Vol 34 No 9 October 2022

TAX INFORMATION Bulletin

CONTENTS

Inland Revenue
Te Tari Taake

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 **taxtechnical.ird.govt.nz** (search keywords: public consultation).

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

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

You can also subscribe at **taxtechnical.ird.govt.nz/subscribe** to receive regular email updates when we publish new draft items for comment.

Your opportunity to comment

Ref	Draft type	Title	Comment deadline
PUB00351	Interpretation statement	Income tax – Application of the s CZ 39 bright-line test to certain family and close relationship transactions	12 October 2022
ED00244	Determination	Tax Depreciation Rates for automated ship mooring systems	13 October 2022

IN SUMMARY

New Legislation

Rulings

Questions we've been asked

IN SUMMARY (continued)

Legal decisions – case summaries

CSUM 22/03 – Taxation Review Authority reconfirms that backdated ACC weekly compensation is taxed in the year of receipt; s 9 of the NZBORA does not support the Disputant's position.

The Disputant challenged her income tax assessment for the year ended 31 March 2017 ("the Period in Dispute"). The Accident Compensation Corporation ("ACC") made a gross payment of $363,808.36 ("the ACC Weekly Compensation Payment") to the Disputant in the Period in Dispute. The Commissioner of Inland Revenue ("the Commissioner") taxed the entire ACC Weekly Compensation Payment in the Period in Dispute, when the Disputant received it.

CSUM 22/04 – High Court reconfirms that backdated ACC weekly compensation is taxed in the year of receipt.

In November 2017, the Accident Compensation Corporation ("ACC") made a gross payment of $188,386.95 ("the ACC Weekly Compensation Payment") to Ms Hoeberechts. The Commissioner of Inland Revenue ("the Commissioner") assessed $150,000 of that amount as taxable on a cash basis and taxed the amount in the tax period when Ms Hoeberechts received it, namely the year ended 31 March 2018 ("the Period in Dispute").

On 1 October 2021, the Taxation Review Authority ("the Authority") dismissed Ms Hoeberechts' challenge to her income tax assessment for the Period in Dispute.

Any appeal of the Authority's decision was required to be filed in the High Court ("the Court") by 1 November 2021. Ms Hoeberechts failed to file an appeal in the required time and sought the Court's discretion to extend the time to file. Ms Hoeberechts also sought an order from the Court dispensing with the requirement that she pay security of costs and for the appointment of an *amicus curiae*. The Commissioner opposed the application.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Order in Council – Taxation (Use of Money Interest Rates) Amendment Regulations (No 2) 2022

Sections 120E(1) and 120H of the Tax Administration Act 1994

Order

The Taxation (Use of Money Interest Rates) Amendment Regulations (No2) 2022 Order in Council was made on 15 August 2022. The Order changes the use of money interest (UOMI) rate on underpayments of taxes and duties in line with market interest rates. The new underpayment rate is 7.96% (previously 7.28%). The new overpayment rate is 1.22% (previously 0%).

Background

The UOMI underpayment rate is charged to taxpayers on underpayments of tax to Inland Revenue, while the UOMI overpayment rate is paid to taxpayers on money paid to Inland Revenue exceeding their liability.

Section 120H(1)(b) of the Tax Administration Act 1994 permits the making of regulations by Order in Council to set the UOMI underpayment and overpayment rates. Once a rate is set, it remains at that rate until changed by a subsequent Order in Council.

The UOMI underpayment rate is based on the 'floating first mortgage new customer housing rate' series published by the Reserve Bank (RBNZ) each month, while the UOMI overpayment rate is based on RBNZ's '90-day bank bill rate' series each month. The UOMI rates are both adjusted if either the RBNZ 90-day bank bill rate or the floating first mortgage new customer housing rate moves by 100 basis points or more, or if one of these indexes moves by 20 basis points or more and the UOMI rates have not been adjusted in the last 12 months.

The UOMI rates are reviewed regularly to ensure they are in line with market interest rates. The new UOMI underpayment rate and existing UOMI overpayment rate are consistent with the floating first mortgage new customer housing rate and the 90-day bank bill rate.

Effective date

The new UOMI underpayment rate applies on and after 30 August 2022.

View the Order in Council: **https://www.legislation.govt.nz/regulation/public/2022/0233/8.0/whole.html#LMS730645**

Order in Council – Tax Administration (August Flood Events) Order 2022

Remission of use-of-money interest for the August flood events (August 2022)

Order

The Tax Administration (August Flood Events) Order 2022 was made on 29 August 2022 and came into force on 30 August 2022. The Order declares the August flood events to be emergency events for the purpose of section 183ABA of the Tax Administration Act 1994. This section allows the Commissioner to remit use-of-money interest payable on late tax payments following emergency events.

Background

The floods, landslides and other damage that occurred because of the heavy rainfall from 17 to 21 August 2022 has been declared to be an emergency event applying to the Far North of the North Island, and Marlborough, Nelson, and Tasman in the South Island.

The Order applies to taxpayers whose ability to pay their tax on time, or estimate their provisional tax, was significantly adversely affected by the disruption caused by the weather fronts in the specified regions and who were unable to pay their tax on time as a consequence. This includes tax payments such as PAYE, which was due on 22 August 2022, as well as GST and provisional tax, which were due on 29 August 2022.

Taxpayers may apply for interest remission once their tax returns and payments are up to date. Different rules apply in cases of financial hardship.

Effective date

The declaration commenced 30 August 2022, and expires 31 January 2023.

Find out more about Inland Revenue's tax relief measures at **ird.govt.nz**

View the Order in Council: **https://www.legislation.govt.nz/regulation/public/2022/0241/11.0/LMS742594**

Order in Council – Tax Administration (Extension of Notification Deadline for Research and Development Tax Credits) Order 2022

Order

The Tax Administration (Extension of Notification Deadline for Research and Development Tax Credits) Order 2022 was made on 29 August 2022 and came into force on 1 September 2022. The Order extends the deadline for making a section 68CB(1)(d) notification for the 2021–22 income year until 30 April 2023.

Background

The Research and Development Tax Incentive functions as a 15% tax credit for eligible R&D expenditure on eligible R&D activities in New Zealand. For an R&D activity to be eligible, a person must include it in a general approval application that is accepted by the Commissioner (unless the person has an appropriate approval for their criteria and methodologies). The provisions governing general approvals are in section 68CB of the Tax Administration Act 1994. A general approval can cover activities for a single year or for multiple (up to three) income years.

Under section 68CB(1)(d), for multi-year general approvals, a person is required to notify in the second year (and third year if applicable) that there have been no material changes for their business for the relevant income year. The ordinary due date for making this notification is the seventh day of the second month after the end of the income year.

This deadline has been particularly problematic for businesses for which it was impossible or unreasonable to make the requisite notification for the 2021–22 income year. For instance, some taxpayers did not have their general approval confirmed until close to or after the section 68CB(1)(d) notice was due.

Extension of notification deadline

The Tax Administration (Extension of Notification Deadline for Research and Development Tax Credits) Order 2022 is made under section 226 of the Tax Administration Act 1994. That section allows for extensions of time to be granted by Order in Council to meet requirements under some of the Inland Revenue Acts, even when the deadline has already expired.

Effective date

The Order came into force on 1 September 2022.

View the Order in Council: **https://www.legislation.govt.nz/regulation/public/2022/0244/latest/LMS738820**

Order in Council – The Tax Administration (COVID-19 Response Variations) Order 2022

Order

The Tax Administration (COVID-19 Response Variations) Order 2022 came into force on 30 September 2022. The Order extends the application of section 6I of the Tax Administration Act 1994 from 1 October 2022 until 30 September 2023.

Background

In 2020, greater administrative flexibility was granted to the Commissioner in section 6I of the Tax Administration Act 1994 as part of the response to COVID-19 (see *TIB vol 32 No 7 August 2020*). The discretion allows the Commissioner to vary time related requirements (such as timelines, due dates, deadlines, and time periods), procedural or administrative requirements when taxpayers are likely to be impacted by COVID-19, and compliance with current requirements is impossible, unreasonable, or impractical.

The discretionary power allows the Commissioner to issue variations to provide flexibility for taxpayers to comply with their tax obligations under the Inland Revenue Acts where they have been affected by the impacts of COVID-19. Where taxpayers comply with a variation, they are treated as if they complied with the requirement set out in legislation.

The measure was originally limited in application to an 18-month period ending 30 September 2021. However, section 6H of the Tax Administration Act 1994 provides that the measure may be extended upon the recommendation of the Minister of Revenue if it is reasonably necessary in the circumstances because of the continuing impact of COVID-19 related measures or circumstances. This power was previously extended until 30 September 2022 by the Tax Administration (COVID-19 Response Variations) Order 2021 to enable the Commissioner to act quickly in the event taxpayers are further impacted by COVID-19.

This Order in Council extends the Commissioner's COVID-19 administrative flexibility measure for another year (30 September 2023). The extension was considered necessary given the continued impact of COVID-19 and the threat of new variants.

View the Order in Council: **https://www.legislation.govt.nz/regulation/public/2022/0245/latest/LMS736490.html**

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**

BR Prd 22/04: Sustainable Mobility Limited (trading as Zilch)

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

Name of person who applied for the Ruling

This Ruling has been applied for by Sustainable Mobility Limited (trading as Zilch).

Taxation Laws

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

This Ruling applies in respect of ss CX 2, CX 33, GB 31 and GB 32.

The Arrangement to which this Ruling applies

The Arrangement is the provision of access to a fleet of primarily electric vehicles by Zilch to a business customer under the terms of a Master Services Agreement (MSA) and a schedule to that agreement (the Services Schedule). The MSA and Services Schedule allow for the short-term rental of vehicles within that fleet by the business customer through a bespoke business booking portal in consideration for a monthly subscription fee. In addition, employees of the business customer may use the vehicles for private purposes in consideration for paying Zilch a price equal to the price Zilch charges a member of the public, subject to a discount of up to 15%.

Further details of the Arrangement are set out below.

1. Zilch's business customers sign-up to Zilch's MSA, which includes the Services Schedule. Together the documents provide the business customer with access to Zilch's fleet of vehicles on an hourly, daily, weekly or monthly basis.
2. The MSA enables business customers to gain access to Zilch's business booking portal. The business customer is responsible for uploading the driver–employees who are eligible to use the vehicles and services described in the MSA. In most cases, the driver–employees will be the employees of the business customer.
3. Under the Services Schedule, a monthly Service Fee is payable by the business customer in consideration for access to a specified number of vehicles, the booking portal service and charging cables. Additional fees are payable in limited circumstances.
4. Zilch does not charge members of the public a fee to access and use its booking portal service.
5. Whenever a vehicle is required, a booking is made through the Zilch business booking portal. The booking procedure requires the driver–employee to state whether the vehicle will be used for business travel or private travel.
6. Where the use is designated as business, the business customer is invoiced and charged for the vehicle use in accordance with the MSA and Services Schedule fees.
7. Where the use is designated as private, the driver–employee must pay Zilch the same rate as Zilch's non-business customers pay for their private vehicle use. Zilch may offer a driver–employee a discount of up to 15% as against standard publicly offered rates in respect of private bookings made on the business booking portal. Any discount Zilch offers is a commercial decision of Zilch and is not made at the request or instruction of the business customer. In addition, any such discount is offered on the same terms as discounts offered to other business customers with comparable numbers of employees.
8. The private booking is subject to the same terms and conditions that are contained in the standard contract with a member of the public. A credit card is required for the booking to be completed and to access the vehicle.

