)). The result of this equation is the taxpayer's notional New Zealand income tax liability for that segment of foreign-sourced income.

177. The foreign tax credit for that segment cannot, therefore, be more than the notional New Zealand income tax liability for that segment.

Example showing how to calculate a foreign tax credit under s LJ 5

Example 3 – how to calculate a foreign tax credit under s LJ 5

Jo is a New Zealand tax resident. She owns a rental property in the Canadian Rockies, which she rents out.

For the 2017 income year, Jo receives $20,000 of rental income and has deductions of $5,000. Jo has paid Canadian income tax of $3,750. Jo's net income for the 2017 income year is $50,000 (including the rental income). Under art 6(1) of the New Zealand/Canada DTA (Double Tax Agreements (Canada) Order 2015), Canada has an unlimited right to tax the rental income and New Zealand is obliged to provide a foreign tax credit under art 21.

Step 1: Calculate Jo's notional New Zealand income tax liability – s LJ 5(5)

Jo needs to calculate her notional New Zealand income tax liability:

(net income – losses)	x	tax rate
$14,000 x .105	=	$1,470
$34,000 x .175	=	$5,950
$2,000 x .30	=	$600
Total:		$8,020

Jo therefore has a notional New Zealand income tax liability of $8,020.

Step 2: Calculate Jo's notional New Zealand income tax liability on the segment of foreign-sourced income - s LJ 5(2)

Jo now needs to calculate her notional New Zealand income tax liability on the segment of foreign-sourced income (the Canadian rental income):

((segment – deductions) ÷ net income) x notional liability

(($20,000 - $5,000) ÷ $50,000) x $8,020 = $2,406

$2,406 is Jo's notional New Zealand income tax liability for the Canadian rental income. This means that the total amount of the foreign tax credit available under subpart LJ for this segment of foreign-sourced income cannot exceed $2,406 (s LJ 2(2)).

Jo has paid $3,750 of Canadian income tax. New Zealand will only grant Jo a foreign tax credit for $2,406, as that is the New Zealand income tax payable on that segment of foreign-sourced income.

**All amounts have been converted to New Zealand dollars.*

[24] Losses are defined in s LJ 5(6)(b) for the purpose of s LJ 5(5) and refer to the taxpayer's own losses. Group company losses which a taxpayer company may use under the loss offset or subvention provisions are not brought into this calculation.

Adjustment under s LJ 5(4), (4B) and (4C)

178. Section LJ 5(4), (4B) and (4C) will adjust the amount of a taxpayer's foreign tax credit if the combined total of New Zealand tax payable under s LJ 5(2) for each segment of foreign-sourced income exceeds their notional New Zealand income tax liability.

179. These rules ensure that in calculating the notional income tax liability for a segment of foreign-sourced income, expenses and losses that are not attributable to a particular segment are spread across all sources of income, both domestic and foreign-sourced.

Example illustrating how to make an adjustment under s LJ 5(4), (4B) and (4C)

Example 4 – how to make an adjustment under s LJ 5(4), (4B) and (4C)

New Co has foreign interest income of $1,000, foreign royalty income of $800, New Zealand sales of $1,000 and $1,500 of deductible expenses attributable to those sales.

Step 1: Calculate New Co's notional New Zealand income tax liability – s LJ 5(5)

New Co needs to calculate its notional New Zealand income tax liability:

(net income – losses) x tax rate

(($1,000 + $800 + $1,000 - $1,500) - $0) x 0.28

$1,300 x 0.28 = $364

Step 2: Calculate New Co's notional New Zealand income tax liability on the different segments of foreign-sourced income - s LJ 5(2)

New Co now needs to separately calculate the notional New Zealand income tax liability on the segments of foreign interest and royalty income.

((interest – deductions) ÷ net income) x notional liability

(($1,000 - $0) ÷ $1,300) x $364 = $280

$280 is the notional New Zealand income tax liability for the foreign interest income.

((royalty – deductions) ÷ net income) x notional liability

(($800 - $0) ÷ $1,300) x $364 = $224

$224 is the notional New Zealand income tax liability for the foreign royalty income.

The total amount of New Zealand tax for all segments of foreign-sourced income is $504 (being $280 + $224). An adjustment needs to be made under s LJ 5(4B) because the total amount of New Zealand tax for all segments of foreign-sourced income ($504) is more than New Co's notional New Zealand income tax liability ($364).

Step 3: Adjustment under s LJ 5(4B)

Under s LJ 5(4B), each amount of New Zealand tax calculated under s LJ 5(2) is multiplied by New Co's notional income tax liability and divided by NZ tax. NZ tax is defined in s LJ 5(4C) to mean the total of all calculations made under s LJ 5(2), including a calculation on New Zealand sourced income. This means:

NZ tax = foreign interest and royalty calculations + NZ income calculation

NZ tax = $280 + $224 + $0*

NZ tax = $504

(*In this instance, the calculation on the New Zealand sourced income is -$140 but it is reduced to zero as it cannot be less than zero).

So for the foreign interest, the amount is $280 x $364 ÷ $504. This gives a figure of $202.22. This means that under s LJ 5(2) the amount of New Zealand tax payable on that foreign-sourced income is $202.22. New Zealand will therefore only grant a foreign tax credit for any foreign tax paid on that segment up to the amount of New Zealand income tax payable on that segment. Similarly, for the foreign royalty income, the amount is $224 x $364 ÷ $504, being $161.78. New Zealand will only grant a foreign tax credit on the royalty income up to an amount of $161.78.

**All amounts have been converted to New Zealand dollars.*

Foreign tax refund – s LJ 7

180. If a taxpayer receives a refund of foreign income tax, they must make an adjustment under s LJ 7. If the refund is received before the taxpayer has self-assessed, the amount of the foreign tax credit will be reduced by the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(2)).

181. If the refund is received after the taxpayer has self-assessed (and used the foreign tax credit), they must pay to the Commissioner the lesser of the amount of the refund or the amount of New Zealand tax payable on the foreign-sourced income calculated under s LJ 5 (s LJ 7(3)). In these circumstances, the date for payment is 30 days after the later of:

- the date the refund is received, or
- the date of the notice of assessment in which the credit was used (s LJ 7(4)).

182. Section LJ 7 only applies to refunds of "foreign income tax". For example, this is where a DTA allocates taxing rights to the other state, but subsequent adjustments are made to the calculation of the foreign income tax, resulting in a refund to the taxpayer. This can be distinguished from the situation where foreign tax has been incorrectly withheld or deducted. Any refund of incorrectly withheld or deducted foreign tax will not be a refund of "foreign income tax". In these circumstances s LJ 7 does not apply. (See [26] and [27] of QB 14/12: "Income tax – foreign tax credits for amounts withheld from United Kingdom pensions" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11.)

Foreign tax credits are non-refundable

183. A foreign tax credit is defined in s YA 1 as a non-refundable credit. This means it must be used to offset an income tax liability or it will be extinguished (s LA 5(2)). It cannot be carried back or forward and used to offset a previous or future year's income tax liabilities.

Time limit for claiming a foreign tax credit

184. Under s 78B of the Tax Administration Act 1994 (TAA), the time limit for claiming a foreign tax credit is "four years after the end of the tax year in which the taxpayer has the foreign tax credit". The Commissioner considers that this means, four years from the end of the tax year in which the taxpayer is liable to pay New Zealand income tax on the foreign-sourced income. There are three arguments that support this interpretation:

- Section 78B links to the foreign tax credit provisions in the Act. Subpart LJ of the Act and s LJ 2(1) in particular, make it clear that a taxpayer "has a tax credit for a tax year". Therefore, to be entitled to a foreign tax credit a taxpayer must have foreign-sourced income (which is assessable income in New Zealand) and have paid foreign income tax on that income. If these requirements are met then the taxpayer will have a foreign tax credit for that tax year. Under s 78B, the time for applying for that credit starts from the tax year in which the taxpayer is eligible to claim (or "has") a foreign tax credit under subpart LJ. This is the tax year in which the taxpayer is liable to pay New Zealand income tax on the foreign-sourced income.
- The predecessor section to s 78B was s LC 13 of the Income Tax Act 2004. This section started the four-year time period from the end of the tax year in which the income tax liability arose. It was not intended that s 78B would change the previous policy of s LJ 3.
- This view is also consistent with s 93C of the TAA. Section 93C requires the Commissioner to amend an assessment where a person is entitled to a foreign tax credit under s LK 1 of the Act (foreign tax credits for CFC income) and where the amount of the credit cannot be determined before the person must file a return. The time period in this case runs from the end of the income year in which the person was entitled to the credit.

185. The Commissioner may extend the four-year period for claiming a foreign tax credit by up to two years (s 78B of the TAA).

186. The time limit for claiming foreign tax credits under s 78B applies to foreign tax credits arising under domestic law and foreign tax credits arising under a DTA.

Timing of foreign tax credits

Does foreign tax have to be paid in the same year in which the income is derived?

187. Foreign tax does not have to be paid in the same year in which the income is derived for New Zealand tax purposes.

188. In the Commissioner's view, s LJ 2 does not require the foreign tax (for which a credit is available) to have been paid in the year in which the income being taxed is derived for New Zealand tax purposes. The reasons supporting this view are:

- The ordinary meanings of ss LJ 1, LJ 2 and LJ 3 do not indicate that the foreign income tax needs to be paid in the same tax period as the foreign tax credit is claimed.

INTERPRETATION STATEMENTS

- The segmentation approach under s LJ 5 only requires the foreign income to be allocated to a tax year and not the foreign income tax paid.
- It is possible that a direct correlation may not exist between most foreign tax periods and the relevant tax year in New Zealand, so Parliament must not have intended a strict correlation between the relevant foreign tax period and the tax year in which the foreign tax credit is claimed.

How to adjust for timing differences

189. If New Zealand income tax is paid in year one and foreign tax on that same income is paid in year two, the Commissioner will re-open an assessment for year one to give credit for the foreign tax paid on that income. The focus is on matching the foreign tax credit to the New Zealand income year of derivation. This might occur where New Zealand and the foreign state have different income years or where the income is treated as derived in a later year in the foreign state.

190. It is not possible to claim a foreign tax credit in year two, because s LJ 5 restricts any foreign tax credit to the amount of New Zealand tax payable on each segment of foreign-sourced income that is allocated to the income year (ie, year two). As the income has already been returned in year one (and New Zealand tax paid), there will be no income in year two against which to claim a credit.

191. Applications to re-open an assessment must be made to the Commissioner in writing. Applications are made under s 113 of the TAA and must contain proof that the foreign tax has been paid (see para [170] above). Further details can be found in Standard Practice Statement SPS 16/01: "Requests to amend assessments" in *Tax Information Bulletin* Vol 28, No 4 (May 2016):12.

