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TAX INFORMATION
Bulletin

CONTENTS

3 **New legislation**
Public Act 2023 No 70 – Taxation Principles Reporting Act Repeal Act 2023
SL2023/288 – Order in Council – Income Tax (Tax Credit) Order 2023

6 **Rulings**
BR Prd 23/02: Waka Kotahi NZ Transport Agency
BR Prd 23/03: Everlasting Nominees Limited
BR Prd 23/04: Everlasting Nominees Limited
BR Prd 23/05: Everlasting Nominees Limited
BR Prd 23/06: WorkRide Limited

34 **Interpretation statement**
IS 23/11: Income tax: Income – when gifts are assessable income

67 **Questions we've been asked**
QB 23/08: Income tax – deductibility of expenditure – renting to flatmates
QB 23/09: Income tax – Forfeited deposits from cancelled land sale agreements
QB 23/10: Foreign investment fund (FIF) calculation methods in cases of non-compliance

94 **Technical decision summaries**
TDS 23/14: Omitted income, shortfall penalties
TDS 23/15: Income Tax and GST – Omitted business income and liability for shortfall penalties
TDS 23/16: Income Tax and GST – Omitted business income and liability for shortfall penalties
TDS 23/17: Income Tax – Omitted income and liability for shortfall penalties
TDS 23/18: Income Tax – Omitted income and liability for shortfall penalties
TDS 23/19: Income Tax – Omitted income and liability for shortfall penalties
TDS 23/20: Deductibility of retention payments
TDS 24/01: Interest free loan and dividends

Inland Revenue
Te Tari Taake

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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 **ird.govt.nz/subscription-service/subscription-form** to receive regular email updates when we publish new draft items for comment.

Ref	Draft type	Title	Comment deadline
ED00253	Determination	Tax Depreciation Rate for metal (scrap) recovery plant	29 February 2024

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IN SUMMARY

New legislation

Public Act 2023 No 70 – Taxation Principles Reporting Act Repeal Act 2023 3

This legislation repeals the requirement on the Commissioner of Inland Revenue to produce reports that was established under the Taxation Principles Reporting Act 2023.

SL2023/288 – Order in Council – Income Tax (Tax Credit) Order 2023 5

The Income Tax (Tax Credit) Order 2023 was made on 27 November 2023. The order increases the Family Tax Credit (FTC) and Best Start Tax Credit (BSTC) amounts in line with inflation. This will take effect from 1 April 2024.

Rulings

BR Prd 23/02: Waka Kotahi NZ Transport Agency 6

This ruling applies to participants in the National Ticketing Solution to be administered by Waka Kotahi NZ Transport Agency across New Zealand.

BR Prd 23/03: Everlasting Nominees Limited 12

This ruling applies to a transfer of digital assets from a business of dealing in cryptocurrency into Everlasting's Estate or Staking investment products, and subsequent transfers out of those products (for example, to beneficiaries).

BR Prd 23/04: Everlasting Nominees Limited 18

This ruling applies to a transfer of digital assets into Everlasting's Estate or Staking investment products in circumstances where the client does not hold the digital assets in a business of dealing in cryptocurrency, and did not originally acquire the digital assets for the dominant purpose of disposal. This ruling also applies to subsequent transfers out of the Estate and Staking investment products (for example, to beneficiaries).

BR Prd 23/05: Everlasting Nominees Limited 24

This ruling applies to the transfer of digital assets into Everlasting's Estate or Staking investment products in circumstances where the client does not hold the digital assets in a business of dealing in cryptocurrency, but the client's digital assets were originally acquired for the dominant purpose of disposal. This ruling also applies to subsequent transfers out of the Estate and Staking investment products (for example, to beneficiaries).

BR Prd 23/06: WorkRide Limited 31

The arrangement is WorkRide's provision of self-powered or low-powered commuting vehicles (equipment) to the employees of WorkRide's customers, where the employees agree to a temporary reduction in salary in return for the temporary lease and the opportunity to own the equipment at the end of the lease period. Examples of equipment are bicycles, electric bicycles, scooters and electric scooters.

Interpretation statement

IS 23/11: Income tax: Income – when gifts are assessable income 34

A gift is not usually subject to income tax. This interpretation statement considers the circumstances in which a gift is subject to income tax in the recipient's hands. The statement applies both to monetary gifts and to non-monetary gifts that are convertible to money. It does not apply to gifts that are not subject to income tax but may be family scheme income for the purposes of Working for Families tax credits.

Questions we've been asked

QB 23/08: Income tax – deductibility of expenditure – renting to flatmates 67

This Question we've been asked explains when a person can claim deductions for expenditure incurred in deriving rental income, where the person rents a room in their home to a flatmate. It considers the possible application of the interest limitation, residential ring-fencing and mixed-use asset rules.

QB 23/09: Income tax – Forfeited deposits from cancelled land sale agreements 75
This Question we've been asked clarifies the circumstances in which a forfeited deposit from a cancelled land sale agreement is income to the seller.