9. After the driver–employee has returned the vehicle, Zilch debits the amount charged for the driver–employee's private use to the driver–employee's private credit card.
10. Under the Services Schedule, Zilch may offer a business customer a rebate based on private bookings made by the business customer's driver–employee's through the business booking portal.
11. Where Zilch has offered the business customer a rebate, the amount of the monthly Service Fee Zilch invoices includes a reduction for an agreed on portion of the private amounts charged to the driver–employees.
12. Zilch's system includes telematic technology fitted to each vehicle in the Zilch fleet. Zilch provides each business customer with access to a detailed report showing the actual use of vehicles for each driver–employee. This enables the business customer to confirm the amount of private and/or business use associated with each booking.
13. The business customer is not allocated specific vehicles. Vehicles of a particular standard or type are made available through the business booking portal. Zilch retains ownership and possession of all vehicles under the MSA.
14. Zilch vehicles that can be booked through the business booking portal are located at hubs situated variously either within or just outside the central business districts.
15. A vehicle hub may also be located at the premises of a business customer. In those cases, the vehicles located at that hub will be used exclusively by that business customer. All vehicles located at a business customer's hub remain the property of Zilch. Individual vehicles may be exchanged at Zilch's discretion.
16. Where a vehicle hub is located at the premises of a business customer, the business customer provides the electricity used for charging the vehicles. Where a driver–employee uses one of those vehicles for private purposes, the cost of the electricity charging the vehicle is part of the fee payable by the driver–employee to Zilch.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The business customer's policies and procedures prohibit private use of the vehicle, including travel to and from a driver–employee's home and place of work, through a business booking in the Zilch system.

(b) The business customer periodically reviews the reports Zilch provides to ensure no private use is made of vehicles booked for business purposes.

(c) If Zilch offers a rebate to a business customer for bookings made by that business customer's driver–employees, the rebate will not be passed on to the business customer's driver–employees.

(d) Where a private booking is made using the Zilch business booking portal, no refund or reimbursement of the cost Zilch charges is provided by the business customer to the driver–employee.

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) None of the following features of the Arrangement gives rise to a "benefit" to a business customer's driver–employees for the purposes of s CX 2(1):
   (i) private bookings made and paid for by driver–employees at an equivalent price to that Zilch offers the public;
   (ii) a driver–employee's access to the business booking portal;
   (iii) the use of a business customer's carpark for Zilch fleet vehicles;
   (iv) the use of an electricity charging facility for Zilch fleet vehicles located in a business customer's carpark; and
   (v) the entering into of the MSA, including the Services Schedule, by the business customer.

(b) Discounting Zilch provides in respect of private bookings made and paid for by a business customer's driver–employees through the business booking portal does not give rise to a "fringe benefit" for the purposes of s CX 2(1) because the benefit is:
   (i) not provided to the driver–employee through an arrangement between the business customer and Zilch for the purposes of s CX 2(2); or
   (ii) excluded from being a fringe benefit by s CX 33.

(c) Neither s GB 31 nor s GB 32 applies to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 July 2022 and ending on 30 June 2025.

This Ruling is signed by me on the 3rd day of August 2022.

Howard Davis
Group Leader
Tax Counsel Office

BR Prd 22/09: Westpac New Zealand Limited

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

Name of person who applied for the Ruling

This Ruling has been applied for by Westpac New Zealand Limited (Westpac).

Taxation Laws

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

This Ruling applies in respect of:

(a) ss BG 1, CC 4, CC 7, EW 15, EW 31, GB 21, RE 1 to RE 6, RE 10, RF 2 to RF 4, RF 12, RF 12I and the definition of "interest" in s YA 1;

(b) part VIB of the Stamp and Cheque Duties Act 1971.

The Arrangement to which this Ruling applies

The Arrangement is a mortgage offset arrangement pursuant to which Westpac customers can elect to use the balance of eligible Westpac transaction and savings accounts to offset against home loan accounts in order to reduce interest payable on those home loan accounts (Choices Offset Arrangement).

The Choices Offset Arrangement allows a customer to link several deposit accounts (known as Linked Deposit Accounts) to one of a variety of home loan accounts (known as a Choices Offset Loan), notionally offsetting the balances of the deposit accounts against the loan account balance. Interest is calculated on the loan account balance after the notional offset. Interest is not paid or payable on any Linked Deposit Accounts for as long as the account is linked to a Choices Offset Loan.

This Ruling does not consider the tax consequences of any arrangement under which a Linked Deposit Account holder agrees to offset their deposit account credit balance against another person's Choices Offset Loan account debit balance in return for valuable consideration (whether in monetary or non-monetary form).

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

Background

1. The Choices Offset Arrangement is a "mortgage offset" arrangement. The customers who may participate are classified as either Restricted Entities or Non-restricted Entities. Special rules apply to each of the two participant entities as discussed below.
2. The Choices Offset Arrangement allows Westpac customers to "link" up to 10 Linked Deposit Accounts to a single loan account such that the balances of the home loan and deposit account(s) will be notionally aggregated (thereby notionally reducing the debit balance of the loan) for the purposes of calculating the amount of interest that accrues on the loan. Westpac will pay no credit interest on the Linked Deposit Accounts during the period they are so linked, even where the deposit balances exceed the loan balance.
3. The Choices Offset Arrangement is not a separate loan product; it is an arrangement that can be used with an existing home loan product and deposit accounts. Further details of the Choices Offset Arrangement, particularly in relation to the eligible home loans and deposit accounts, interest calculations, interest rates, eligibility requirements of participants and relevant documentation are set out in the following paragraphs.

Eligible home loans that can be offset

4. Westpac offers its retail and business customers several loan products, including Choices Home Loans, which may have a fixed or floating interest rate.
5. Westpac will determine from time to time which loan products may be included in a Choices Offset Arrangement (Qualifying Loans). Currently, only floating-rate Choices Home Loans may be included in the Choices Offset Arrangement. Other Choices Home Loan types (excluding the Choices Everyday Loan) may be added in due course.
6. Qualifying Loans will have a variety of repayment options, including table, reducing (flat) and interest only. A Qualifying Loan included in a Choices Offset Arrangement is referred to as a Choices Offset Loan.

7. The effect of offsetting is that interest will be payable on the lower notional principal balance of the Choice Offset Loan. In the case of:
   (a) a table loan, the term of the loan will be reduced;
   (b) a non-table loan, the interest payments will be reduced. Any interest savings will result in either a reduction of interest payments or (if any minimum periodical payments are maintained) a reduction in the term of the loan;
   (c) an interest-only loan, interest payments will be reduced.

Eligible deposit accounts that can be offset

8. Westpac also offers its customers a variety of deposit accounts, including transaction accounts and savings accounts. Westpac determines, from time to time, which of these accounts may be included in a Choices Offset Arrangement.
9. Deposit accounts are not required to be new deposit accounts opened for the purpose of the Arrangement. Further, no new deposit account types have been (or will be) created as part of the Choices Offset Arrangement.
10. To participate in the Choices Offset Arrangement, the deposit account (or accounts) must be linked to a Choices Offset Loan. As noted above, a deposit account that has been linked to a Choices Offset Loan pursuant to the Choices Offset Arrangement is referred to as a Linked Deposit Account.
11. Only one Qualifying Loan and up to 10 Linked Deposit Accounts may be included in a Choices Offset Arrangement.

Offsetting features

12. The key feature of the Choices Offset Arrangement is the "offsetting" of the aggregate credit balance of the Linked Deposit Account(s) against the debit balance of a Choices Offset Loan. This offsetting occurs before interest is calculated.
13. A net notional balance will be calculated for the Choices Offset Loan. Interest then accrues on that net notional balance only. This is the case as a matter of both contract (as set out in the terms and conditions applying to the Choices Offset Arrangement, which are discussed in more detail below) and as a matter of practice (in terms of Westpac's internal systems and accounting).
14. There are no actual transfers of funds, no set-offs or netting of funds, and no transfer of any interest in, or entitlement to, funds between the Choices Offset Loan account and Linked Deposit Account (or Accounts).
15. The effect of offsetting is that interest will be payable on the lower notional principal balance of the Choices Offset Loan.
16. Financially, the consequences for a customer of linking one or more deposit accounts and a Choices Offset Loan in a Choices Offset Arrangement are similar in terms of reduced interest costs that may arise from the use of Westpac's revolving home loan product (Choices Everyday Loan). Under the revolving home loan product, the balance on which interest is calculated is reduced, resulting in a reduced term of the loan for table mortgages and reduced periodic payments for non-table mortgages.

Interest calculations under a Choices Offset Loan

17. The balance on which interest accrues on any day under a Choices Offset Loan will be calculated by notionally reducing the debit balance of the Choices Offset Loan at the end of that day by an amount equal to the aggregate of the credit balances of each Linked Deposit Account at the end of that day.
18. If the aggregate of the credit balances of all Linked Deposit Accounts equals or exceeds the debit balance of the relevant Choices Offset Loan, no interest will accrue on the Choices Offset Loan.
19. No interest will accrue or be paid on the credit balance of a Linked Deposit Account for so long as it is linked to a Choices Offset Loan. This is the case irrespective of whether, on any given day, the aggregate of the credit balances of all Linked Deposit Accounts at the end of that day exceeds the debit balance of the Choices Offset Loan to which they are linked.
20. Interest will accrue on any Linked Deposit Account for any period that it is not linked to a Qualifying Loan. Clause 3 of the Offset Arrangement Agreement and Clause 2 of the Offset Arrangement Contributor Agreement make it clear that interest is suspended on Linked Deposit Accounts only for so long as they are linked to a Choices Offset Loan under those agreements.
21. Default interest will not be subject to the offsetting arrangement. It will continue to accrue in accordance with the standard terms and conditions that apply to any Choices Offset Loan.