Example illustrating how to adjust for timing differences

Example 5 – foreign tax credits and timing differences

Sven is a New Zealand tax resident who owns a commercial rental property in Australia. The rent is paid annually on 12th March directly into Sven's New Zealand bank account. As Sven is a New Zealand tax resident he is taxed in New Zealand on his worldwide income, including his Australian rental income. Sven files his New Zealand IR3 tax return on 12 June 2016 (before the 7 July deadline for filing). He declares his Australian rental income and pays New Zealand income tax on that income under s CC 1 of the Act. At this time, Sven has not filed his Australian tax return and has not paid any Australian income tax on the rental income. He therefore cannot claim a foreign tax credit for Australian income tax because he has not yet paid this tax, as is required under s LJ 2(1).

In October, Sven prepares his Australian tax return. The Australian tax year runs from 1 July to 30 June and returns are due on 31 October. Sven understands that he must also pay tax in Australia on the rental income. Sven files his Australian tax return and pays Australian income tax on the rental income on 31 October 2016. Sven has now paid tax twice on this rental income.

Under art 6 of the New Zealand/Australia DTA both states (Australia and New Zealand) have a shared right to tax the rental income. However, under art 23 of the DTA, New Zealand (as the state of residence), must provide a foreign tax credit for the tax imposed by and paid in Australia on the rental income (subject to the calculation provisions in subpart LJ).

Sven understands that he is entitled to claim a foreign tax credit for the Australian tax paid on the rental income. He understands that he must match this foreign tax credit with the income in the year the income was derived. Sven therefore applies to the Commissioner in writing under s 113 of the Tax Administration Act 1994 (TAA) to amend his 2016 return to claim a foreign tax credit for the foreign tax paid in Australia. Sven must make his application within the time limits prescribed by s 78B of the TAA and he must provide proof that he has paid Australian income tax on the rental income.

Further examples

192. The examples set out below are included to assist in explaining the application of the law. Examples 6 to 8 consider whether a taxpayer may be able to claim a foreign tax credit for certain foreign taxes. Examples 9 and 10 consider more complex foreign tax credit issues. These examples have been included because they are current issues that the Commissioner has been asked to consider.

193. Where not otherwise stated, foreign amounts have been converted to New Zealand dollars.

Example 6 – Australian Temporary Budget Repair Levy – integrated into a tax covered under art 2

194. Kai is a New Zealand tax resident. He owns two commercial properties in Sydney. During the 2016 New Zealand tax year, he derives rental income from those properties that results in taxable income of AUS$200,000. This is Kai's only income for the 2016 tax year.

195. In addition to Australian income tax, Kai's taxable income is subject to the Australian Temporary Budget Repair Levy (TBRL) at a rate of 2% on taxable income above AUS$180,000:

Taxable income: AUS$200,000

Australian income tax: AUS$72,000

Australian Temporary Budget Repair Levy: AUS$400

196. Kai understands that he can claim a foreign tax credit under the New Zealand/Australia DTA for Australian income tax paid. Australian income tax is specifically covered by the DTA under art 2(1)(a)(i). Article 6 (Income from real property) allocates an unlimited right to tax the rental income to Australia (as the state of source). New Zealand may also tax the income, but will have to provide a foreign tax credit under art 23 (Elimination of double taxation) for foreign tax paid.

197. Kai wants to know whether his foreign tax credit for Australian income tax would include credit for the TBRL.

198. As the list of taxes covered in art 2 of the New Zealand/Australia DTA is an exhaustive list, the TBRL will only be creditable if it is integrated into one of the taxes covered or if it is an identical or substantially similar tax under art 2(2).

199. The TBRL was introduced as part of the 2014-2015 Federal Budget of Australia. It was enacted as a short-term measure to try and reduce the Australian Federal budget deficit. The TBRL is imposed at a rate of 2% on individual taxpayers with a taxable income of more than AUS$180,000 per year[25]. It applies to residents and non-residents from 1 July 2014 until 30 June 2017. The TBRL is applied after a taxpayer's basic income tax liability has been calculated (taxable income – tax offsets) because it cannot be reduced by non-refundable tax offsets.

200. The TBRL is reflected in s 4-10(3) of the Income Tax Assessment Act 1997 (Australia's main tax Act). Section 4-10(3) contains the rules for calculating Australian income tax. Note 2 states:

> Section 4-11 of the *Income Tax (Transitional Provisions) Act 1997* (which is about the temporary budget repair levy) may increase the amount of income tax worked out under this section.

201. Section 4-11 of the Income Tax (Transitional Provisions) Act 1997 sets out the rules for calculating the TBRL (as relevant):

> **4-11 Temporary budget repair levy**
>
> *Temporary budget repair levy*
>
> (1) You must pay extra income tax (***temporary budget repair levy***) for a financial year if:
>
> (a) you are an individual; and
>
> (b) your taxable income for the corresponding income year exceeds $180,000; and
>
> (c) the financial year is a temporary budget repair levy year.
>
> Note: This section will also affect the income tax payable by some trustees who are taxed as if certain trust income were income of individuals. See sections 98 and 99 of the *Income Tax Assessment Act 1936*.
>
> *Amount of temporary budget repair levy*
>
> (2) Your temporary budget repair levy is worked out by reference to your taxable income for the corresponding income year using the rate or rates that apply to you.
>
> Note: See Part IV of the *Income Tax Rates Act 1986*.
>
> …

202. The relevant legislation is clear that the TBRL is not a separate tax, but an increase in the rate of income tax, or extra income tax. The effect of applying the TBRL is that a taxpayer's Australian income tax liability will increase. On this basis, the Commissioner considers that the TBRL is included in the Australian income tax and is not a separate tax. It will therefore be creditable under the DTA as Australian income tax.

203. The TBRL is similar to the Australian Temporary Flood and Cyclone Reconstruction Levy introduced for the 2011-2012

[25] Individuals with a taxable income of less than AUS$180,000 will not pay the levy, except where their income is subject to some other tax rate based on the top personal marginal tax rate or based on a calculation comprising the top personal tax rate.

income year to help rebuild infrastructure damaged as a result of the 2010-2011 Queensland floods. Like the TBRL, the levy was simply an increase in the rate of Australian income tax and would be creditable under the DTA as Australian income tax.

204. New Zealand will therefore provide Kai with a foreign tax credit for Australian TBRL. The credit will be calculated under subpart LJ and the foreign tax credit will be limited to the amount of New Zealand income tax payable on that foreign-sourced income.

Example 7 – Australian income tax on capital gains – covered by a DTA

205. Anna is a New Zealand tax resident who owns an investment property on the Gold Coast. In the 2017 income year Anna sells the property for a profit and makes a capital gain. She is taxed on that capital gain in Australia. Anna is also required to account for the capital gain in New Zealand under s CB 6A, as she purchased and sold the property within two years. Anna wants to know if she can claim a foreign tax credit for the tax paid in Australia.

206. Article 2(1)(i) of the New Zealand/Australia DTA explains that Australian income tax is covered by the DTA.

207. Australian capital gains tax is not a separate tax, but a component of Australian income tax. Because the DTA covers Australian income tax (art 2(1)(i)), New Zealand would (if required by the DTA) allow a credit for Australian income tax imposed on capital gains.

208. Article 13(1) of the New Zealand/Australia DTA concerns gains derived by a resident of a contracting state from the alienation of real property. It gives the source state (Australia) an unlimited right to tax that income. New Zealand may also tax that income, but must also provide a foreign tax credit under art 23.

209. New Zealand will therefore provide Anna with a foreign tax credit for Australian income tax (which includes the taxation of capital gains). The credit will be calculated under subpart LJ and the foreign tax credit will be limited to the amount of New Zealand income tax payable on that foreign-sourced income.

Example 8 – Brazilian Income Tax – No DTA in force

210. During the 2016 New Zealand tax year, Elsa derives interest income from investments in Brazil. Brazilian income tax (Imposto de Renda Retido na Fonte (IRRF)) is withheld from the interest income at source.

211. As Elsa is tax resident in New Zealand, she must also pay New Zealand income tax on the Brazilian-sourced interest income. Elsa wants to know if she can claim a foreign tax credit in her 2016 income tax return for the Brazilian income tax paid.

212. There is currently no DTA between New Zealand and Brazil. This means that Elsa cannot claim a foreign tax credit under a DTA. However, Elsa may be entitled to claim a foreign tax credit under the domestic law foreign tax credit rules. The rules will allow a foreign tax credit for foreign income tax paid if the foreign income tax is of "substantially the same nature as income tax imposed under s BB 1". (See IS 14/02 for details on how to apply this test.)

213. Brazilian IRRF is compulsory, enforceable by law and paid to the Federal Government of Brazil. It is imposed on taxable income and calculated as a proportion of a taxpayer's income. It is not a penalty, service charge or licence fee, and there is no connection between the payment of the tax and any specific benefit.

214. The Commissioner therefore considers that Brazilian IRRF would satisfy the s YA 2(5) test. Specifically, Brazilian IRRF would satisfy s YA 2(5)(b) – as it is imposed as a collection mechanism for Brazilian income tax and is of substantially the same nature as New Zealand NRWT.

215. Elsa's foreign tax credit is calculated under subpart LJ. The amount of the credit will be limited to the amount of New Zealand income tax also payable on that foreign-sourced income.

Example 9 – United Kingdom employment income incurred when a transitional resident

This example follows on from example 1 at para [47] of this Interpretation Statement

216. Lucy recently migrated to New Zealand and is a transitional resident under s HR 8(2). Lucy is therefore a New Zealand tax resident but is exempt from income tax on certain items of foreign-sourced income. Prior to migrating, Lucy had been tax resident in the United Kingdom for 10 years.

217. During her first year as a transitional resident, Lucy returns to the United Kingdom and derives employment income while there. United Kingdom income tax and national insurance (NI) contributions are deducted from this income by Lucy's United Kingdom employer (the employer is resident in the United Kingdom and the employment income was borne by a permanent establishment or fixed base in the United Kingdom). Under s CW 27(a) employment income is not subject to the transitional resident exemption, so the income is also assessable to Lucy in New Zealand. Lucy wants to know if she can claim a foreign tax credit for the United Kingdom income tax and NI contributions.

218. NI contributions are not a tax covered by art 2 of the New Zealand/ United Kingdom DTA. This means Lucy will need to look to the domestic law foreign tax credit rules to determine if she is eligible for a foreign tax credit. One of the requirements of eligibility is that the foreign tax paid must satisfy the test in s YA 2(5). This means it must be a "tax of substantially the same nature as income tax imposed under s BB 1". The Commissioner considered the creditability of NI contributions in IS 14/02. The Commissioner determined that United Kingdom NI Contributions did not satisfy the test in s YA 2(5) (see paras [223] to [225] of IS 14/02). This means that Lucy is not entitled to a foreign tax credit for NI contributions.

219. However, under art 2(1)(a) of the New Zealand/United Kingdom DTA, United Kingdom income tax is a tax covered by the DTA. (It is assumed for the purposes of this example, that under art 4 of the DTA, Lucy tie-breaks to New Zealand and is therefore deemed to be resident in New Zealand for the purposes of the DTA.)