Interest rate

22. The rate of interest applicable to a Choices Offset Loan will be a market rate that Westpac determines.

Eligible persons and entities

23. Under a Choices Offset Arrangement, deposit accounts held by the following persons may be linked to a Choices Offset Loan:
    (a) the Borrower, that is, the person (or persons acting jointly) who has (have) taken out the Qualifying Loan to be included in the Choices Offset Arrangement;
    (b) in limited circumstances (as discussed below), persons other than the Borrower (known as a Contributor).
24. The Offset Arrangement Agreement draws a distinction between "Restricted Entities" and "Non-Restricted Entities" for the purposes of determining what deposit accounts can be linked to a Choices Offset Loan. These terms, and the consequences arising, are discussed below.

Restricted Entities

25. Where the Borrower is a Restricted Entity only the following deposit accounts may be linked to a Choices Offset Loan:
    (a) A deposit account in respect of which the Borrower is the Account Holder; and
    (b) if the Borrower is party to this Agreement in its capacity as the trustee(s) of a trust or executor(s) of an estate, deposit accounts that are held by the Account Holder in its capacity as the trustee(s) of the same trust or executor(s) of the same estate.
26. A Restricted Entity is
    (a) any body corporate or other person, including a body of persons acting jointly, other than a natural person or two natural person(s) jointly who are Partners; and
    (b) any person(s), including any natural person(s), who is/are acting in its/their capacity as the trustee(s) of a trust or executor(s) of an estate.
27. The effect of being a Restricted Entity is that only deposit accounts in respect of which the Borrower is the sole account holder can be linked to the Borrower's Choices Offset Loan.
28. In the case of a Borrower acting in its/their capacity as the trustee(s) of a trust or the executor(s) of an estate, deposit accounts held only by the Borrower in its/their capacity(ies) as the trustee(s) of the same trust or executor(s) of the same estate can be linked to its Choices Offset Loan.
29. By way of example, if ABC Limited has established a Choices Offset Arrangement in connection with its Qualifying Loan, deposit accounts held only by ABC Limited may be linked to that loan. Further, if ABC Limited is a party to the Choices Offset Loan as trustee of a trust, deposit accounts held only by ABC Limited in its capacity as trustee of the same trust may be linked to that loan.

Non-Restricted Entities

30. Where the Borrower is not a Restricted Entity, deposit accounts held either individually or jointly by the Borrower, their partner (spouse, civil union or de facto partner), any of their children (or a child together with his or her partner), or any of their parents (or a parent together with his or her partner) can be linked to the Borrower's Choices Offset Loan (on the condition that such persons are not themselves Restricted Entities). This can be done by:
    (a) the Borrower where he or she (or they) can do so within the parameters of any linking rules determined by Westpac from time to time (which will require, among other things, that the Borrower has sufficient authority to operate the relevant deposit account);
    (b) the Borrower acting with the consent of the relevant Contributor, in circumstances where the linking rules determined by Westpac from time to time require the relevant Contributor's consent (which will be the case where the Borrower does not have sufficient authority to operate the relevant deposit account);
    (c) Contributor, where the relevant deposit account is held by a Contributor and that Contributor has already provided consent in relation to another deposit account (and, therefore, has already signed up to the relevant terms and conditions under which the Borrower and the relevant Contributor agree that the Contributor may do so).

31. By way of example only, if Mr and Mrs Brown jointly establish a Choices Offset Loan:
    (a) deposit accounts held by Mr and Mrs Brown jointly may be linked to that Choices Offset Loan;
    (b) subject to any further criteria set by Westpac from time to time, deposit accounts held by Mr Brown in his individual capacity may be linked to that Choices Offset Loan (most likely by Mr Brown himself);
    (c) subject to any further criteria set by Westpac from time to time, deposit accounts held by Mrs Brown's father may be linked to that Choices Offset Loan by:
        (i) Mr and Mrs Brown, as the Borrower, with the consent of Mrs Brown's father; or
        (ii) Mrs Brown's father, if Mrs Brown's father has already consented to another deposit account being linked to Mr and Mrs Brown's Choices Offset Loan;
    (d) deposit accounts held by Mr Brown's father or by Mr Brown's father and his de facto partner jointly may be linked to that Choices Offset Loan (in accordance with relevant linking criteria above); and
    (e) deposit accounts held by ABC Limited, or by Mr Brown in his capacity as a trustee, or any other Restricted Entity, cannot be linked to that Choices Offset Loan.

Offset Arrangement documentation

32. The terms and conditions of the Choices Offset Arrangement are set out in the following documents provided to Inland Revenue on 20 April 2022:
    (a) Choices Home Loan Summary (which forms part of the agreement pursuant to which Westpac advances home lending to a particular customer).
    (b) Choices Home Loan Terms & Conditions (which is a standard form master document that contains generic provisions applying to all Westpac loans of a particular type).
    (c) Offset Arrangement Agreement (being the principal agreement between the Choices Offset Loan customer and Westpac in relation to the Offset Arrangement).
    (d) Offset Arrangement Contributor Agreement (being the document that a Contributor signs in addition to Westpac and the Borrower to join an Offset Arrangement).
33. The Choices Offset Arrangement documentation will override certain of the terms and conditions that would otherwise apply to the relevant Qualifying Loan and Linked Deposit Accounts that are included in an Offset Arrangement.
34. In particular, the Choices Offset Arrangement Agreement sets out the interest calculation method to be used for the Choices Offset Loan, provides for no interest to accrue on Linked Deposit Accounts for as long as the account(s) are linked to a Choices Offset Loan, and sets out the eligibility criteria (in relation to loans, accounts and account holders).
35. Therefore, Westpac customers who wish to include a Qualifying Loan in a Choices Offset Arrangement would enter into the standard loan documentation applicable to the Qualifying Loan as well as the Choices Offset Arrangement documentation. A customer may not have a Choices Offset Arrangement without a Qualifying Loan.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

- All interest rates offered by Westpac in relation to an Offset Arrangement are at arm's length market rates.

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:

Financial arrangements rules

- When, under the Choices Offset Arrangement, a credit balance of a Linked Deposit Account and a debit balance of a Choices Offset Loan account are offset, no amount of consideration is paid or payable by virtue of that offset for the purposes of calculating income or expenditure under ss EW 15 and EW 31 of the financial arrangements rules (as defined in s EW 1(2)). Therefore, offsetting does not, of itself, give rise to any income or expenditure under the financial arrangements rules. For the avoidance of doubt, fees payable (if any) by a Borrower to Westpac for the Choices Offset Arrangement constitute consideration for the purposes of the financial arrangements rules.

Withholding tax

- There is no payment of, or entitlement to, interest (as defined in s YA 1) in relation to the credit balance(s) of Linked Deposit Account(s) in the Choices Offset Arrangement. Therefore, no holder of a Linked Deposit Account derives any interest income on such accounts for the purposes of s CC 4, and Westpac does not pay any interest and has no obligation to deduct resident withholding tax or non-resident withholding tax under the Act or pay approved issuer levy under part VIB of the Stamp and Cheque Duties Act 1971.
- The Choices Offset Arrangement is not an indirect associated funding arrangement as that term is defined in section RF 12I.

Section CC7

- No income arises under s CC 7 for Westpac or its customers in relation to the Choices Offset Arrangement.

Tax avoidance

- Sections BG 1 and GB 21 do not apply to the Choices Offset Arrangement

The period for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2022 and ending on 31 March 2027

This Ruling is signed by me on the 14th day of July 2022.

James McKeown
Tax Counsel Lead
Tax Counsel Office

QUESTION WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 22/06: Deductibility of overseas travel expenses

Question

Can income tax deductions be claimed for overseas travel costs (other than meal costs)?

Answer

Income tax deductions can be claimed for overseas travel costs (other than meal costs) but only to the extent that they have a connection with deriving assessable income or carrying on a business.

Income tax deductions cannot be claimed for any part of the costs that are of a private or domestic nature, of a capital nature, or incurred in deriving exempt income or income from employment.

If the costs need to be apportioned between deductible and non-deductible amounts, then this must be done on a basis that is reasonable in the circumstances.

Key terms

General permission a rule in s DA 1 that allows a deduction for costs incurred.

General limitations rules in s DA 2 that deny a deduction for costs incurred.

Explanation

Scope of this QWBA

1. This Question We've Been Asked (QWBA) discusses the deductibility of overseas travel costs (other than meal costs).
2. It also covers how to apportion costs when:
   - only part of the total amount incurred is deductible under the general permission (s DA 1); or
   - a deduction for part of the amount is denied under a general limitation (s DA 2).
3. This QWBA updates and replaces the policy statement "Overseas travel expense claims".[1] That policy statement stated that when travel relates to a group tour or conference, tour organisers may apply to Inland Revenue for prior approval of expense claims. This is no longer the case. Unless a taxpayer applies for a private or short-process ruling under part 5A of the Tax Administration Act 1994,[2] current Inland Revenue policy is that no prior approval is available because of the different circumstances of each taxpayer.
4. This QWBA does not consider the following two issues:
   - Whether a companion's travel costs may be deducted by a taxpayer who takes a business trip. This issue is considered in QB 13/05: Income tax – Deductibility of a companion's travel expenses.[3]
   - The deductibility of meal costs. This issue is considered in IS 21/06: Income tax and GST – Treatment of meal expenses.[4]

[1] *Tax Information Bulletin* Vol 7, No 2 (August 1995): 13.

[2] A short-process ruling may be a good option in this context. For information on short-process rulings see the IRD website Short-process rulings (ird.govt.nz/managing-my-tax/short-process-rulings)

[3] *Tax Information Bulletin* Vol 26, No 1 (February 2014): 40.

[4] *Tax Information Bulletin* Vol 33, No 7 (August 2021): 30.

5. This QWBA addresses the deductibility of **overseas** travel costs only. Although the statutory tests for deductibility apply in the same way to domestic travel costs, more specific provisions may apply to domestic travel costs.
6. For the avoidance of doubt, this QWBA applies to costs incurred by a person on overseas travel that the person takes themselves (that is, costs incurred by a self-employed person who is travelling for the purposes of their income earning activity) and to costs incurred by an employer on overseas travel of employees.
7. Examples of how the law applies are provided at the end of this QWBA.

Deductibility

8. A taxpayer's overseas travel costs will be deductible if they satisfy the requirements of the general permission. The general permission is satisfied where costs[5] are incurred by the taxpayer and a sufficient nexus or connection exists between the advantage gained or sought to be gained by the costs and:
   - deriving assessable income; or
   - carrying on of a business for the purpose of deriving assessable income.
9. To determine whether a sufficient nexus exists, the nature of the costs and their relevance to the taxpayer's income earning process or business must be considered.[6]
10. Even if the costs satisfy the requirements of the general permission, a deduction will not be allowed if one of the general limitations applies. The relevant general limitations are the:
    - private limitation;
    - capital limitation;
    - exempt income limitation; and
    - employment limitation.
11. To decide whether a general limitation applies to a cost, it is necessary to consider the cost from the perspective of the person who incurred it. This involves determining what the person intended to achieve from a practical, business point of view. In doing this, trivial or minor advantages are effectively ignored.[7]
12. The general permission and general limitations contemplate apportionment; that is, part of the costs may be deductible, and part may not.
13. Special rules apply to prepaid travel and accommodation costs over $14,000.
14. The general limitations, apportionment, and the special rules applying to prepaid costs are discussed further below. This discussion is followed by examples.