220. Employment income is considered under art 16 of the DTA:

Article 16 – Dependent personal services

(1) Subject to the provisions of Articles 17, 19 and 20, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

(2) Notwithstanding the provisions of paragraph (1) of this Article, remuneration derived by a resident of a Contracting State in respect of employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any consecutive period of 12 months; and

(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

(3) Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that State.

221. Under this article, the residence state (New Zealand) has the exclusive right to tax the employment income, unless the employment is exercised in the other state (United Kingdom). If the employment is exercised in the United Kingdom, then the income may be taxed there.

222. In this case, Lucy's employment is exercised in the United Kingdom. The Model Commentary notes that "[e]mployment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid". Lucy was physically present in the United Kingdom when performing her employment duties.

223. Article 16 states that where the employment is exercised in the other contracting state, then it may be taxed there. As noted at para [147] above, use of the words "may be taxed" indicates that taxing rights to that income are to be shared. This means New Zealand, as the state of residence must provide a foreign tax credit for the tax imposed in the United Kingdom, subject to the calculation provisions in s LJ 5.

224. Article 16 is subject to arts 17 (Directors' fees), 19 (Pensions and annuities), and 20 (Government service). As Lucy's employment income cannot be characterised as directors' fees, a pension or income from government service, these articles do not apply.

225. Paragraph 2 of art 16 must also be considered. This paragraph limits the taxing rights of the United Kingdom (as the state where the employment is exercised), where the employment is short-term in nature. It essentially prevents the United Kingdom from taxing the employment income and gives New Zealand back the sole right to tax the income, where all three conditions are met:

- Lucy is present in the United Kingdom for a period or periods not exceeding in the aggregate 183 days in any consecutive period of 12 months; and
- The income is paid by, or on behalf of, an employer who is not a resident of the United Kingdom; and
- The income is not borne by a permanent establishment or a fixed base which the employer has in the United Kingdom.

226. In Lucy's case these three conditions are not met. Lucy had previously lived in the United Kingdom for 10 years before moving to New Zealand, so she had been present in the United Kingdom for a period exceeding 183 days in the consecutive period of 12 months. Lucy's employer was resident in the United Kingdom and the employment income was borne by a permanent establishment or fixed base which the employer had, as the employer was already resident in the

INTERPRETATION STATEMENTS

United Kingdom. Failure to satisfy one of these conditions means that the paragraph does not apply. In this case, all three conditions are not met. This means that the outcome under art 16(1) prevails and the United Kingdom has an unlimited right to tax the employment income, with New Zealand providing a foreign tax credit for the tax paid in the United Kingdom, subject to the calculating provisions in s LJ 5.

Example 10 – New Zealand/United States DTA and the application of art 1(3)

227. The New Zealand/United States DTA is different from other DTAs that New Zealand has entered into. This is because the United States taxes individuals on the basis of citizenship, rather than residency.

228. This position is reflected in the Reservation to art 1 of the Model Convention, which notes:

> 28. The United States reserves the right, with certain exceptions, to tax its citizens and residents, including certain former citizens and long-term residents, without regard to the convention.

229. The United States taxes its citizens (wherever they reside) and resident aliens on their worldwide income. This means that United States citizens residing in New Zealand will be taxable here on the basis of residency, and taxable in the United States on the basis of citizenship. (Citizenship is determined under United States domestic law and is not a DTA concept.) In these circumstances, the DTA applies differently to relieve double taxation, as the following example illustrates.

230. Olaf is a New Zealand tax resident and a self-employed business consultant. He is also a United States citizen. During the 2016 tax year, Olaf worked as an independent contractor in the United States for three months. He provided consultancy services to Widget Co (and its clients) in the United States. Olaf was paid for his services, and United States Federal income tax was withheld from this payment.

231. As Olaf is a New Zealand tax resident he is taxed in New Zealand on his worldwide income. Additionally, Olaf is a United States citizen and is therefore taxable in the United States on his worldwide income. Olaf wants to know if he is entitled to any foreign tax credit relief.

232. In these circumstances, the New Zealand/United States DTA applies. Article 7 (business profits) applies to "business profits of an enterprise". Article 3(1)(m) of the DTA explains that "enterprise" applies to the "carrying on of any business", and art 3(1)(n) notes that the term "business" includes "the performance of professional services and other activities of an independent character". Therefore, art 7 applies to Olaf's professional services income.

233. Article 7 (business profits) is the appropriate article because art 14 (independent personal services) of the New Zealand/United States DTA was revoked from 12 November 2010. The revocation is consistent with the Model Convention, which has also deleted this article. The Model Commentary on arts 5 and 14 states that income derived from professional services or other activities of an independent character should be considered under art 7, as business profits.

234. Article 7(1) of the New Zealand/United States DTA provides:

> 1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

235. Under art 7, Olaf's business profits are taxable only in New Zealand, unless he carries on business in the United States through a permanent establishment. Article 5 (permanent establishment), defines "permanent establishment":

> 1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

236. Olaf and his business are based in New Zealand. He provided advice in the United States on a short-term basis. He worked at various times at the office of Widget Co and at their clients' offices. He therefore does not have a "fixed place of business" in the United States through which his business is wholly or partly carried on and so does not have a "permanent establishment". Therefore, under art 7, Olaf should only be subject to tax in New Zealand on the income earned in the United States.

237. However, as mentioned above, the New Zealand/United States DTA operates differently to other DTAs. In these circumstances reference must be made to art 1(3) of the DTA, known as the "savings clause". Article 1(3) states:

> 3. Except to the extent provided in paragraph 4, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Residence)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that Contracting State.

238. The effect of art 1(3) is that the United States maintains its right to tax its United States citizens, regardless of the DTA. So,

while New Zealand has been allocated the exclusive right to tax Olaf's personal services income under art 7, the United States also continues to tax that income under art 1(3).

239. However, there is an exception to the application of art 1(3), set out in art 1(4), which helps to resolve this double taxation outcome:

> 4. The provisions of paragraph 3 shall not effect (sic):
>
> (a) the benefits conferred in a Contracting State under the Convention in accordance with paragraph 2 of Article 9 (Associated Enterprises), paragraph 1(b) of Article 18 (Pensions and Annuities), and Articles 22 (Relief from Double Taxation), 23 (Non-Discrimination), and 24 (Mutual Agreement Procedure); and
>
> (b) the benefits conferred in a Contracting State under the Convention in accordance with Articles 19 (Government Service), 20 (Students), and 26 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

240. Under art 1(4)(a), art 22 (relief from double taxation) is listed as an exception to the rule in art 1(3). Put another way, the "savings clause" in art 1(3) is not to affect the application of art 22. Article 22(1) provides:

> 1. Subject to paragraph 4, and in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), in the case of the United States double taxation shall be avoided as follows:
>
> (a) the United States shall allow to a resident or citizen of the United States or a United States company as a credit against United States tax the income tax paid to New Zealand by or on behalf of such resident, citizen or company; and
>
> (b) the United States shall also allow to a United States company owning at least 10 percent of the voting stock of a company (other than a United States company) which is a resident of New Zealand and from which the United States company receives dividends, as a credit against United States tax, the income tax paid to New Zealand by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.
>
> For the purposes of this paragraph, the taxes referred to in paragraphs 3(a) and 4 of Article 2 (Taxes Covered) shall be considered income taxes.

241. Under art 22(1) the United States agrees to provide Olaf with a foreign tax credit for the New Zealand income tax imposed on the income earned in the United States. That credit will be calculated under the domestic law of the United States. (As Olaf is a United States citizen, the United States will also want to tax Olaf on his worldwide income, including income earned in New Zealand. Olaf will need to determine which article or articles apply to his New Zealand income and how those articles will relieve double taxation.)

242. The United States Internal Revenue Code contains the foreign tax credit calculation provisions. Section 904 IRC 26 USC restricts the amount of the foreign tax credit to the amount of United States tax payable on that income from sources outside the United States. This section could potentially deny Olaf a credit, as his income has a United States source. The problem is resolved by referring back to the DTA. Article 22(4)(c) of the New Zealand/United States DTA applies to deem the income to have a New Zealand source, therefore allowing the credit under United States domestic law:

> 4. For the purpose of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:
>
> …
>
> (c) For purposes of paragraph 3, income beneficially owned by a resident of New Zealand who is a citizen of the United States or a United States company shall be deemed to arise in New Zealand to the extent necessary to give effect to the provisions of this paragraph.

243. Olaf must apply to the United States Inland Revenue Service for a foreign tax credit. He cannot seek a foreign tax credit from New Zealand, because under the New Zealand/United States DTA, New Zealand has been allocated the sole right to tax this income.

References

Related rulings/statements

IS 14/02: "Income tax – foreign tax credits – what is a tax of substantially the same nature as income tax imposed under s BB 1?" *Tax Information Bulletin* Vol 26, No 5 (June 2014): 3

QB 14/12: "Income tax – foreign tax credits for amounts withheld from United Kingdom pensions" *Tax Information Bulletin* Vol 26, No 11 (December 2014): 11

SPS 16/01: "Requests to amend assessments" in *Tax Information Bulletin* Vol 28, No 4 (May 2016): 12

IS 16/03: "Tax residence" *Tax Information Bulletin* Vol 28, No 10 (October 2016)

Subject references

Double tax agreements

Foreign income tax

Foreign tax credit

Income tax

Residence

Source

Substantially similar

Transitional residents

Legislative references

Income Tax Act 2007 – ss BB 1, BD 1, BH 1, CB 6, CB 6A, CC 1, CW 27, HR 8, LA 5, LJ 1, LJ 2, LJ 3, LJ 4, LJ 5, LJ 7, LK 1, YA 2(5), YD 1, YD 2, YD 4, YD 5, YF 1, and YZ 1, subparts LJ and LK, sch 27, and the definitions of "company", "foreign-sourced amount", "New Zealand" and "non-refundable credit" in s YA 1

Tax Administration Act 1994 – ss 78B, 93C and 113

Double Taxation Relief (Australia) Order 2010

Double Tax Agreements (Canada) Order 2015

Double Taxation Relief (United Kingdom) Order 1984

Double Taxation Relief (Spain) Order 2006

Double Taxation Relief (United States of America) Order 1983

The Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, ratified by New Zealand on 4 August 1971) entered into force on 27 January 1980 – arts 31 and 32

Case references

Bayfine UK v Revenue and Customs Commissioners [2011] EWCA Civ 304, [2011] STC 717

Case 8/2014 [2014] AATA 961, 2014 ATC 1-070

CIR v JFP Energy Inc (1990) 12 NZTC 7,176 (CA)

CIR v E R Squibb & Sons (New Zealand) Ltd (1992) 14 NZTC 9,146 (CA)

CIR v United Dominions Trust Ltd [1973] 2 NZLR 555 (CA)

Coblentz v R (1996) 96 DTC 6,531 (Fed CA)

CT v Lamesa Holdings BV 97 ATC 4752 (FCA)

Kinsella v The Revenue Commissioners [2007] IEHC 250

McDermott Industries Pty Ltd v FCT 2005 ATC 4398 (FCAFC)

National Distribution Union Inc v General Distributors Ltd [2007] ERNZ 120 (EmpC)

R v Crown Forest Industries Ltd 95 DTC 5389 (SCC)

TD Securities (USA) LLC v R 2010 TCC 186, 2010 DTC 1137 (Tax Court of Canada)

Thiel v FCT 90 ATC 4717 (HCA)

Undershaft No 1 Ltd v FC of T; Undershaft No 2 BV v FC of T 2009 ATC 20-091 (FCA)

Virgin Holdings SA v FC of T [2008] FCA 1503, 2008 ATC 20-051

Weiser v HMRC [2012] UKFTT 501 (TC)

Other references

Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed, Kluwer Law International, The Netherlands, 1997)

E Reimer and A Rust (eds), *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015)

OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (OECD Publishing, Paris, 2014)

The Concise Oxford English Dictionary (12th ed, Oxford University Press, New York, 2011)

INTERPRETATION STATEMENTS

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 BH 1(4) provides:

BH 1 Double tax agreements

…

Overriding effect

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

(a) income tax:

(b) any other tax imposed by this Act:

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

3. Section LJ 5 provides:

LJ 5 Calculation of New Zealand tax

What this section does

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

Calculation for single segment

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

((segment – person's deductions) ÷ person's net income) x notional liability.