Private limitation

15. The private limitation denies a deduction for costs to the extent to which they are of a private or domestic nature.
16. Costs are of a private nature if they are costs of living as an individual member of society, such as costs for food, clothing, or protective shelter. Costs are of a domestic nature if they relate to the individual household or family unit.
17. Certain kinds of costs have some relationship with deriving income because they are necessary prerequisites, or incidental or relevant to deriving income (for example, travel to a place of work and childcare costs). Despite this, because of the private limitation, such costs are not deductible.
18. It is noted that the private limitation does not apply to companies since they are not natural persons who have need of food, clothing, or protective shelter. Where a company incurs costs on a shareholder or an employee that is of a private or domestic nature for the shareholder or employee, then more specific provisions may apply to the company. Such costs may be:
    - deductible wages and salary subject to PAYE;
    - deductible fringe benefits subject to fringe benefit tax; or
    - non-deductible dividends that may be subject to the imputation credit rules.

[5] These rules also apply to losses (eg, depreciation losses), but this QWBA generally refers to costs for ease of reading.

[6] See, for example, *CIR v Banks* (1978) 3 NZTC 61,236 (CA).

[7] *Cox v CIR* (1992) 14 NZTC 9,164 (HC) at 9,176.

19. Also, where a company incurs costs on a shareholder or an employee that is of a private or domestic nature, the amounts involved may be assessable income of the shareholder or employee if they are wages, salary, a dividend or income under ordinary concepts.

Capital limitation

20. The capital limitation denies a deduction for costs to the extent to which they are of a capital nature.[8]
21. When considering whether the capital limitation applies, the courts have identified various factors that may be relevant.[9] These factors include:
    - the need or occasion that called for the costs;
    - whether the costs were of a once-and-for-all nature, producing assets or advantages that were an enduring benefit;
    - whether the costs were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned;
    - whether the costs were made from fixed or circulating capital; and
    - how the costs would be treated under ordinary principles of commercial accounting.
22. If the capital limitation applies to deny a deduction, then the costs may have produced depreciable property and a depreciation deduction may be available instead.

Exempt income limitation

23. The exempt income limitation denies a deduction for costs to the extent to which they are incurred in deriving exempt income.
24. Exempt income includes income derived by a person who is a transitional resident if the income is foreign-sourced and is neither employment income nor income from the supply of services.

Employment limitation

25. The employment limitation denies a deduction for costs to the extent to which they are incurred in deriving income from employment.
26. This means that if a taxpayer is an employee and incurs overseas travel costs to derive employment income, then no deduction is available to the taxpayer.
27. If an employer incurs the costs of their employee's private overseas travel (for example, as a bonus or reward or as part of the employee's remuneration) then a deduction may be available to the employer. However, as noted when considering the private limitation, more specific provisions may apply to costs incurred by the employer.

Prepayments

28. Costs are usually deductible in the income year they are incurred. However, where costs are prepaid, deductions may be spread over multiple income years. This applies to advance bookings for travel and accommodation over $14,000, or to bookings that are for more than six months after a taxpayer's balance date.[10]
29. The deduction is spread by treating part of the prepayment (the "unexpired portion") as income.[11] Then in the following income year a deduction will be allowed for the unexpired portion of the costs.[12] This is repeated, if necessary, until the prepayment has been fully allocated to the income years in which the advantage of the costs has been enjoyed.

Apportionment

30. The use of the phrase "to the extent to which" in the general permission and the general limitations means that apportionment is required in relevant situations.
31. Where two advantages are sought and a general limitation applies to one advantage, then it will be necessary to apportion the costs between the two. The method of apportionment must be reasonable in the circumstances.

[8] In *Case K32* (1988) 10 NZTC 286 and *Case L73* (1989) 11 NZTC 1,426 deductions for the cost of overseas travel were denied because of the capital limitation.

[9] See, for example, *Trustpower Ltd v CIR* [2016] NZSC 91, (2016) 27 NZTC 22-061.

[10] Determination E12: Persons excused from complying with section EA 3 of the Income Tax Act 2007 (Inland Revenue, Wellington, March 2009).

[11] Under s EA 3 (Prepayments).

[12] Under s DB 50 (Adjustment for prepayments).

32. One way of apportioning overseas travel costs is an apportionment based on the number of days spent on business as a fraction of the total number of days spent on travel. This method was accepted as a reasonable method of apportionment on the facts considered in *Case G5*.[13]

33. The Commissioner will accept other methods of apportionment if they are reasonable in the circumstances.

34. The cost of an international airfare needs to be apportioned where the travel has income-earning and private purposes, and neither purpose is incidental to the other.[14] In a case where the private purpose is incidental to the income earning purpose, a deduction can be claimed for the full cost of the airfare.[15] In a case where the income earning purpose is incidental to the private purpose, no deduction should be claimed for the cost of the airfare. In any case, other costs such as accommodation and local travel may still require apportionment.

Record keeping and care

35. Because the onus of proof rests on the taxpayer, they will need to retain sufficient evidentiary documents to justify any deduction claimed, including evidence justifying the apportionment of costs. Unless authorised otherwise, records must be kept in New Zealand and in either English or te reo Māori.[16]

36. It is important to be careful when working out what costs are deductible. If a taxpayer claims costs that are not deductible, then, depending on the circumstances, the taxpayer could be liable for shortfall penalties. For more information, see the guidance on Inland Revenue's website on *Shortfall penalties*.

Case law examples

37. TRA cases on the deductibility of travel costs include *Case F152* (1984) 6 NZTC 60,324; *Case G5* (1985) 7 NZTC 1,011; *Case K32* (1988) 10 NZTC 286; *Case K48* (1988) 10 NZTC 397; and *Case L73* (1989) 11 NZTC 1,426.

38. Some of these cases concern now-repealed provisions (such as provisions allowing deductions for employment-related costs and export incentives). However, they are still useful for their consideration of different factual situations.

Case F152 – travel by an employed electrician to do contract work

39. In *Case F152*, the taxpayer was a qualified electrician who carried out electrical contracting work in partnership with his wife. The taxpayer travelled to Australia with his wife for 14 days. The taxpayer spent 4 days visiting the factory that made the electrical units on which he was doing contract work. His wife did not accompany him on these visits.

40. The taxpayer claimed a deduction for two-thirds of the cost of the return airfares for himself and his wife.

41. The TRA accepted that the reason for the taxpayer's travel to Australia was to visit the factory in Melbourne. Had it not been for that reason, the travel would not have been undertaken. The TRA also accepted that the visit to the factory was rewarding for the taxpayer and, in turn, for the partnership business.

42. The TRA held that the cost of the taxpayer's ticket was wholly incurred for business purposes. The TRA saw no justification or ground for an apportionment of the cost of the taxpayer's airfare. However, the TRA held that the private limitation applied to the cost of the wife's airfare.

Case G5 – travel for both business and private reasons

43. In *Case G5*, the taxpayer travelled to Europe for 42 days. He spent 11 days visiting factories and a motor show and the remainder of his time (31 days) visiting his parents (who were having their 50th wedding anniversary).

44. The TRA found that the travel had a dual purpose. The TRA found that:

    - the taxpayer would have travelled for private purposes even if not for the purpose of visiting the factories and motor show; and
    - the taxpayer would have needed to go to Europe at some time to visit the firms if he had not done so while on his trip to visit his parents.

[13] *Case G5* (1985) 7 NZTC 1,011.

[14] *Case G5*; *Case K48* (1988) 10 NZTC 397.

[15] *Case F152* (1984) 6 NZTC 60,324.

[16] The Commissioner has the discretion to authorise the offshore storage of records or to authorise records being kept in a language other than English or te reo Māori. See s 22(2BA) of the Tax Administration Act 1994. See also SPS 21/02 *Retention of business records in electronic formats, application to store records offshore and keeping records in languages other than English or te reo Māori* (6 May 2021).

QUESTIONS WE'VE BEEN ASKED

45. The Commissioner had argued that no part of the expenditure was deductible because it was all of a private or domestic nature. Therefore, the question of how to make an apportionment was not in issue. Nevertheless, the TRA considered that the cost of the airfares was apportionable and properly apportionable on the basis claimed in the taxpayer's return. The taxpayer had claimed a deduction for $588, being his accountant's estimate of 11/42 of the total return air fare cost of $2,354.

46. Having regard to the facts, the TRA considered this amount to be reasonable. The TRA noted that it was based on the time the taxpayer was involved with visiting factories and the motor show during the total period he was overseas. The TRA described this as a commonsense, fair and intelligible basis of apportionment for that case. Therefore, the TRA held that the taxpayer had, on the balance of probability, satisfied the onus of proof of providing an acceptable basis of apportionment.

Case K32 – travel to establish a new plant

47. In *Case K32*, the taxpayers were a manufacturing company and the company's shareholder–managing director. The company manufactured auto electronic devices that its managing director designed for the local market. Among other things, this case concerned the deductibility of overseas travel costs incurred by the company when the managing director travelled to two overseas markets. The purpose was to establish a manufacturing plant for some of the company's products.

48. The TRA held that the principal object of the overseas trips had been to establish new plants permanently where none had existed previously. Hence, the travel costs were of a capital nature for capital development. Therefore, the capital limitation applied to deny a deduction for the costs incurred.

Case K48 – travel for business and recreation by married taxpayers and their family

49. In *Case K48*, the taxpayers were a married couple who had been fully engaged in a family enterprise. Between 1973 and 1977, the taxpayers and some family members had travelled overseas on four occasions – in part for business and in part for recreational purposes. The Commissioner allowed deductions for only 5% of the overseas travel costs as being related to carrying on their business.

50. The TRA held that it was more important to focus on the nature of the costs in the context of the business and to be satisfied that a nexus of "obvious necessity" existed between the costs and the income-earning process. It held that the taxpayers' claim for overseas travel costs appeared to have been overstated. It also held that the Commissioner's allowance of only 5% of the costs seemed too abstract. What should have been done was to assess the worth of each trip against the taxpayers' account of how the time was spent. Accordingly, the TRA held that deductions should be allowed for 40% of the taxpayers' costs for the 1973 trip, 5% for the 1974 trip, 15% for the 1976 trip, and 5% for the 1977 trip.

Case L73 – travel paid for by taxpayer company for employee who was also self-employed

51. In *Case L73*, the taxpayer was a company carrying on business as a milk vendor. Its main employee and shareholder was also a self-employed engineering contractor who maintained certain machines. The taxpayer paid for an overseas trip for the employee to learn about maintenance of the machines. Depending on the results of the trip, it was contemplated that the taxpayer might commence business maintaining or running the machines.

52. The TRA held that the costs were preparatory to the establishment of a new business venture by the taxpayer that had not previously been involved with the maintenance of machines. Therefore, the costs were of a capital nature and not deductible.

Examples

Example 1 - Travel overseas for two purposes

Gertrude owns a transport business. In May this year she went to Europe to visit her parents on their 50th wedding anniversary and to negotiate contracts for her business. She was overseas for 42 days and spent 11 days on business.

Gertrude would have gone to visit her parents regardless of whether she went over for business. However, she needed to go overseas at some stage during the year for business. Before she left, Gertrude contacted her business contacts overseas and arranged to meet them.

Gertrude travelled overseas for two different purposes. In the circumstances, a reasonable apportionment is to allow a deduction for 11/42 of the cost of the airfare and allow deductions for the cost of accommodation and meals on the 11 days while she was on business.

Example 2 - Incidental purpose

Fred is the owner-operator of a hardware store. He was running short of stock, so he went to Australia to buy stock. While there, Fred took the opportunity to spend a day with his old friend Bert. Fred spent a total of three days in Australia, one day on holiday and two days on business.

In Fred's situation, the holiday aspect of the trip is a trivial or minor purpose to the main business purpose. Fred visited Bert only because he was there for business and took the opportunity to see him.

A reasonable apportionment would be to allow a deduction for the total cost of the airfare, and the cost of two days of accommodation for business.

Example 3 - Employee travel

Eat Auckland Ltd provides hospitality promotion services to Auckland Council. The company decides to send Kasey, one of the company's employees, to Melbourne to run a stall at a food festival to promote restaurants in Auckland.

Kasey is keen to catch up with some mates while she is in Melbourne and her manager agrees to push out the return flight by three days and approve some annual leave.

The company pays for Kasey's return flights and travel costs other than for the extra three days that Kasey is on leave, which Kasey covers herself.

The purpose of the trip was business-related. Although Kasey's manager was happy for Kasey to extend the trip and take some time off, this was not a purpose of the trip.

The company can claim a deduction for the full cost of the return flights and the accommodation costs that it incurred.

Variation

Same facts as above, except Eat Auckland Ltd agrees to pay for the cost of Kasey's three additional nights' accommodation as a reward for Kasey's recent good performance. Kasey stays at the same hotel for the whole trip and pays for the accommodation using a company credit card.

In this variation, Eat Auckland Ltd needs to treat the cost of the additional three nights' accommodation as income subject to PAYE in Kasey's pay for the relevant period.

Example 4 - Main purpose of travel is private

Chris, who lives in New Zealand, owns a rental property on the Gold Coast of Australia. She uses a property manager to look after the tenancy and maintenance of the rental property.

Chris travels to the Gold Coast for her annual holiday. While on holiday, Chris arranges to meet with the property manager at the property for an inspection. Chris hires a car for the day to travel from her hotel to the property.

The main purpose of Chris's trip to the Gold Coast was for a holiday. Chris accepts that she wouldn't have travelled to the Gold Coast just to attend the property inspection.

Chris can claim a deduction for the cost of the hire car for the day. There is a sufficient nexus between this expenditure and her rental activity. However, Chris cannot claim deductions for any part of her airfare to the Gold Coast or for her other holiday travel costs.

Example 5 - Cancellations

Deborah is self-employed. She had booked and paid for transport, accommodation and conference costs for a business-related conference in France. The conference is scheduled to take place before the end of the income year. Due to unforeseen events, Deborah cancels the bookings for the flights, accommodation and conference. She receives a refund for some of the costs incurred. But she still has $1,200 of costs that could not be refunded. Can Deborah claim a deduction for these costs?

Despite not being able to enjoy the benefits of the costs, the costs were still incurred by Deborah in the course of carrying on a business for the purpose of deriving her assessable income. In this case, Deborah's entire trip was for the business-related conference. This will satisfy the general permission and no general limitations will apply. Therefore, the $1,200 of costs are deductible.

References

Legislative References

Sections DA 1, DA 2, DB 50, EA 3 of the Income Tax Act 2007

Case References

Case F152 (1984) 6 NZTC 60,324.

Case G5 (1985) 7 NZTC 1,011.

Case K32 (1988) 10 NZTC 286.

Case K48 (1988) 10 NZTC 397.

Case L73 (1989) 11 NZTC 1,426.

CIR v Banks (1978) 3 NZTC 61,236 (CA).

Cox v CIR (1992) 14 NZTC 9,164 (HC) at 9,176.

Trustpower Ltd v CIR [2016] NZSC 91, (2016) 27 NZTC 22-061.

Other References

Determination E12: Persons excused from complying with section EA 3 of the Income Tax Act 2007 (Inland Revenue, Wellington, March 2009) *Tax Information Bulletin* Vol 21, No 2 (April 2009): 13.

IS 21/06: Income tax and GST – Treatment of meal expenses *Tax Information Bulletin* Vol 33, No 7 (August 2021): 30.

Policy Statement "Overseas travel expense claims" *Tax Information Bulletin* Vol 7, No 2 (August 1995): 13.

QB 13/05: Income tax – Deductibility of a companion's travel expenses *Tax Information Bulletin* Vol 26, No 1 (February 2014): 40.

QB 22/07: Income Tax and Goods and Services Tax – Treatment of bloodstock breeding

Question

Income tax

We have been asked to consider how the bloodstock provisions apply where a person is purchasing their first horse with a view to breeding it for profit in the future. In the meantime, they will race the horse for several years to try to improve its breeding value.

The specific income tax issues we have been asked to consider are:

- whether s EC 39 allows a write-down in the year of purchase;
- whether, if the person is a partnership, partners carrying on another bloodstock breeding business may apply the write-down in s EC 39; and
- how to treat the sale of breeding stock when the person is carrying on a bloodstock breeding business.

GST

The specific GST issue we have been asked to consider is whether a person in a situation with the following characteristics is carrying on a taxable activity for GST purposes:

- The horse selected is a thoroughbred horse with a top pedigree and cost in excess of $200,000.
- The person engages an experienced manager with the necessary contacts to carry out actions needed to implement the breeding plan once the person reaches the phase of actually breeding from the horse.
- The person engages an experienced trainer with a history of training successful racehorses.
- The person implements (and follows) a detailed plan covering the purchase of the horse, care, training, racing and breeding, including the estimated timeframes and cost for each stage.

The Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Act 2019 introduced specific provisions for taxpayers acquiring certain high-priced bloodstock. For discussion of those rules see "New legislation: Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Act 2019", *Tax Information Bulletin* Vol 31, No 4 (May 2019): 3. This QWBA considers the income tax treatment of bloodstock that does not come within those rules.

Answer

Income tax

A person purchasing their first horse with a view to racing that horse for several years before breeding will not be entitled to a write-down for that horse in the year of purchase. Section EC 39 requires the taxpayer to be carrying on a breeding business. The purchase of a person's first horse in these circumstances will not give rise to a breeding business.

Where the person is a partnership, partners that are carrying on another bloodstock breeding business (separate from the partnership) will be entitled to a write-down for their share of the horse:

- if their share was bought with the intention of using the horse for breeding in the partner's (separate) breeding business; or
- at the point when the horse is being used for racing.

Where a person is carrying on a bloodstock breeding business and sells bloodstock (whether before or after they have used the horse for breeding):

- the sale proceeds will be income; and
- there will be no year-end add back in the year of sale for any carrying value for the bloodstock sold. This effectively means a deduction is allowed for the remaining value of the bloodstock (that is, the cost price less any previous write-down).

GST

Although each situation must be considered on its facts, a person in a situation with the characteristics described above is likely to be carrying on a taxable activity. If so, they will be entitled to an input tax deduction for costs incurred in that taxable activity (for example, the purchase of the horse and ongoing costs). The person must also return GST on any supplies that they make (including race winnings and any bloodstock sold).

Explanation – Income Tax

1. All legislative references are to the Income Tax Act 2007 unless otherwise stated.
2. The Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Act 2019 provides specific rules that apply to certain high-priced bloodstock purchased at a premier yearling sale. Where bloodstock comes within the new rules, subpart EC will allow a person to write down the cost of bloodstock even if the person is not carrying on a bloodstock breeding business. These rules are discussed in *Tax Information Bulletin* Vol 31, No 4 (May 2019): 3. This QWBA considers the income tax treatment of bloodstock that **does not** come within those rules.
3. The first issue is whether s EC 39 applies to allow a write-down in the year the first horse is purchased. This requires consideration of:
   - whether the purchase of the first horse will commence a "bloodstock breeding business"; and
   - where the person is a partnership, whether partners carrying on a bloodstock breeding business outside the partnership may apply the write-down.
4. Sections EC 39 to EC 48 set out the rules for valuing bloodstock used in a bloodstock breeding business. Section EC 39 specifies the closing value for bloodstock at the end of its first year in a breeding business. It applies to bloodstock that is two years of age or older at the end of the first income year in which a person:
   - uses the bloodstock for breeding in their breeding business (s EC 39(1)(a)); or
   - forms the intention of using the bloodstock for breeding in their breeding business (s EC 39(1)(b)); or
   - buys the bloodstock with the intention of using it for breeding in their breeding business (s EC 39(1)(c)).
5. The relevant paragraph in this situation is para (c). In summary, para (c) requires the taxpayer to purchase the bloodstock with the intention of using it for breeding "in their breeding business". In the situation being considered, the person is purchasing their first horse. Consequently, there will not be a breeding business in existence at the time they purchase the bloodstock. Therefore, it is necessary to consider when a bloodstock breeding business would commence. In particular, we were asked whether a breeding business could commence with the purchase of a single horse with a view to using it for breeding in the future and that will be raced prior to breeding to try to improve its breeding value.
6. The term "person" used in this QWBA has the meaning in the Legislation Act 2019 for income tax purposes and as defined in s 2 of the Goods and Services Tax Act 1985 for GST purposes and includes an individual, a company and a partnership. The analysis in this QWBA applies in the same way to any ownership structure under which bloodstock is held (with the exception of [34] to [41], which discuss provisions that are specific to partnerships and [42], which applies to joint ventures).

Whether a bloodstock breeding business commences with the first horse

7. The test for whether a business exists is set out in *Grieve v CIR* (1984) 6 NZTC 61,682. This test requires consideration of the nature of the taxpayer's activities and whether they have an intention to profit. The factors to consider in determining whether a business exists include:
   - the nature of the activity;
   - the period over which the activity is carried on;
   - the scale of operations and volume of transactions;
   - the commitment of time, money and effort;
   - the pattern of activity; and
   - the financial results.
8. *Grieve* also notes that, while the taxpayer's statements about their intentions are relevant, actions will often speak louder than words.