Definition of items in formula

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

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

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

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

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

When subsection (4B) applies

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

Modification to results of formula for single segment

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

person's notional income tax liability ÷ NZ tax.

Definition of item in formula

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

Person's notional income tax liability

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

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

Definition of items in formula

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

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

(b) **losses**—

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

(ii) must be no more than the amount of the person's net income:

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

4. Section YD 1 provides:

YD 1 Residence of natural persons

What this section does

(1) This section contains the rules for determining when a person who is not a company is a New Zealand resident for the purposes of this Act.

Permanent place of abode in New Zealand

(2) Despite anything else in this section, a person is a New Zealand resident if they have a permanent place of abode in New Zealand, even if they also have a permanent place of abode elsewhere.

183 days in New Zealand

(3) A person is a New Zealand resident if they are personally present in New Zealand for more than 183 days in total in a 12-month period.

Person treated as resident from first of 183 days

(4) If subsection (3) applies, the person is treated as resident from the first of the 183 days until the person is treated under subsection (5) as ceasing to be a New Zealand resident.

Ending residence: 325 days outside New Zealand

(5) A person treated as a New Zealand resident only under subsection (3) stops being a New Zealand resident if they are personally absent from New Zealand for more than 325 days in total in a 12-month period.

Person treated as non-resident from first of 325 days

(6) The person is treated as not resident from the first of the 325 days until they are treated again as resident under this section.

Government servants

(7) Despite subsection (5), a person who is personally absent from New Zealand in the service, in any capacity, of the New Zealand Government is treated as a New Zealand resident during the absence.

Presence for part-days

(8) For the purposes of this section, a person personally present in New Zealand for part of a day is treated as—

(a) present in New Zealand for the whole day; and

(b) not absent from New Zealand for any part of the day.

[subss (9) and (10) have been repealed]

Treatment of non-resident seasonal workers

(11) Despite subsection (3), a non-resident seasonal worker is treated for the duration of their employment under the recognised seasonal employer (RSE) instructions as a non-resident.

5. Section YD 4 provides:

YD 4 Classes of income treated as having New Zealand source

What this section does

(1) This section lists the types of income that are treated as having a source in New Zealand for the purposes of this Act.

Business in New Zealand

(2) Income derived from a business has a source in New Zealand if—

(a) the business is wholly carried on in New Zealand:

(b) the business is partly carried on in New Zealand, to the extent to which the income is apportioned to a New Zealand source under section YD 5.

Contracts made or performed in New Zealand

(3) Income derived by a person from a contract has a source in New Zealand if the contract is—

(a) made in New Zealand, except to the extent to which the person wholly or partly performs the contract outside New Zealand, and the income is apportioned to a source outside New Zealand under section YD 5:

(b) made outside New Zealand but the person wholly or partly performs the contract here, to the extent to which the income is apportioned to a New Zealand source under section YD 5.

Personal services in New Zealand

(4) An amount that is income under section CE 1 (Amounts derived in connection with employment) has a source in New Zealand if the amount is earned in New Zealand, even if the employer is not a New Zealand resident.

Accident compensation payments

(5) An accident compensation payment as defined in section CF 1(2) (Benefits, pensions, compensation, and government grants) has a source in New Zealand.

Pensions

(6) The following amounts have a source in New Zealand:

(a) a pension or annuity payable by the government of New Zealand:

(b) a pension or annuity payable out of a superannuation scheme established in New Zealand:

(c) a gratuitous payment, within the definition of **pension** in section CF 1(2), if the services are provided in New Zealand.

Income from land owned in New Zealand

(7) Income derived by a person as the owner of land in New Zealand has a source in New Zealand.

Income from use in New Zealand of personal property

(8) Income, other than a royalty, derived as consideration for the use of, or right to use, personal property in New Zealand has a source in New Zealand if the income is—

(a) paid by a New Zealand resident:

(b) paid by a non-resident, and for which the non-resident is allowed a deduction.

Royalties

(9) A royalty has a source in New Zealand if it is—

(a) paid by a New Zealand resident and not made in connection with a business they carry on outside New Zealand through a fixed establishment outside New Zealand:

(b) paid by a non-resident, and for which the non-resident is allowed a deduction.

Dividends

(10) Income derived from shares in, or membership of, a company resident in New Zealand has a source in New Zealand.

Income from debt instruments

(11) The following amounts have a source in New Zealand—

(a) interest or a redemption payment derived from money lent in New Zealand:

(b) interest or a redemption payment derived from money lent outside New Zealand—

(i) to a New Zealand resident, unless the money is used by them for the purposes of a business they carry on outside New Zealand through a fixed establishment outside New Zealand:

(ii) to a non-resident, if the money is used by them for the purposes of a business they carry on in New Zealand through a fixed establishment in New Zealand:

(c) income from securities issued by the government of New Zealand:

(d) income derived from debentures issued by a local authority or public authority:

(e) income derived from a mortgage of land in New Zealand.

Income from disposal of New Zealand property

(12) Income derived from the disposal of property situated in New Zealand has a source in New Zealand.

Beneficiary income

(13) Income derived by a beneficiary from a trust has a source in New Zealand to the extent to which the income of the trust fund has a source in New Zealand.

Income from air transport

(14) Income derived from transporting people or property by air has a source in New Zealand if the transportation leaves from New Zealand.

Income from sea transport

(15) Income derived from transporting people or property by sea has a source in New Zealand if the transportation leaves from New Zealand to the extent to which the income is apportioned to a New Zealand source under section YD 6.

Non-resident general insurers

(16) A premium for general insurance paid to a non-resident general insurer of the type described in section YD 8 has a source in New Zealand to the extent set out in section YD 8(2).

Non-resident life insurers: policies in New Zealand

(17) Income of a non-resident life insurer calculated under section EY 48 (Non-resident life insurers with life insurance policies in New Zealand) has a source in New Zealand.

Income from New Zealand partnerships

(17B) Income has a source in New Zealand if, treating all of the partners of a New Zealand partnership as resident in New Zealand, the income is treated as having a source in New Zealand under another provision of this section. The application of the other provisions of this section is unaffected if this subsection does not apply.

Any other source in New Zealand

(18) Income derived directly or indirectly from any other source in New Zealand has a source in New Zealand.

6. Section YD 5 provides:

YD 5 Apportionment of income derived partly in New Zealand

When this section applies

(1) This section applies when—

(a) a person carries on business partly in New Zealand and partly outside New Zealand; or

(b) a contract is made in New Zealand and is performed, in whole or in part, by a person outside New Zealand; or

(c) a contract is made outside New Zealand and is performed, in whole or in part, by a person in New Zealand.

Relationship with source rules

(1B) This section does not apply to limit the effect of—

(a) any of the source rules in section YD 4 other than those in section YD 4(2) and (3); or

(b) the source rules in section YD 4(2) and (3) to the extent to which the income referred to is also income referred to in any source rule other than those in section YD 4(2) and (3).

Apportionment

(2) The amount of income derived from the business or under the contract, and the amount of expenditure incurred in deriving the income, must be apportioned between New Zealand and sources outside New Zealand to the extent necessary to achieve the result in subsection (3).

Necessary effect of apportionment

(3) The result of the apportionment, to the extent consistent with subsection (2), must be that the person's net income or net loss, in relation to the business or contract, is the same as a separate and independent person would have if they were carrying out only the person's activities in New Zealand and dealing at arm's length.

7. Section YZ 1 states:

YZ 1 Source rule for interest

Application from 29 July 1983

(1) Section YD 4(11)(a) and (b) (Classes of income treated as having New Zealand source) applies to—

(a) interest derived from money lent under a binding contract entered into on or after 29 July 1983:

(b) a redemption payment made on a commercial bill if—

(i) it was issued on or after 29 July 1983; and

(ii) it was not issued under a binding contract entered into before that date.

Meaning of issue

(2) In this section, **issue** has the meaning given in section 2 of the Bills of Exchange Act 1908.

Vienna Convention

8. Articles 31 and 32 of the Vienna Convention provide:

Article 31

General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) Any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32

Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) Leaves the meaning ambiguous or obscure; or

(b) Leads to a result which is manifestly absurd or unreasonable.

Model Convention

9. Article 4(2) and (3) of the Model Convention state:

Article 4 Resident

…

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
   a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
   b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
   c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
   d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

10. Article 23B of the Model Convention states:

Article 23B Credit method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
   a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
   b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

   Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

LEGISLATION AND DETERMINATIONS

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

Special determination S48: Spreading Method to be applied by Bank, valuation of shares by Bank on Conversion and solely attributable

This Determination may be cited as *Special Determination S48: Spreading Method to be applied by Bank, valuation of shares issued by Bank on Conversion and solely attributable.*

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

1.1 This determination relates to a funding transaction involving the issue of Notes by Bank to Parent pursuant to a Deed Poll. The Notes will contain a conversion mechanism to allow them to be recognised as Additional Tier 1 capital for the purposes of the Reserve Bank of New Zealand framework relating to the capital adequacy of banks.

1.2 The funding transaction is the subject of private ruling BR Prv 16/53, issued on 18 October 2016 and is fully described in that ruling.

1.3 The agreement to subscribe for shares provided for in the Deed Poll is a financial arrangement (as defined in s EW 3) and an "agreement for the sale and purchase of property or services" (as defined in s YA 1). The Notes, the Deed Poll and the ordinary shares in Bank issued on Conversion are, together, part of a wider financial arrangement. That wider financial arrangement includes excepted financial arrangements being the ordinary shares in Bank.