9. The Court of Appeal in *Calkin v CIR* (1984) 6 NZTC 61,781 considered what is necessary for a business to commence. The court found that a business will not commence until a profit-making structure is established and ordinary current business operations have begun (at 61,787):

> **There is too a distinction between transactions which are preparatory to the commencement of business and those which occur once the business has begun** which is well recognised in the authorities, if sometimes difficult of application in particular cases. Thus in the leading case, *Birmingham and District Cattle By-Products Co Ltd v Commrs of IR* (1919) 12 TC 92, Rowlatt J held that a company had not commenced business during the period in which the works were erected, plant assembled and agreements entered into for the purchase of materials preparatory to commencing manufacturing … **Clearly it is not sufficient that the taxpayer has made a commitment to engage in business: he must first establish a profit making structure and begin ordinary current business operations**. [Emphasis added]

10. This does not necessarily mean the business must be deriving income from its operations. In many industries, such as forestry and horticulture, a business can commence even though it will earn no income until the trees, plants or crops have sufficiently matured. However, this area of law is very fact specific, so the circumstances that are sufficient for the commencement of a business will vary from industry to industry and from case to case. Consequently, while it is possible to draw analogies with case law on other industries, the most relevant authorities will be those that consider horse racing and breeding.

Leading New Zealand authority – *Drummond v CIR*

11. The leading New Zealand authority in this area is the High Court decision in *Drummond v CIR* (2013) 26 NZTC 21,023; [2013] NZHC 1,768. In *Drummond*, Brewer J expressly considered whether a bloodstock breeding business had commenced when the syndicate purchased its first horse (this was considered as an alternative argument).

12. Brewer J found (at [13]) as a matter of fact that the plaintiffs joined the syndicate on the basis that the colt would be used as a stud stallion if that were feasible:

> [13] Against this background, I make the following findings of fact:
>
> …
>
> (b) The plaintiffs joined the syndicate on the basis that the colt would be used as a stud stallion if that were feasible.

13. Further, at [49] he stated:

> … I am entitled to infer from the evidence of Mr Ellis and from the evidence of the plaintiffs, corroborated by the syndicate members' use of the s EC39 regime, that it was the intention collectively of the syndicate to stand the colt at stud if that were feasible.

14. However, this was not sufficient to find that a breeding business had commenced. Brewer J found that it was necessary to have **a fixed intention to breed**, whereas the plaintiffs had only **a contingent intention** to use the colt for breeding purposes. In *Drummond*, whether the colt would ultimately be used for breeding was contingent on future events such as how it raced (at [76]) and whether it would be gelded (at [77]). The activities of acquiring, training and racing the colt – while furthering its chances of one day standing at stud – were preparatory to a breeding business, not a part of it.

15. Brewer J pointed to particular aspects of the syndicate agreement that he noted supported this conclusion. This raises the question of whether his Honour might have reached a different conclusion, if the relevant documentation between the parties suggested a more definitive decision to breed when the horse was purchased. That is, was his Honour intending to set out criteria for an agreement that would be sufficient to evidence the commencement of a racing business when a colt is purchased?

16. In the Commissioner's view, the contingencies that Brewer J was concerned with could not have been overcome by correcting the perceived deficiencies in the syndicate agreement. Brewer J was looking for both decisions and actions: "In my view, what was required was a decision to stand the colt at stud and then activities aimed specifically at implementing that decision" (at [80]). His Honour, quoting *Grieve*, noted that "actions speak louder than words" (at [80]). The examples he gave of the sort of actions that would suffice were "making a stallion available for stud, or advertising it as available" (at [80]). While he stated that these examples were not prescriptive, both examples are close in time to the actual breeding activity and are not likely to occur until the contingencies with which Brewer J was concerned are no longer present.

17. In finding that an intention to breed, if that were feasible, was not a sufficient commitment or decision to breed, it seems Brewer J was also influenced by his finding that the taxpayers understood the high probability that the colt would never be able to stand at stud (at [74]). The effects of performance at the racetrack and the likelihood of gelding were at least part of the factual background against which his Honour concluded that the taxpayer had a contingent intention to breed, not a fixed one.

18. In the Commissioner's view, even if the syndicate agreement in *Drummond* had been more definitive, it would not have been possible for the agreement to do more than evidence an intention to breed the bloodstock if it were feasible to do so. Even with a more detailed plan to get from purchase to breeding, the same fundamental contingences that exist in *Drummond* would still exist. At the time the horse is purchased, which is several years before any actual breeding activity is planned to occur, the nature of the activity means the best that can be said is that a person is committed to breeding if that is feasible. And, in the horse breeding business, at the time of acquiring the horse, that can be only a contingent intention.

Other bloodstock business cases

19. It has also been suggested that *Case K40* (1988) 10 NZTC 343 supports the view that a breeding business can commence when a person purchases their first horse. The Commissioner agrees that, in some circumstances, a breeding business could commence with the purchase of a single breeding horse; for example, where mature bloodstock is purchased with a view to commencing breeding in a short timeframe. However, the decision in *Case K40* is distinguishable from both that situation and the one under consideration in several respects.
20. *Case K40* did not consider when the business in question began. The years under consideration (1981–1983) were several years after the taxpayer purchased their first mare (1973). By that time, the taxpayer owned several horses and had successfully bred and sold progeny from their horses. *Case K40* was concerned with whether the taxpayer was carrying on a hobby, rather than a business. In finding that a business existed in the relevant years, District Court Judge Keane considered the pattern of activity over the whole period.
21. Even if *Case K40* could be seen as suggesting that the taxpayer's business commenced when they acquired the first horse, the facts are very different to those being considered here. There was only a brief period of racing before breeding – the mare had successfully produced a foal within two years of purchase and had produced three foals within six years. The taxpayer also appears to have made an early decision about which stallion she wanted to service the mare. No evidence existed of any contingencies that would prevent the taxpayer from trying to breed from the mare of the type that the High Court was concerned existed in *Drummond*.
22. *MR & SL Block v FCT* (2007) ATC 2,735 also considered whether a partnership was carrying on a business of breeding thoroughbred horses or whether the activity was a hobby. The Administrative Appeals Tribunal concluded that the taxpayer (a husband and wife partnership) was carrying on a business. The Senior Member of the tribunal (A Sweidan) noted that the husband and wife had purchased their first mare and bred her to produce a foal in 1991. Between 1991 and 1996, they developed and expanded the number of quality brood mares they held. The tribunal found that, when the taxpayer commenced business in 1996, they had five or six mares. This case is, therefore, again markedly different from the fact situation being considered.
23. In *Case X28* 90 ATC 276, the Administrative Appeals Tribunal also held that the taxpayers were carrying on a small-scale horse breeding and racing business. In that case, the business commenced with the purchase of two mares, one of which was already in foal. Breeding activities, therefore, commenced immediately. Once again, this case is very different to the facts being considered in this item.

Orchard and forestry cases

24. We have also considered whether case law on business commencement in the horticulture and forestry industries is analogous to business commencement in the bloodstock breeding industry. In orchard and forestry cases, the courts have found that the taxpayer is carrying on a business once they have planted trees even though the trees will not bear fruit or timber for years. This situation could be seen as analogous to purchasing a horse to use for breeding at some time in the future.
25. However, the Commissioner considers the orchard and forestry cases to be different. As noted above, the circumstances that are required for the commencement of a business vary from industry to industry. With orchards and forests, there will generally be a fixed intention to carry on the relevant business at the time the trees are planted. This is the case even though an unexpected event may occur before the trees mature. The contingencies Brewer J was concerned with in *Drummond* do not exist with orchards and forests; rather these cases are more consistent with Brewer J's finding that a racing business has commenced even though the colt had not yet been raced.

Conclusion – business commencement

26. In the Commissioner's view, a bloodstock breeding business will not commence with the purchase of a single horse that is not intended to be used for breeding for several years but will be raced in the interim to try to improve its breeding value. This is not because the bloodstock is intended to be raced for a significant period before breeding. The Commissioner accepts that racing bloodstock can be an integral part of a breeding business. However, for racing to be part of a breeding

business, that breeding business must first have commenced. In the Commissioner's view, a person purchasing a horse in these circumstances can have only a contingent intention to breed. A contingent intention is insufficient for a breeding business to have commenced. Once a breeding business exists, s EC 46 allows racing activities to be treated as part of a breeding business (discussed further from [30] below).

27. This conclusion may mean that, at the time they purchase the first horse the person will not have absolute certainty as to the ultimate tax treatment of their investment because the treatment will depend on whether the person later commences a bloodstock breeding business. However, in the Commissioner's view, the tax treatment is clear. For an investment to be taxed as a bloodstock breeding business, a bloodstock breeding business must have commenced. At the time a person purchases a single horse (with a view to breeding from the horse but not for several years), no deduction will be available because the person is not carrying on a breeding business. This conclusion is consistent with the tax treatment of pre-commencement expenditure in any other type of business. It simply reflects the different nature of the contingencies relevant to the bloodstock industry compared with those in other industries.

28. If the person later commences a breeding business, as long as they hold the horse as part of the breeding business, they will be allowed a write-down in the year the breeding business commences. Where the breeding business commences because the person is using the first horse for breeding, s EC 39(1)(a) will apply (as, at that time, the person is using the horse for breeding in an existing breeding business). Where the breeding business commences because the taxpayer acquires other horses, s EC 39(1)(c) will apply at the point that the breeding business commences. At that time the taxpayer is able to form the intention of using the horse for breeding in their (existing) breeding business.

29. In addition to concluding, on the facts before him, that a breeding business did not commence with the purchase of the first horse, Brewer J also concluded that s EC 39(1)(c) required a breeding business to already exist at the time the horse was purchased. This was Brewer J's primary reason for finding against the taxpayer. In the Commissioner's view this is another argument supporting the conclusion that a person in a situation covered by this QWBA is not entitled to a write-down for the purchase of their first horse. However, given the Commissioner's view that the person will be entitled to the write-down if, and when, a breeding business eventually commences, (see [28] above) the outcome under the two views will be the same. Under either view, the taxpayer will not be allowed a write-down before the commencement of a breeding business and will be allowed one after the business commences.

Income tax treatment of horse racing

30. Generally, bloodstock racing is outside the income tax net. No deductions are allowed for expenditure or loss incurred on (or in relation to) the racing of bloodstock (s DW 2(1)). Also, subject to specific exceptions, no deduction is allowed for expenditure or loss incurred in preparing bloodstock for racing (s DW 2(2) and (3)). Consistent with this, stake money and prize money for horse races are generally exempt income (s CW 60).

31. However, s EC 46(1)[1] treats the use of the bloodstock for racing as use in the course of the breeding business where a bloodstock owner:
    - is in the business of breeding bloodstock for sale; and
    - uses bloodstock for racing.