2. Reference

This determination is made under ss 90AC(1)(bb), 90AC(1)(h) and 90AC(1)(i) of the Tax Administration Act 1994.

3. Scope of determination

3.1 This determination applies to a funding transaction involving the issue of Notes by Bank to Parent pursuant to a Deed Poll.

3.2 If a Conversion occurs, the relevant number of Notes must be immediately and irrevocably converted. In summary, the steps for the conversion of the Notes will be as follows:

(a) Bank will issue a specified number of ordinary shares in Bank to Parent for each Note to be converted.

(b) Parent's rights in relation to each Note to be converted will be immediately and irrevocably terminated for an amount equal to the Issue Price of the Note to be converted. Bank will apply this amount by way of payment for the subscription of the ordinary shares referred to in paragraph (a).

3.3 This determination applies:

(a) if shares are issued by Bank on a Conversion of the Notes, to determine the value of the shares for the purposes of the financial arrangements rules;

(b) to determine the spreading method to be used in respect of the Notes; and

(c) to determine whether any amounts are solely attributable to the ordinary shares in Bank.

4. Principle

4.1 The Notes and the subscription for shares are, together, part of a financial arrangement (as defined in s EW 3). The agreement to subscribe for shares in Bank by Parent is an "agreement for the sale and purchase of property and services" (as defined in s YA 1), because it is a conditional agreement to acquire property. The shares in Bank are excepted financial arrangements (as defined in s EW 5(13)).

4.2 The agreement to subscribe for shares is not a "short-term agreement for sale and purchase" (as defined in s YA 1), because settlement is not required to occur within 93 days. Therefore, the agreement to subscribe for shares is not an excepted financial arrangement under s EW 5.

4.3 For the purposes of determining the consideration paid or payable under the financial arrangements rules, the value of the shares issued by Bank must be established under s EW 32. None of subs (2B) to (5) of s EW 32 apply to the share subscription.

4.4 Under s EW 32(6), the Commissioner is required to determine the value of the property. Bank is required to use this amount.

4.5 A person who uses IFRS to prepare financial statements and to report for financial arrangements can use the IFRS financial reporting method in s EW 15D. Bank uses IFRS to prepare financial statements and to report for financial arrangements.

4.6 Under s EW 15I, because the financial arrangement includes in part an excepted financial arrangement, s EW 15C(1) does not apply and Bank must use one of the methods in s EW 15I(2) to allocate an amount of income or expenditure to an income year. One of the methods available under s EW 15I(2) is a determination made by the Commissioner.

4.7 Under s EW 6(2), an amount that is "solely attributable" to an excepted financial arrangement described in any of ss EW 5(2) to EW 5(16) is not an amount that is taken into account under the financial arrangements rules.

5. Interpretation

In this determination, unless the context otherwise requires:

- All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
- **Bank** means the bank issuing the Notes.
- **Conversion** has the meaning set out in the terms of the Notes, as described in private ruling BR Prv 16/53, issued on 18 October 2016.
- **Deed Poll** has the same meaning as described in private ruling BR Prv 16/53, issued on 18 October 2016.
- **IFRS** means a New Zealand Equivalent International Financial Reporting Standard in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place.
- **Notes** means the Notes issued to Parent pursuant to a Deed Poll.
- **Parent** means the parent company of Bank.

6. Method

6.1 The funding transaction does not involve the advancement or deferral of income or expenditure.

6.2 The IFRS financial reporting method in s EW 15D (as modified by s EW 15D(2)) must be used to allocate income and expenditure over the term of the Notes, provided none of the restrictions for application of the IFRS financial reporting method in s EW 15D(2B) apply to the Notes.

6.3 For the purposes of s EW 32(6), the value of the shares issued by Bank is equal to the amount Parent paid for those shares.

6.4 No amount of consideration paid or payable under the Notes or the share subscription is "solely attributable" to an excepted financial arrangement.

7. Example

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

Bank issues Notes having a face value of $100. Prior to the Notes being redeemed or converted, Bank will use the IFRS financial reporting method to allocate income and expenditure over the term of the Notes.

On a Conversion, Notes having an Issue Price of $100 are to be converted into ordinary shares in Bank.

Bank immediately pays an amount equal to the Issue Price of the Notes to Parent for termination of Parent's rights under the Notes. This amount is automatically applied on Parent's behalf to subscribe for ordinary shares in Bank. Bank issues the number of shares to Parent calculated in accordance with the formula in the terms of the Notes. The value of the shares, for the purposes of s EW 32, is $100.

None of these amounts are solely attributable to an excepted financial arrangement.

This Determination is signed by me on the 18th day of October 2016.

Fiona Heiford
Manager, Taxpayer Rulings

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, 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.

Partial strike out of Judicial Review of Commissioner's decision to issue notices under s 17 of the Tax Administration Act 1994

Case	Chatfield & Co Limited v Commissioner of Inland Revenue [2016] NZHC 2289
Decision date	27 September 2016
Act(s)	Section 17 Tax Administration Act 1994, Judicature Amendment Act 1972 and Double Taxation Relief (Republic of Korea) Order 1983
Keywords	Strike out; judicial review; s 17 notice; legitimate expectation; relevant considerations; DTA

Summary

The Commissioner of Inland Revenue ("the Commissioner") applied to strike out an application by Chatfield & Co Ltd and Chatfield & Co's (together "Chatfield") seeking judicial review of the decision of the Commissioner to issues notices under s 17 of the Tax Administration Act 1994 ("TAA"). The Court struck out the first cause of action and the first two particulars of the second cause of action. The third particular of the second cause of action, alleging that the Commissioner did not take into account the terms of Article 25 of the Double Taxation Relief (Republic of Korea) Order 1983 ("the DTA"), the Court considered to be reasonably arguable and permitted to proceed to trial.

Impact

Chatfield's substantive proceeding will continue to trial on the sole cause of action alleging the Commissioner did not take into account the terms of the DTA when issuing the 15 notices under s 17 of the Tax administration Act 1994 requiring Chatfield to produce documents and records held on behalf of various companies ("the Notices").

This decision highlights the limited scope for an application of legitimate expectation as a cause of action in judicial review in a tax context.

Facts

Chatfield is the registered tax agent of various companies ("the Companies") which are currently under investigation by the tax authorities of the Republic of Korea ("Korea"). Korea's National Tax Service ("the NTS") asked the Commissioner to obtain and provide information relating to the Companies, pursuant to the DTA.

The Commissioner issued the Notices. Chatfield resisted the Notices and in its judicial review application asked the court to set them aside on two grounds.

The Commissioner contended that neither of the causes of action pleaded by Chatfield was reasonably arguable.

Decision

Lang J struck out the first cause of action and the first two particulars of the second cause of action, ordering costs in the Commissioner's favour.

On the second cause of action Lang J held that the third particular, whether the terms of the DTA had been taken into account, needed to go to trial.

The first cause of action: denial of legitimate expectation

Lang J considered there are significant obstacles to this cause of action, referring to the Court of Appeal decision in *Dandelion Investments Ltd v Commissioner of Inland Revenue* [2003] 1 NZLR 600 (CA) as an example of the approach courts are likely to take in respect of a claimed legitimate expectation in a tax context. Lang J went on to state that "the Court of Appeal has not yet definitively held that applications for judicial review based on denial of legitimate expectation cannot succeed in a taxation context."

Lang J took the view that nothing in OS 13/02 established an unambiguous commitment or promise by the Commissioner that information would be sought from the taxpayer or other third parties before a notice under s 17 would be issued to a taxpayer's tax agent. As a result the first cause of action was not reasonably arguable and must be struck out.

The second cause of action: failure to take into account relevant considerations

In his decision, Lang J considered that the first two particulars of the second cause of action were not reasonably arguable:

1. In this case the Commissioner was not required to take OS 13/02 into account. OS 13/02 contains no reference to the manner in which the Commissioner will use s 17 of the TAA to give effect to New Zealand's obligations under Double Tax Agreements with other countries and was therefore irrelevant.
2. The Commissioner was not required to have regard to the nature of the relationship between Chatfield and its taxpayer clients, whether limited or otherwise because she would have no way of knowing the nature and scope of those relationships. The fact that an entity such as Chatfield is registered as a taxpayer's tax agent is sufficient to entitle the Commissioner to consider it may hold information relevant for her purposes.

Lang J considered that third particular to the second cause of action was reasonably arguable. Lang J held that the Commissioner was required to take into account the terms of the DTA when deciding whether to comply with the request from the NTS and subsequently issue the Notices. Chatfield's claim in this respect was focused on whether any of the exceptions to Article 25 of the DTA applied.

Lang J found that the Court must proceed on the basis Chatfield can prove that the Commissioner did not take the terms of the DTA into account when making her decision to issue the Notices. Despite this, Lang J foreshadowed that there is likely to be an issue at trial as to the extent to which the Court may scrutinise this aspect of the Commissioner's decision, noting that this issue cannot be determined in the context of a strike out application.

PAYE convictions upheld by the Court of Appeal – trial Judge found not to have acted with apparent bias

Case	David Ian Henderson v The Queen [2016] NZCA 431
Decision date	10 October 2016
Act(s)	Tax Administration Act 1994
Keywords	PAYE convictions – apparent bias – adverse rulings during course of trial

Summary

The Court of Appeal dismissed an appeal against conviction on seven counts of aiding and abetting a company to knowingly apply deemed PAYE deductions for purposes other than payment to the Inland Revenue Department ("IRD"). The sole appeal ground was whether the District Court Judge acted with apparent bias at trial, giving rise to an unfair trial. The Court found that a reasonable lay observer, watching the whole trial and reading the Judge's minutes would not reasonably apprehend the Judge had become partial or predetermined the overall question of guilt.

Impact

This Judgment provides further authority for the test for apparent judicial bias as laid down by the Supreme Court in *Saxmere Co Ltd v Wool Board Disestablishment Ltd* [2009] NZSC 72 ("*Saxmere*"). It highlights the importance of viewing Judges' comments in context of the proceeding as a whole when considering whether there is a risk of apparent bias.

Facts

The Appellant was the sole director of a company which did not pay PAYE on its employees' wages to the IRD for the months of April-October 2010. After a Judge-alone trial before Judge MacAskill in the Christchurch District Court, the Appellant was convicted on seven counts of aiding and abetting the Company to knowingly apply deemed PAYE deductions for purposes other than payment to the IRD.

The Appellant appealed the conviction (but not sentence) to the Court of Appeal, initially listing a series of grounds which were abandoned once counsel was engaged. The sole ground ultimately pursued on appeal was that Judge MacAskill acted with apparent bias.

Decision

The Court of Appeal dismissed the appeal (judgment given by Kós P) finding that a reasonable observer, taken as having been present throughout the entire trial and having read the Judge's minutes would not reasonably apprehend the Judge had become partial or had predetermined the overall question of guilt. The Court of Appeal acknowledged that some of the language the judge used was unfortunate and not to be encouraged, but that in the circumstances the comments were understandable and did not indicate that guilt had been predetermined.

The Appeal and Relevant Law

The trial had been conducted in three main phases over the course of 10 months. Judge MacAskill adjourned the trial twice to enable the appellant to refocus on the merits of the prosecution case as it was clear that the appellant did not really engage with the substance of the prosecution case. The appellant was self-represented in the first and third phases, but represented by counsel in the second phase. Their Honours found that it had been a difficult trial and the Judge's comments must be considered in this context.

The Court of Appeal applied the test as laid down by the Supreme Court in *Saxmere* whether a fair-minded lay observer might reasonably apprehend that the Judge might not bring an impartial mind to the resolution of the question the Judge is required to decide. Following *Saxmere*, the Court of Appeal in the present case found that the observer is not to be taken as legally trained but a person who is aware of the judicial oath and understands the Court process. The Court of Appeal further emphasised that an important trait attributed to the hypothetical lay observer is their ability to view matters in context.

With reference to *Johnson v Johnson* (2000) 201 CLR 488 and *Muir v Commissioner of Inland Revenue* [2007] 3 NZLR 495 (CA), the Court of Appeal noted that Judges may give forthright and robust indications of their tentative views. Such views are helpful to enable the parties to address the Judge with a view to persuading the Judge to a different view. Their Honours also observed that a trial Judge has a responsibility to ensure lay litigants do not spend time on irrelevant matters in a manner which is wasteful of the Court's resources.

Pre-trial matters and trial phase one (November 2014)

The appellant had made a pre-trial application for a discharge under s 347 of the Crimes Act 1961. While not directly relevant to the appeal, their Honours observed that this was the start of a pattern of technical arguments raised in the appellant's defence.

During the first phase of the trial, the defendant had chosen not to call any witnesses or cross-examine the witnesses called by the Crown. After the Crown had closed, the appellant applied for a s 347 discharge based on a technical argument based on the dates on the indictment. The Court of Appeal observed that *"[the appellant] held a single egg in his hand and proceeded to place it in the Court's basket."*

Judge MacAskill declined the s 347 application and adjourned the trial to provide the appellant another chance at cross-examining the witnesses. In his written reasons, Judge MacAskill commented that *"the defendant had presumably concluded that there was no other reasonably arguable defence available to him, a conclusion which was not obviously wrong."* The appellant submitted that this remark, together with other comments by the Judge, gave rise to a perception of prejudgment.

The Court of Appeal found that the exchange did not show apparent bias but was a comment on the apparent lack of a defence at that point in the trial. The Judge's adjournment for the sake of fairness to the appellant (which he was under no obligation to grant) would rather suggest that the Judge was open to consider other defences.

Trial phase two (May 2015)

The appellant complained that the Judge's interactions with the prosecutor were inappropriate as an observer could, in the appellant's submission, infer from the exchanges that the Judge was unduly helping the prosecutor to improve the Crown's case and that the prosecutor and the Judge were collaborating to amend the indictment so as to find the appellant guilty.

The Court of Appeal found that a reasonable observer would have understood the Judge to be ascertaining the prosecution's position on a particular point, which was not inappropriate. Even though one particular exchange, if viewed in isolation, might suggest to someone hearing only that legal discussion that the Judge had rather teamed up with the prosecutor, their Honours found that a reasonable, informed lay observer would not reach that view, given the whole context.

While many comments were expressed in robust language, especially during the Judge's engagement with defence counsel (for example expressions such as *"I am astonished"* and *"Don't muck me around"*) the Court of Appeal found that a reasonable observer would understand that the expressions were an understandable reflection of the Judge's frustration in the face of a difficult and lengthy trial and that the Judge was taking a robust approach to managing the trial, rather than predetermining guilt. Other comments were found to be appropriate expressions of tentative views.

The Court of Appeal found that certain language was unfortunate, such as the Judge's reference to events *"proved"* by the evidence, and the use of expressions *"defence spin"* and *"tactic that crossed the line into illegitimacy"*. Even though such language was not to be encouraged, in the Court of Appeal's view the comments were understandable in the circumstances and did not indicate that guilt had been predetermined. Furthermore, the Judge's willingness to adjourn for a second time for the sake of fairness to the appellant indicated his continued open-mindedness.

Further Adjournment (June 2015) and trial phase three (September 2015)

When the trial did not resume as planned in June 2015 due to on-going issues, the Judge issued a minute in which he noted his provisional view of the Crown case. The appellant submitted that this was a further indication of predetermination. The Court of Appeal found that the comments in the minute were expressly tentative and in any event only responded to one technical aspect of the defence case. In their Honours' view, the observer would have understood the ultimate question of guilt to still be open in the Judge's mind. No issue was taken with any comments made in the third trial phase.

Default assessments for income tax and shortfall penalties for evasion, abusive tax position and gross carelessness upheld by Taxation Review Authority

Case	TRA 26/14 & TRA 5/16 [2016] NZTRA 11
Decision date	7 October 2016
Act(s)	Income Tax Act 2007 ss BG 1, GA 1 and GB 27 Income Tax Act 2004 ss CA 1 and GC 14B Income Tax Act 1994 ss CH 3 and GC 14B Tax Administration Act 1994 ss 141, 141C, 141D and 149A
Keywords	Suppressed income, tax avoidance, evasion penalties

Summary

The Taxation Review Authority ("the Authority") upheld the Commissioner of Inland Revenue's ("the Commissioner") default assessments issued on the basis that the disputant had suppressed income by failing to return amounts paid to him and on his behalf as a condition of his employment, arranging for management fees to be paid to trusts he controlled, and by arranging for his services to be remunerated by loan payments either made to himself or his family trusts. The Authority also upheld shortfall penalties imposed for evasion, abusive tax position and gross carelessness.

Impact

The decision provides a useful statement of the standards required for the imposition of tax evasion shortfall penalties, abusive tax position penalties and gross carelessness shortfall penalties. It also reaffirms the principle in Brent v Commissioner of Taxation (1971) 125 CLR 418, that all amounts received for services rendered will be income under ordinary concepts.

Introduction

The disputant challenged default assessments and separate proceedings were issued in March 2016 for the shortfall penalties issued to him by the Commissioner for the 2001 – 2009 income tax years. The assessments were issued on the basis that the disputant had suppressed income:

(a) by failing to return amounts paid to him and on his behalf by his employer as a condition of his employment;

(b) by arranging for management fees for services he performed to be paid to trusts he controlled; and

(c) by arranging for his services to be remunerated by receipt of loan payments either made to himself or his family trusts.

In addition, the Commissioner imposed shortfall penalties, which the disputant also challenged. By consent, both challenges were heard together.

Facts

The disputant is a businessman who was involved in the management and control of a number of companies during the relevant tax years. During this period he enjoyed a comfortable lifestyle and accumulated substantial assets. He achieved this using various payment arrangements and a number of different companies and trusts.

The investigation into the disputant's tax affairs was complex and took a number of years. The Authority noted that the disputant took an obstructive position and had been convicted of aiding and abetting his wife in obstructing Inland Revenue officers executing a search warrant and he had also been convicted of failing to comply with a notice issued under s 17 of the Tax Administration Act 1994 ("the TAA").

During the 2001 – 2003 tax years the disputant was employed by GPL. He received a minimal salary and paid a small amount of PAYE. GPL paid the disputant's personal and living expenses, totalling $220,974.16. The Commissioner assessed these payments as employment income or alternatively as income under ordinary concepts or as part of a tax avoidance arrangement.

After this period the disputant worked for a group of entities controlled by a businessman referred to as Mr Smith. The group of entities, described as the Q/C Entities, involved a complex structure of companies and trusts which grew rapidly in the 2002 – 2007 period.

In the 2004 – 2008 tax years, the Q/S Entities paid various amounts of management fees to the disputant's family trusts (the AF 2 Trust, AF Trust and Y Trust) for services provided by the disputant. The Commissioner assessed these fees as attributable to the disputant under the personal services attribution rule or in the alternative, as part of a tax avoidance arrangement. The Commissioner also assessed management fees of $40,000 and $180,000 charged by the AF 2 Trust solely as being part of a tax avoidance arrangement.

In 2006, the disputant received $600,000 which he says was a loan from QLL. The funds were paid from a facility that QLL had with X Finance Co. The Commissioner assessed this amount as income to the disputant under ordinary concepts.

Finally in the 2004 – 2009 tax years, the disputant and/or trusts associated with him (his family trusts and R Trust) received loans from the Q/S Entities. The Commissioner contended that these loans were received as part of a tax avoidance arrangement.

Decision

GPL Payments

The disputant initially maintained that the payments from GPL towards his personal and living expenses were a loan to him or the AF2 Trust. This was in direct contradiction to an affidavit the disputant had sworn during separate court proceedings in 2003. At the end of the hearing the disputant conceded that these payments were employment income but contended that the total amount should be reduced by the sum of $100,000 (which was a repayment by the disputant and the AF 2 Trust under a settlement agreement with GPL and other shareholders of GPL).

The Authority did not accept that the payments made by GPL were a loan or that the $100,000 settlement amount related to repayment of the alleged loan.

The Authority was satisfied that the disputant received the total amount of $220,974.16 over the 2001 – 2003 income years for personal services provided by him to GPL and that these payments were income to the disputant under s CH3 of the Income Tax Act 1994.

Management Fees

The Commissioner alleged that various management fees derived by the disputant's family trusts were attributable to the disputant under the personal services attribution rule (GB 27 of the Income Tax Act 2007 and GC 14B of the Income Tax Act 1994 and 2004). Following the completion of evidence the disputant conceded that these fees were attributable to him.

X Finance Co Payment

The Commissioner contended that a payment of $600,000 made to the disputant in 2006 was consideration for services rendered by the disputant and is income under ordinary concepts. The Authority recognised the principle that "under ordinary concepts all amounts received from the provision of services whether as an employee or independent contractor is income" and cited Brent v Commissioner of Taxation (1971) 125 CLR 418.

The disputant entered into an agreement to purchase an apartment in 2005 and the balance of the purchase price ($600,000) was paid using funds drawn down on QLL's loan facility with X Finance Co. The disputant submitted that the sum was a loan from QLL which had been secured by a caveat over the apartment. However, no caveat was registered on the title. In 2005 the disputant borrowed $500,000 from Z Bank, which was secured against the apartment. The disputant stated that this other loan was used to repay the advance from X Finance Co.

The Authority however found that there was no evidence of the $600,000 payment being a loan from QLL.

The disputant also submitted that it was a reasonable inference that the $500,000 loan from Z bank was used for investment purposes in the Q Group, and was in effect a partial repayment of the $600,000 to QLL. The Authority found that there was no sufficient factual basis for such an inference as there were no records as to where the funds were paid.

The Authority found that the disputant was unable to discharge the onus that the Commissioner was wrong in her assessment that the $600,000 payment was income under ordinary concepts.