32. Therefore, once a taxpayer is carrying on a business of breeding bloodstock for sale, bloodstock that they use for racing may qualify for a reduction under s EC 39. In the Commissioner's view, s EC 46 does not require the raced bloodstock to be used as part of the breeding business (as long as it is able to be used for breeding in the future (see s EC 46(3)).

33. If, at any time, the person no longer expects that they will be able to use the racing bloodstock for future breeding, s EC 46(3) will apply and the bloodstock will no longer be treated as being used in the person's bloodstock breeding business. Section EC 47(1) will then apply to deem a disposal from the person's bloodstock breeding business of the bloodstock at market value.

Partners carrying on another bloodstock breeding business

34. The following paragraphs ([35] to [41]) apply only to partnerships.

35. If the partnership's breeding business has not yet commenced, it is possible that a partner who carries on their own bloodstock breeding business outside of the partnership may still be able to apply s EC 39 to write down their share of the horse.

[1] This is subject to the exceptions in s EC 46(2) (the voluntary opt-out for bloodstock not used in the course of a business of breeding bloodstock for sale) and s EC 46(3) (the exception for non-breeding bloodstock).

QUESTIONS WE'VE BEEN ASKED

36. Section HG 2 provides that partnerships are generally look-through entities meaning that the partners account for the activities of the partnership in their personal income tax returns. However, s HG 2(1) states that the rules in s HG 2(1)(a)-(d) apply to a partner "in their capacity of partner of a partnership". These words provide that a person who is a partner of a partnership may have liabilities and obligations under the Act in both their partner and non-partner capacities.
37. Section HG 2(1), among other things, treats a partner as holding their proportionate share of the partnership property and as carrying on the partnership's activity and having the partnership's status, intention and purpose – which would include whether the partnership was carrying on a business. For example, where a partnership is racing bloodstock, each partner will be treated as owning a proportionate share of a horse used for racing. It would also include the partnership's intention in acquiring the horse.
38. Therefore, in the Commissioner's view, s HG 2(1) treats a partnership interest as separate from a partner's other property. This means that property a partner owns through one partnership is treated separately from property that the partner owns in their own name or through another partnership. Therefore, an interest in a horse that one partnership owns cannot generally be treated as being used in a bloodstock breeding business that the partner or another partnership is carrying on. However, s EC 39(1)(c) can apply to the partner's share of the partnership bloodstock in some situations.
39. Where a partner in the partnership in question[2] is also carrying on a bloodstock breeding business outside of the partnership, s EC 39(1)(c) will apply if the partnership bloodstock is bought with the intention of using it **for breeding in the partner's separate breeding business**. To establish this intention, the Commissioner would generally expect the partner to either:
    - have a right to use the horse (for example, where the partnership purchased the horse to provide service rights to the partners and the partner in question intends to use those service rights in their separate breeding business). Usually this right would be reflected in the partnership agreement; or
    - otherwise have the ability to control where the partnership bloodstock is used for breeding (for example, the partner in question has the power to use the horse in their other breeding business and intends to do so).
40. Section EC 39 can also be applied to the partner's proportionate share of any racing bloodstock that is treated as being part of their bloodstock breeding business under s EC 46 (as discussed at [32]). This treatment will be the same whether the bloodstock breeding business is being carried on:
    - directly (in the partner's own name); or
    - through the partner's investment in one or more other partnerships where at least one of those partnerships is carrying on a bloodstock breeding business.
41. The partner can apply this write-down only once. If the partnership later uses the bloodstock in a breeding business, the partner cannot obtain a second write-down. However, any partners that have not previously claimed the write-down will be entitled to claim it at this time.

Carrying on a breeding business through a joint venture

42. Some arrangements may involve a joint venture rather than a partnership. In that case s HG 2 does not apply. Instead, under s HG 1, each person in a joint venture must calculate their net income for a tax year taking into account their share of the joint income and deductions. Where a person purchases a horse as part of a joint venture, they will be allowed a deduction under s EC 39(1)(c) if the person individually, or the joint venture, intends to use the horse in an existing bloodstock breeding business. It is not necessary to have an agreement with the other joint venture members, or control over the horse, to claim a deduction, in contrast to the situation where a partnership owns the horse (as discussed at [39]). In other words, the joint venture investment is treated as part of the person's individual existing bloodstock breeding business.

Treatment where bloodstock sold before breeding

43. As set out above, a person will **not** be carrying on a bloodstock breeding business if they purchase a single horse with a view to using it for breeding in the future and, in the meantime, race it to try to improve its future breeding value. However, if the person was carrying on a bloodstock breeding business, an issue arises as to how to treat bloodstock that they sell (either before or after using that horse for breeding).
44. At the end of each income year, the closing value of the bloodstock[3] is income under s CH 1(3). The taxpayer is then allowed a deduction for that amount under s DB 49(3) in the following income year.

[2] The partnership that is not carrying on a bloodstock breeding business.

[3] The closing value is the cost price less the reduction for the year or the opening value less the reduction for the year as appropriate.

45. If a person sells bloodstock during an income year, the sale proceeds will be income. There will be no year-end add back in the year of sale for any carrying value for the bloodstock sold. This effectively means they are allowed a deduction for the remaining value of the bloodstock (that is, the cost price less any previous write-down).

Explanation – GST

46. We have also been asked whether a person would be carrying on a taxable activity from the time they purchase the first horse in a situation that has the following characteristics:
    - The horse selected is a thoroughbred horse with a top pedigree and cost in excess of $200,000.
    - The person engages an experienced manager with the necessary contacts to carry out actions needed to implement the breeding plan once the person reaches the phase of actually breeding the bloodstock.
    - The person engages an experienced trainer with a history of training successful racehorses.
    - The person implements (and follows) a detailed plan covering the purchase of the horse, care, training, racing and breeding, including the estimated timeframes and cost for each stage.
47. This scenario is different to the one considered in QB 17/04 "Goods and services tax — whether a racing syndicate can be a registered person" *Tax Information Bulletin* Vol 29, No 6 (July 2017); 36. QB 17/04 covers the situation where a person carries on horse racing as a stand-alone activity. In contrast, the specific scenario considered here involves a person who has purchased a top pedigree horse with a view to breeding from it; they are undertaking the racing activity solely to improve potential breeding value.
48. To be a "taxable activity", the following three requirements must be satisfied:
    - there is an activity;
    - a person carries on the activity continuously or regularly; and
    - the activity involves, or is intended to involve, supplies made to any other person for a consideration.
49. Even if no actual supplies have been made, the definition of "taxable activity" may still be satisfied if the person has an "intention" that the activity will involve the making of supplies. Any stated intention of making supplies must be tested objectively.
50. Section 6(2) of the Goods and Services Tax Act 1985 treats anything done in connection with the beginning or ending (including a premature ending) of a taxable activity as being carried out in the course or furtherance of the taxable activity. However, s 6(2) cannot create a taxable activity where one would otherwise not exist; rather, s 6(2) adds the commencement activity to the taxable activity.
51. Section 6(3) excludes from a taxable activity any activity that is carried on (or that if carried on by a natural person would be carried on) essentially as a private recreational pursuit or hobby.
52. The Goods and Services Tax Act 1985 does not distinguish between racing and breeding activities. For this reason, a taxable activity could involve either racing or breeding or both. Whether a taxpayer is carrying on a taxable activity is a question of fact that must be considered in each case, taking into account the legal arrangements they have entered into and whether the taxpayer's subsequent actions support the stated intention.
53. However, the Commissioner's view is that a person that meets the above criteria will most likely be carrying on a taxable activity from the time they acquire the bloodstock. In particular, on the specific facts set out at para [46], the person is unlikely to be subject to the private recreational pursuit or hobby exclusion (in the absence of any additional facts that demonstrate that).
54. Where the person is carrying on a taxable activity, input tax may be deducted for any goods or services used or available for use in making taxable supplies (that satisfy the requirements of s 20(3C) of the Goods and Services Tax Act 1985). Therefore, the person would be able to deduct input tax on the cost of the horse and ongoing expenses in relation to the taxable activity as long as they meet legislative requirements (for example, holding the relevant tax invoice).
55. The person must also return GST on any supplies that they make (including race winnings and any bloodstock sold).

References

Legislative References

Goods and Services Tax Act 1985: ss 6 and 20(3C)

Income Tax Act 2007: ss CH 1(3), CW 60, DB 49(3), DW 2, EC 39 to EC 48, HG 1 and HG 2

Case References

Calkin v CIR (1984) 6 NZTC 61,781 (CA)

Case K40 (1988) 10 NZTC 343

Case X28 90 ATC 276

Drummond v CIR (2013) 26 NZTC 21-023; [2013] NZHC 1,768

Grieve v CIR (1984) 6 NZTC 61,682

MR & SL Block v FCT (2007) ATC 2,735

Other References

QB 17/04 "Goods and services tax — whether a racing syndicate can be a registered person" *Tax Information Bulletin* Vol 29, No 6 (July 2017); 36. **https://www.taxtechnical.ird.govt.nz/tib/volume-29---2017/tib-vol29-no6**

"New legislation: Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Act 2019", Tax Information Bulletin Vol 31, No 4 (May 2019): 3. **https://www.taxtechnical.ird.govt.nz/tib/volume-31---2019/tib-vol31-no4**

LEGAL DECISIONS – CASE SUMMARIES

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.

Case summary

Taxation Review Authority reconfirms that backdated ACC weekly compensation is taxed in the year of receipt; s 9 of the NZBORA does not support the Disputant's position

Decision date: 23 August 2022

CSUM 22/03

Case

Disputant v Commissioner of Inland Revenue [2022] NZTRA 2

Legislative References

Income Tax Act 2007, s BD 3;

Accident Compensation Act 2001, s 252;

New Zealand Bill of Rights Act, ss 6 and 9.

Legal terms

Backdated ACC weekly compensation; income; derive; cash basis; NZBORA.

Forum

Taxation Review Authority

Summary

The Disputant challenged her income tax assessment for the year ended 31 March 2017 ("the Period in Dispute"). The Accident Compensation Corporation ("ACC") made a gross payment of $363,808.36 ("the ACC Weekly Compensation Payment") to the Disputant in the Period in Dispute. The Commissioner of Inland Revenue ("the Commissioner") taxed the entire ACC Weekly Compensation Payment in the Period in Dispute, when the Disputant received it.

Impact

The decision reaffirms that an individual who has no trade, and who receives backdated ACC weekly compensation, is taxed on a cash basis (ie, in the year of receipt) in accordance with s BD 3 (2) of the Income Tax Act 2007 ("the ITA 2007"). The decision also confirms that the High Court case of *Hollis v Commissioner of Inland Revenue* (2010) 24 NZTC 23,967 (HC), is still the leading authority in this area of the law. Finally, the decision asserts that s 9 of the New Zealand Bill of Rights Act 1990 (NZBORA) does not support the Disputant's position.