Tax Avoidance Arrangements

The Commissioner contended that there were two discrete tax avoidance arrangements:

1. the "Management Fee Arrangement" (limited to the payments of $40,000 in 2003 and $180,000 in 2004 due to the disputant's concession that the management fees were properly assessed under the personal services attribution rule); and
2. the "Q/S Entities Loan Arrangement", where instead of receiving income that was commercially realistic for the services rendered to the Q/S Entities, the disputant and/or his trusts received loans.

The Authority treated these arrangements individually, applying the two-stage analysis in Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue [2008] NZSC 115, [2009] 2 NZLR 289 ("Ben Nevis").

First Arrangement: Management Fees Arrangement

Was there an arrangement?

The Authority accepted the arrangement as defined by the Commissioner, describing the arrangement as: the AF 2 Trust contracted with DML and the QL Trust for the provision of management services which were provided by the disputant. AF 2 Trust charged management fees to these entities. The disputant and his family were beneficiaries of the AF 2 Trust. While the disputant resigned as a trustee in 2003, he remained in control of the AF 2 Trust (including its bank accounts) and made decisions for this trust. The disputant used the management fees paid to the AF 2 Trust for his benefit and that of his family. The tax effect of the arrangement was that the AF 2 Trust derived the management fees and became liable for the tax rather than the disputant. The AF 2 Trust did not return the income and nor did it pay the disputant for his services.

Specific provisions? (Ben Nevis Stage One Inquiry)

The Authority agreed with the Commissioner that the disputant avoided s CH 3 (employment income) and s CD 5 (income under ordinary concepts) of the Income Tax Act 1994 (and the comparable provisions in the 2004 Act - Sections CE 1 and CA1(2)) by ensuring that the funds that would be his income for services rendered were received by the AF 2 Trust. The Authority also agreed that Parliament would not have contemplated that either of those provisions could be bypassed through the use of an artificial and contrived agreement that lacked commercial merit.

Parliamentary contemplation? (Ben Nevis Stage Two Inquiry)

The Authority acknowledged that the facts were similar to Penny & Hooper [2011] NZSC 95, [2012] 1 NZLR 433, and outlined the Supreme Court decision.

The Authority stated that Parliament would not have contemplated that the disputant could divert income earned from his personal exertions to his family trust without being paid a market salary where the disputant still continued to enjoy the benefit of those funds. The Authority did not consider that there could be any commercial explanation for the structure and in all the circumstances, it found the arrangement to be artificial and contrived.

The Authority was satisfied that taking all the factors into account, the purpose or effect of this arrangement was one of tax avoidance.

Tax purpose or effect of the arrangement more than merely incidental

On the basis that the arrangement was contrived and artificial and lacked any commercial reality, the Authority held that the tax avoidance purpose or effect of the arrangement was more than merely incidental to any other purpose or effect.

Counteracting the Tax Advantage?

The Authority was satisfied that the management fee arrangement was a tax avoidance arrangement, and agreed with the Commissioner's reconstruction of the disputant's income on the basis that the management fees paid to AF2 trust were the income of the disputant.

Second Arrangement: Q/S Entities Loan Arrangement

Was there an arrangement?

The Authority accepted that during the 2004 - 2009 tax years there was a pattern of substantial loans made to the disputant or his trusts by the Q/S Entities, where there were no specific loan agreements, no requirements to pay interest and no provision for repayment. These loans were used to pay the living and other expenses of the disputant and his family. Over the same period the disputant received employment income on which he paid PAYE fixed at a rate which was not in any way commensurate with his various management positions.

The Authority accepted that there was an arrangement involving the steps as identified by the Commissioner.

Specific Provisions? (Ben Nevis Stage One Inquiry)

The Authority stated that Parliament would not have contemplated that ss CE 1 (employment income) and/or CA 1(2) (income under ordinary concepts) of the Income Tax Act 2007 (and the comparable provisions in the earlier Acts - ss CE 1 and CA 1(2) of the Income Tax Act 2004 and ss CH 3 and CD 5 of the Income Tax Act 1994) could be bypassed in the way that has occurred in this arrangement.

Parliamentary Contemplation? (Ben Nevis Stage Two Inquiry)

The Authority noted that the Commissioner did not dispute that the amounts were loans, before outlining the analogous decision of Krukziener v Commissioner of Inland Revenue (2011) 25 NZTC 20-055 (HC) ("Krukziener"). In Krukziener, Courtney J held that a genuine loan does not necessarily mean that there cannot be a tax avoidance arrangement.

The Commissioner contended that the commercial and economic reality of the arrangement, notwithstanding the legal form, was that the amounts paid as loans were paid because of services provided to the Q/S Entities by the disputant. The Authority agreed with the Commissioner and stated that the disputant's $36,000 income did not reflect the disputant's roles and work responsibilities. The loans, totalling $7,302,275, were used as income subsidies to fund the disputant's living and other expenses. The Authority stated that, though in theory, the loans had to be repaid, the disputant continued to have control of and access to the funds, there was no commercial rationale for the loans (the disputant and/or his trusts would not be able to repay the loans), interest was not charged (except in the 2007 year) or paid, and no provision or efforts were made for repayment.

The Authority agreed with the Commissioner that the disputant received the loans as income substitutes and the fact that they were used to purchase capital assets does not convert those payments into capital receipts.

The Authority was satisfied that viewed in a commercially and economically realistic way, the arrangement circumvents the relevant provisions in a way which Parliament would not have contemplated.

Tax purpose or effect of the arrangement more than merely incidental

The Authority stated that the arrangement lacked any commercial reality, and the only purpose or effect of the arrangement was tax avoidance.

Counteracting the tax advantage

The Authority accepted the Commissioner's reconstruction of the loans as the disputant's income as being well within the Commissioner's discretion and appropriate in the circumstances. The Authority did not accept the disputant's attempt to raise the issue of apportionment, as the disputant had not established a factual foundation for the issue.

Shortfall penalties

The Commissioner assessed the disputant for shortfall penalties at different rates: evasion penalties in relation to the payments received from GPL; abusive tax position penalties in relation to the loans from Q/S Entities, the payment from X Finance Co and the management fees; and gross carelessness penalty for the DML payment.

Tax Evasion Shortfall Penalties – Payments by GPL

The Commissioner argued that the taxpayer was liable to pay an evasion shortfall penalty under s 141(1)(a) of the TAA. The Authority, adopting the Commissioner's analysis, concluded that the disputant was well aware that he was required to pay tax on the income earned by him as an employee of GPL, including on the expenses paid on his behalf by that company, and he deliberately failed to do so.

The Authority stated that evasion requires intentional behaviour or subjective recklessness. Subjective recklessness requires actual awareness of the risk of breaching the obligation. It observed that the disputant was an experienced businessman who has managed and owned a number of companies in different industries. It accepted that he was knowledgeable about tax matters (although it noted that it does not require sophisticated knowledge to be aware of the obligation to pay tax on employment income). The Authority found that the Commissioner had satisfied her onus of proof. The shortfall penalties for evasion were properly imposed.

Abusive Tax Position Penalties - Q/S loan, the X Finance Co payment and management fees

The Authority found that, regarding these payments, the disputant took a tax position which, viewed objectively, was not likely to be correct. The Authority was also satisfied that he took these tax positions with the dominant purpose of avoiding tax. The Authority concluded that the disputant took an abusive tax position and that the Commissioner was correct to impose penalties under s 141D of the TAA in respect of these payments.

Gross Carelessness Shortfall Penalty – the DML payment

The Authority decided that a shortfall penalty for gross carelessness was properly imposed, finding that a reasonable person in the disputant's position, with his experience, would have known that the amount was income and that the disputant showed a high level of disregard for the consequences of not returning the income.

Court of Appeal allows appeal of the Commissioner's decision to decline request under s 113 of the Tax Administration Act 1994

Case	Charter Holdings v Commissioner of Inland Revenue [2016] NZCA 449
Decision date	13 October 2016
Act(s)	Tax Administration Act ss 109, 113, 138E (1)(e)(iv) and Part 8A
Keywords	Judicial review; Tannadyce

Summary

This was an appeal by Charter Holdings Limited ("CHL") against the High Court's dismissal of CHL's application for judicial review of the Commissioner of Inland Revenue's ("the Commissioner") decision refusing to amend her assessments under s 113 of the Tax Administration Act 1994 ("TAA"). The Court of Appeal allowed the appeal, ordering that the matter be referred back to the Commissioner for further consideration.

Impact

This case is significant in the context of the scheme of the Revenue acts, particularly the interaction between s 113, s 109 of the TAA, the statutory disputes and challenge process ("SDCP") (provided for in parts 4A and 8A of the TAA) and the role of judicial review in a taxation context post *Tannadyce Investments Ltd v Commissioner of Inland Revenue* [2011] NZSC 158, [2012] 2 NZLR 153 ("*Tannadyce*").

Primarily, this case indicates that, whether the SDCP could be entered into at the time of a taxpayer making a s 113 request is an important consideration that may persuade the Court that relief should not be granted, but it is not a substantive rule preventing judicial review of a decision declining the request in the first place.

Facts

CHL appealed against the dismissal by the High Court of an application for judicial review of a decision by the Commissioner refusing to amend her assessments of CHL's tax liability in the 2006 to 2012 tax years under s 113 of the TAA. The subject matter of this decision concerned CHL attempting to secure amended assessments reducing its tax liability for the 2006 to 2012 tax years by bringing into account losses incurred in the 2000 to 2005 tax years.

The High Court considered that application for review on the basis that CHL:

1. had been in a position to invoke the SDCP under Parts 4A and 8A of the TAA in respect of the assessments in question;
2. had failed to do so; and
3. could not, therefore, use the judicial review process to dispute the quantification of its tax liability for the relevant income tax years.

The High Court, in applying s 109 of the TAA and *Tannadyce*, stated that judicial review of a decision under s 113 ought not to be used as a means to consider the merits of assessments by circumventing the SDCP. As a result of this approach the High Court did not consider the merits of CHL's application for review, including alleged mistakes of fact in her decision making process.

Decision

Section 109 and Tannadyce

The Court of Appeal was satisfied that the High Court erred when it held that the judicial review of a decision under s 113 must be refused except when the SDCP could never be invoked. The Court of Appeal considered that s 113 is intended to stand outside of and be supplementary to the SDCP and that based its clear exclusion from right of challenge under s 138E (1)(e)(iv) of the TAA. While the decision whether to amend or not under s 113 cannot be subject to the SDCP, an amendment under s 113 can.

The Court of Appeal considered that the Commissioner's power under s 113 is remedial in nature and its utilisation to ensure correctness of assessments is in accordance to s 6(2) of the TAA, in terms of protecting the integrity of the tax system.

The Court of Appeal was not persuaded that s 109 of the TAA has any impact on s 113, considering that s 109 is to ensure the SDCP is used in the case of disputable decisions. The Court of Appeal discussed *Tannadyce*, holding that the Supreme Court's decision does not require any restriction on the general right to apply for judicial review of the exercise of the Commissioner's powers under s 113, stating that a decision under s 113 is not a disputable decision and therefore s 109 has no direct application.

The Court of Appeal held that it did not matter that CHL's ultimate objective was for its assessments to be amended so as to utilise losses referable to the 2000 to 2005 years. Furthermore it held that while the ability to access the SDCP will be an important consideration that may persuade the Court that relief should not be granted, it should not be elevated to a substantive rule. This would have the result of ousting the High Court's jurisdiction to consider applications for review in the absence of a statutory direction to that effect.

The merits of the application for review

The Court held that the Commissioner had erred by finding that:

1. Mr Padfield, sole director of CHL (who completed CHL's income tax returns, failing to carry forward losses), had demonstrated knowledge of the process for carrying forward losses in his personal tax returns, leading the Commissioner to reject his claim that he had made a genuine error in not carrying forward CHL's losses;
2. the sale of the assets of CHL had not been a true sale, without any factual foundation for doing so; and
3. trading income should have been recorded in the tax return for the 2005 year, while CHL was in receivership, having sold its business and assets in 2003.

The Court of Appeal considered that the factual errors made were such that they must have caused the Commissioner to doubt the genuineness of Mr Padfield's claim on behalf of CHL.

The Court of Appeal allowed the appeal of the Commissioner's decision to decline CHL's request under s 113 of the TAA, ordering that the matter be referred back to the Commissioner for further consideration.

General permission not satisfied when shareholder incurs legal fees in derivative action

Case	TRA 004/16, [2016] NZTRA 13
Decision date	14 October 2016
Act(s)	Income Tax Act 2007 ss DA 1 and DA 2 Companies Act 1993 ss 165 and 166
Keywords	Deductibility of legal expenses, derivative action, general permission, nexus, assessable income, income under ordinary concepts, advantage gained or sought to be gained

Summary

The issue in this case was whether a shareholder/director was entitled to a deduction for legal fees he incurred in bringing a derivative action against other directors. The Taxation Review Authority ("Authority") concluded that the true nature of what was gained and what was sought to be gained by the expenditure of legal fees was the same thing – recovery of losses suffered by the company. Any recovery by the shareholder would be an indirect consequence of a successful claim by the company. The Authority held that the general permission was not satisfied as there was insufficient linkage between the payment of the legal fees and the shareholder's income earning process for the expenditure to be deductible.

Impact

The judgment provides a useful statement on the application of s DA 1 of the Income Tax Act 2007 ("ITA") with respect to legal fees incurred by individual shareholders pursuing derivative actions in the name of a company. It confirms the position that such expenditure does not satisfy the general permission under s DA 1.

Facts

The disputant was a director and shareholder (as to 3/900 shares) of ABCL. The disputant's family trust was also a shareholder (as to 297/900 shares) in the company. The remaining shares were held by the other two directors of ABCL, Ms M and Mr X, who held 300/900 shares each.

A dispute arose between the disputant on the one hand, and Ms M and Mr X on the other. When the dispute could not be resolved, the disputant sought leave to bring a derivative action in the name of ABCL against Ms M and Mr X, under s 165 of the Companies Act 1993 ("CA 1993"). Leave was granted on condition that the disputant would be personally responsible for all costs and disbursements. The disputant did not seek an order under s 166 of the CA 1993 for the costs to be borne by ABCL.

ABCL did not succeed on its principal claims, but enjoyed limited success in relation to two causes of action. In its statement of claim, the remedy sought was an award in favour of ABCL for damages and/or an account of profits and/or damages for loss of anticipated profits. However, the order sought in ABCL's closing submissions at the hearing was for equitable compensation to be paid directly to the disputant in the amount of one third of such loss as ABCL may be found to have suffered.

The Court ordered that Ms M pay equitable compensation in the amount of $3,333.33 (being one third of the company's loss) to the disputant; and that both Ms M and Mr X pay equitable compensation in the amount of $8,200 to the disputant. As ABCL did not succeed on its principal claims, the Court held that it was appropriate for costs to lie where they fell.

In the current proceeding, the disputant claimed a deduction of $78,348.91 for the legal fees incurred by him in bringing the derivative action. Even though the disputant recognised that the compensation awarded to him was for losses suffered by ABCL, the disputant claimed that because the company was not in liquidation, ABCL's funds in his hands could only be a dividend to him, which was his assessable income. This was so even though the compensation was not paid in proportion to the shareholdings in ABCL.

In the disputant's submission, he had incurred the legal expenses with a view to receive the equitable compensation, which he claimed was his assessable income. He therefore claimed that there was a sufficient nexus between his assessable income and the legal expenditure so as to make the legal expenses deductible under s DA 1 of the ITA.

Alternatively, the disputant contended that the compensation received by him was his income under ordinary concepts (being funds which replaced a dividend that would clearly have been his income). The disputant submitted that consequently the legal fees incurred in deriving the compensation were deductible.

Decision

The Authority found that no deduction was allowed for the legal fees incurred by the disputant in respect of the derivative action because there was an insufficient nexus between the expenditure on the legal fees and the disputant's assessable income.

Referring to Buckley & Young Limited v Commissioner of Inland Revenue [1987] 2 NZLR 485 (CA) at 487, the Authority noted that a deduction is available under s DA 1 only where the expenditure has the necessary relationship both with the taxpayer concerned and with the gaining or producing of the taxpayer's assessable income or with the carrying on of a business for that purpose.

The Authority commented that the legal fees for which the deduction was claimed were clearly incurred for the purpose of prosecuting the derivative action. As such, the Judge recognised that the expenditure could be said (at least in part) to be "incidental and relevant" to the gaining or producing of assessable income by ABCL (The Authority cited from Magna Alloys & Research Pty Ltd v Federal Commissioner of Taxation (1980) 33 ALR 213 at 225; which was followed in Creer v Federal Commissioner of Taxation 28 ATR 442 (FCA)).

The Judge did not accept the disputant's submission that the quality of the advantage gained (as opposed to what was sought to be gained) should be the focus of the inquiry so that the equitable compensation took on the quality of income in the disputant's hands. The Authority accepted the Commissioner's submission that the true nature of what was gained and what was sought to be gained was the same; namely the recovery of losses suffered by ABCL as a consequence of the alleged breaches by two of its directors/shareholders. In the Authority's view, the fact that an order was made to pay equitable compensation of one third of such losses to the disputant did not alter the purpose of the expenditure and did not create the necessary linkage between the expenditure and the gaining or producing of assessable income by the disputant.

In the disputant's submission, it was incorrect and too narrow to conclude that the disputant only sought to gain an advantage for ABCL. Rather, the disputant claimed that he incurred the legal fees to benefit himself. The Authority did not accept the disputant's submission and found that, while the disputant would have pursued the derivative action with the hope/expectation of some recovery to the remaining shareholders, any such advantage to the disputant would be an indirect consequence of a successful claim by ABCL.

Referring to Case T9 (1997)18 NZTC 8,049, the Authority observed that where a business person conducts business through a company in which that person is a shareholder, expenditure by that business person on behalf of the company is very likely to relate to the company's income earning process not to the income earning process of the business person.

The Authority was satisfied there was an insufficient nexus between the expenditure on legal fees incurred by the disputant in respect of the derivative action and the gaining or producing of the disputant's assessable income. It therefore found that the general permission under s DA 1 was not satisfied.

As the Authority had concluded that the general permission under s DA 1 had not been satisfied, her Honour concluded that it was not necessary to consider whether the expenditure was income or capital under s DA 2.

The Commissioner's refusal to accept a NOPA upheld by Taxation Review Authority and proceeding struck-out

Case	TRA 007/16 [2016] NZTRA 12
Decision date	14 October 2016
Act(s)	Sections 89K and 138C Tax Administration Act 1994
Keywords	Strike out, NOPA

Summary

The Commissioner of Inland Revenue ("the Commissioner") can refuse to accept a late Notice of Propose Adjustment ("NOPA") where the disputant is unable to satisfy the requirement of s89K of the Tax Administration Act 1994 ("TAA").

Impact

This decision confirms the circumstances in which the Commissioner may refuse to accept a NOPA under s 89K of the TAA.

Facts

The Commissioner applied, under s 89K of the TAA, to strike out proceedings brought by the disputant challenging the Commissioner's decision to refuse to accept a NOPA claiming a goods and services tax ("GST") refund.

According to the disputant, the Commissioner, in a letter dated 27 April 2007, promised that $6,121.83, being the amount of the GST refund, would be released "as soon as possible".

The Commissioner took the position that she made a disputable decision on 18 August 2007 to not make the refund.

The disputant issued a NOPA on 27 September 2011, requesting the refund.

On 21 December 2011 the Commissioner informed the disputant that the NOPA was invalid.

The disputant sought orders that its NOPA be declared valid and that the refund plus interest be made.

Decision

Date of Disputable Decision

The Taxation Review Authority ("the TRA") agreed that the Commissioner's letter dated 20 August 2007, declining to pay the refund was a disputable decision.

Whether the disputant can successfully challenge the Commissioner's decision under s 89K of the TAA

Exceptional Circumstances

The TRA found that the disputant made no mention at any stage of any event or reason why he could not issue the NOPA within the required period, and that there is no evidence of any event or circumstance beyond the control of the disputant which would provide a justification for not issuing the NOPA within the required time period.

Demonstrable Intention

It is for the disputant to show a demonstrable intention to enter into the disputes process and the TRA found that no steps were taken by the disputant to do so. The disputant's threat to issue legal proceedings was found not to show a demonstrable intention.

As soon as reasonably practicable

The TRA found the four years delay in filing the NOPA to be "simply extraordinary" and there was no possible basis on which it could be found that the NOPA was issued "as soon as reasonably practicable".

The TRA found the disputant unable to meet the requirements of s 89K of the TAA and accordingly held that it has no reasonably arguable cause of action. On this basis the Commissioner's application to strike out the proceedings was granted.

Furthermore, the TRA also granted the Commissioner's application to strike out on the basis that the proceedings were not issued by the disputant within the statutory time period.

In respect of the disputant's further grounds of opposition, the TRA held as follows:

S 6 of the TAA and s 27 of the New Zealand Bill of Rights Act 1990 ("NZBORA") 1990

The TRA rejected the disputant's submission that a strike out application is in breach of s 6 of the TAA and s 27 of the NZBORA. The TRA held that the Commissioner is entitled to bring a strike out application if she considers that grounds exist for doing so and that the disputant has the right to oppose the application.

TRA's power to strike out challenge proceedings

The TRA held that it does have jurisdiction to hear and determine interlocutory applications, including strike out applications. The TRA stated that Regulation 4 of the District Court Rules applies to interlocutory steps and proceedings in the TRA as if those proceedings were civil proceedings in the District Court, and there is no inconsistency between the District Court Rules and the Regulations.

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/aboutir/newsletters/tib** and complete the subscription form.

There is a TIB index at the link above which is updated annually.