Facts

From the income tax year ended 31 March 1995 to June 2015 the Disputant received ACC payments relating to an injury. In that period there were times when she was not paid any ACC weekly support.

On 20 September 2016, ACC issued a letter to the Disputant saying that:

- it had reviewed her entitlement for the period from 26 July 2000 to 7 August 2016; and
- she was entitled to a net payment of $340,508.78.

After adjustments, the Disputant received a payment of $363,808.36 in the tax year ending 31 March 2017; of that $328,032.71 related to the compensation that should have been paid in the tax years ending 2001 to 2016.

In the period from 31 March 1999 onwards, the Disputant was not self-employed or trading on her own account.

Issues

As there was no factual dispute to resolve, the Taxation Review Authority ("the Authority") was required to determine:

- What is the correct tax treatment of the lumpsum payment; and
- Does section 9 of the NZBORA affect the application or interpretation of the legislation?

Decision

Tax treatment of the lumpsum payment

The Authority determined that the Disputant was correctly taxed in the year she received the payment in arrears.

The Disputant's main argument was that the correct tax treatment is to tax the ACC Weekly Payment in the years they accrued. In addition, she argued that taxing the income in the year of receipt is "degrading" or "disproportionately severe treatment" under s 9 of the NZBORA.

The Commissioner, on the other hand, argued that the law unequivocally required the lumpsum be taxed as income in the year of receipt and accordingly have the tax rate applicable to that year applied.

The Authority noted that if the income was derived in the years to which the back payments relate, she would have derived it at that time. If the Disputant were correct, she would have been obliged to include the income in her tax returns and pay tax. If an attempt were made to go back and amend assessments from earlier years, the Disputant would potentially be liable for late payment penalties and use of money interest. The only reasonable time to tax the compensation is at the time of payment or later.

The Authority rejected all the disputant's contentions; not only because of the long line of authority but because they were fundamentally flawed in principle.

The Authority held that taxing backdated weekly compensation payments in the year of receipt is long established and a deliberate policy setting in the current ITA 2007, along with consistent payment provisions in the Accident Compensation Act 2001.

Section 9 of the NZBORA

The NZBORA does not support the Disputant's position.

The Authority recognised that every statutory decision-maker is bound by the NZBORA. However, there are long standing principles for the allocation of income, with inevitable benefits and detriments to the different taxpayers.

The Authority reiterated the important principle that cash-basis taxpayers are not taxed on income they have not received.

The Disputant's situation does not reach the high threshold of being "degrading" or "disproportionately severe treatment" in terms of s 9 of the NZBORA. These circumstances do not allow statutory decision-makers to ignore the clear effect of a legislative provision.

About this document

These are brief case summaries, prepared by Inland Revenue, of decisions made by the Taxation Review Authority, the District Court, the High Court, the Court of Appeal or the Supreme Court in matters involving the Revenue Acts. For Taxation Review Authority matters, names have been anonymized. The findings of the court described in a case summary will no longer represent current law where the matter has been successfully appealed or subsequent amended legislation has been enacted.

Case summary

High Court reconfirms that backdated ACC weekly compensation is taxed in the year of receipt

Decision date: 31 August 2022

CSUM 22/04

Case

Veronica Anne Hoeberechts v Commissioner of Inland Revenue [2022] NZHC 2200.

Legislative References

Income Tax Act 2007, s BD 3;

Accident Compensation Act 2001, s 252.

Legal terms

Backdated ACC weekly compensation; income; derive; cash or accruals basis; discretion.

Forum

High Court

Revenue Type(s)

Income Tax

Summary

In November 2017, the Accident Compensation Corporation ("ACC") made a gross payment of $188,386.95 ("the ACC Weekly Compensation Payment") to Ms Hoeberechts. The Commissioner of Inland Revenue ("the Commissioner") assessed $150,000 of that amount as taxable on a cash basis and taxed the amount in the tax period when Ms Hoeberechts received it, namely the year ended 31 March 2018 ("the Period in Dispute"). On 1 October 2021, the Taxation Review Authority ("the Authority") dismissed Ms Hoeberechts challenge to her income tax assessment for the Period in Dispute.

Any appeal of the Authority's decision was required to be filed in the High Court ("the Court") by 1 November 2021. Ms Hoeberechts failed to file an appeal in the required time and sought the Court's discretion to extend the time to file. Ms Hoeberechts also sought an order from the Court dispensing with the requirement that she pay security of costs and for the appointment of an *amicus curiae*. The Commissioner opposed the application.

Impact

The decision reaffirms that an individual who has no trade, and who receives backdated ACC weekly compensation, is taxed on a cash basis (ie, in the year of receipt) in accordance with s BD 3 (2) of the Income Tax Act 2007 ("the ITA 2007"). The decision also confirms that *Hollis v Commissioner of Inland Revenue* (2010) 24 NZTC 23,967 (HC), is still the leading authority in this area of law and continues to apply so long as income tax legislation continues to use (as it does) general terms such as "income" and "derive". Finally, the decision reiterates the higher courts position that liability under income tax legislation is imposed by statute and not by the Commissioner.

Facts

The ACC Weekly Compensation Payment received in November 2017 was in respect of an injury that Ms Hoeberechts suffered in 2014. The ACC Weekly Compensation Payment resulted from a decision of the District Court in 2017, overturning ACC's view of Ms Hoeberechts' entitlement. The ACC Weekly Compensation Payment was therefore backdated compensation, being in respect of shortfalls in compensation ACC should have paid to Ms Hoeberechts.

ACC allocated the ACC Weekly Compensation Payment in the following way:

- ACC paid $38,386.65 to the Ministry of Social Development in respect of the taxable benefit that Ms Hoeberechts had received from it from April 2014 to September 2017; and
- ACC treated the balance of the payment (roughly $150,000) as a PAYE payment, paying the tax due to Inland Revenue and the remainder to Ms Hoeberechts.

The Commissioner assessed the $150,000 as taxable on a cash basis for the tax year ended 31 March 2018. Ms Hoeberechts challenged that assessment before the Authority arguing that rather than taxing the ACC Weekly Compensation Payment in the year of receipt, it should have been taxed on an accrual basis – that is, spread across the tax years ended 31 March 2015 to 2018. She also argued that the Commissioner had a discretion to apply the lower tax rates that would have applied had the ACC Weekly Compensation Payment been allocated to the tax years over which her entitlement to ACC compensation had accrued. Ms Hoeberechts also argued that the conduct by the Commissioner was "reprehensible".

In a decision dated 1 October 2021, the Authority rejected all of Ms Hoeberechts' contentions and confirmed the Commissioner's assessment for the Period in Dispute. The case manager emailed the decision to Ms Hoeberechts advising her that any appeal must be brought within 20 working days. The final day for Ms Hoeberechts to file her appeal was 1 November 2021. She filed her appeal late. Ms Hoeberechts' letter seeking leave to file out of time was accepted by the Court on 10 November and on 11 November, she provided the Commissioner with a copy of the notice of appeal (but not the letter). A full set of documents was not served on the Commissioner until 25 November 2021 with Ms Hoeberechts saying that COVID-19 restrictions had caused the delay in her filing and serving the documents.

Issues

The issues that the Court were required to determine were whether it should grant Ms Hoeberechts' applications for:

- an extension of time to file her appeal;
- dispensing with the requirement to pay security of costs; and
- an *amicus curiae* to be appointed.

Decision

The Court was satisfied that the delay was attributable in part to difficulties experienced as a result of restrictions that were then in place to control COVID-19. Therefore, the only basis on which the Court could refuse Ms Hoeberechts' extension would be that the proposed appeal is clearly hopeless; that on the facts to which there is no challenge the appeal cannot possibly succeed. This was the basis on which the Commissioner opposed leave and was the principal issue on the application.

Ms Hoeberechts wished to advance two grounds for appealing the Authority's dismissal:

- Firstly, that the Authority erred in concluding that the Commissioner correctly taxed the $150,000 backdated weekly compensation payment on a cash basis for the tax year ended 31 March 2018 — the tax year in which Ms Hoeberechts received the payment. The Court referred to this as the *tax treatment ground*.
- Secondly, that even if the Authority were correct in its view of the Commissioner's tax treatment of the backdated payment, the Authority erred in holding that the Commissioner had no discretionary power to alter the usual application of tax laws. The Court refereed to this as *the discretionary ground*.

Tax treatment ground

The Court upheld the Authority's determination that Ms Hoeberechts was correctly taxed in the year she received the ACC Weekly Compensation Payment.

The Court referred to s BD 3 (2) of the ITA 2007, which sets out the general rule for allocating income to a particular income year and held that there was no suggestion that any provision of Parts C or E to I of the ITA 2007 provides for allocation on another basis.

It also referred to *Hollis v Commissioner of Inland Revenue*, which the Authority relied on, as case law that continues to apply. The Court concluded that on Ms Hoeberechts' proposed appeal, the Court (and any appellate court) would be bound to apply the principle that taxpayers who are not in trade are appropriately taxed on a cash basis. On the unchallenged facts, the Court held that Ms Hoeberechts cannot possibly succeed on the first ground of her proposed appeal.

The discretionary ground

The Court ratified the Authority's decision that the Commissioner has no discretionary power to alter the usual application of tax laws. Liability under income tax legislation is imposed by statute, not by the Commissioner.

Ms Hoeberechts had argued that the Commissioner has a discretionary power to alter the usual application of tax law and that it should be exercised to ensure that ACC claimants receiving backdated payments are taxed at a rate that provides a more accurate accounting of their income from the date of their incapacitating injuries.

The Court rejected this argument and reaffirmed that the Commissioner has no discretion to exercise when assessing the amount of a taxpayer's liability – and it is the assessment of Ms Hoeberechts' tax liability that would be at issue in the proposed appeal.

Thus, the Court concluded that Ms Hoeberechts cannot possibly succeed on the second ground of the proposed appeal.

Conclusion

The Court declined to extend time for Ms Hoeberechts' to file her appeal which meant it was unnecessary to address the two subsidiary questions as to security for costs and the appointment of an *amicus curiae*.

Although sympathetic to the position in which Ms Hoeberechts has been placed by ACC's late payment of her entitlements in that she has been exposed to a higher rate of tax than she would have incurred had ACC paid her entitlements on time, Justice Campbell said he had no doubt that that treatment is in accordance with the ITA 2007 and that "any change in that treatment is a matter for Parliament. Neither the Commissioner, the Authority nor this Court has power to effect any such change".

About this document

These are brief case summaries, prepared by Inland Revenue, of decisions made by the Taxation Review Authority, the District Court, the High Court, the Court of Appeal or the Supreme Court in matters involving the Revenue Acts. For Taxation Review Authority matters, names have been anonymized. The findings of the court described in a case summary will no longer represent current law where the matter has been successfully appealed or subsequent amended legislation has been enacted.

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