QB 23/10: Foreign investment fund (FIF) calculation methods in cases of non-compliance 86
This Question we've been asked explains that a person has a choice of methods to calculate FIF income even if they fail to declare the income in a tax return and later file a voluntary disclosure, or fail to file a tax return by the due date and later provide one including the income. It also explains what happens if a person does not file a return and the Commissioner issues a default assessment. This item is particularly relevant for natural persons and eligible trustees.

Technical decision summaries

TDS 23/14: Omitted income, shortfall penalties 94
Whether the Taxpayer returned all their assessable income for the income years in dispute. If not, whether the Taxpayer was liable for shortfall penalties.

TDS 23/15: Income Tax and GST – Omitted business income and liability for shortfall penalties 101
Income tax, GST: Omitted business income; Tax Administration Act: Shortfall penalties, onus and standard of proof.

TDS 23/16: Income Tax and GST – Omitted business income and liability for shortfall penalties 108
Income tax, GST: Omitted business income; Tax Administration Act: Shortfall penalties, onus and standard of proof.

TDS 23/17: Income Tax – Omitted income and liability for shortfall penalties 114
Income tax: Omitted employment income; Tax Administration Act: Shortfall penalties, onus and standard of proof.

TDS 23/18: Income Tax – Omitted income and liability for shortfall penalties 119
Income tax: Omitted employment income; Tax Administration Act: Shortfall penalties, onus and standard of proof.

TDS 23/19: Income Tax – Omitted income and liability for shortfall penalties 124
Income tax: Omitted employment income; Tax Administration Act: Shortfall penalties, onus and standard of proof.

TDS 23/20: Deductibility of retention payments 129
Income tax: Deductibility of expenditure, general permission, capital limitation, consolidated group deductions, timing of deductions.

TDS 24/01: Interest free loan and dividends 132
Income tax: Capitalisation of company structure; interest free loan whether a dividend arises; withholding tax; tax avoidance.

NEW LEGISLATION

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

Public Act 2023 No 70 – Taxation Principles Reporting Act Repeal Act 2023

Overview

The Taxation Principles Reporting Act 2023 was introduced on 18 May 2023. It received its first reading on the same day, its second reading on 15 August 2023 and its third reading on 22 August 2023. The new Act received Royal assent on 30 August 2023 and came into effect on 31 August 2023. It introduced a set of tax principles and descriptors, and a regular reporting process based around those principles.

The Taxation Principles Reporting Act Repeal Act 2023 was introduced on 19 December 2023 and passed on 21 December 2023. The new Act received Royal assent on 22 December 2023 and repealed the Taxation Principles Reporting Act 2023 the following day.

Taxation Principles Reporting Act Repeal Act 2023

The Taxation Principles Reporting Act Repeal Act 2023 is a short piece of legislation designed to repeal the Taxation Principles Reporting Act 2023 (the "original Act").

The legislation was introduced and went through all stages under urgency. As the original Act was repealed prior to 31 December 2023, the requirement to present the first interim report and all subsequent reports under the original Act is no longer required.

Key features

The main features are:

- repeal of the Taxation Principles Reporting Act 2023
- remove the Taxation Principles Reporting Act 2023 from the list of Inland Revenue Acts in Schedule 1 of the Tax Administration Act 1994, and
- remove the new Act from the statute books on 1 January 2025.

Effective date

The legislation takes effect on 23 December 2023, the day after Royal assent. The Act will be removed from the statute books on 1 January 2025.

Detailed analysis

Repeal of the Taxation Principles Reporting Act 2023

On the commencement of this Act (23 December 2023), the Taxation Principles Reporting Act 2023 is repealed. All requirements of the reporting framework under the original Act are removed immediately. Schedule 1 of the original Act, setting out taxation principles and their descriptors and a statement on the general purpose of a tax system, are also repealed.

The main features of the original Act were:

- The obligation on the Commissioner of Inland Revenue to produce either an interim or full report annually. The reports would be published by the Commissioner and the full report would be tabled in Parliament. A full report would be required every three years starting from 2025. The first interim report was required by 31 December 2023
- The taxation principles and descriptions contained within Schedule 1 of the Act around which the reports would be focused
- The approved taxation principles measurements which would be the measures to be included in the reports that provide information relevant to the taxation principles

- Information and privacy would be protected, and
- There would be no effect on revenue assessments, and the reports and principles could not be used as evidence in a matter of law, that is, they were for information purposes only.

As a consequential change, the Taxation Principles Reporting Act 2023 is removed from the list of Inland Revenue Acts in Schedule 1 of the Tax Administration Act 1994.

Inland Revenue will continue to report and publish information as required under other pieces of legislation including:

- Public Finance Act 1989, a requirement to provide information on the appropriations and performance measures under Vote Revenue, and a statement of significant tax policy decisions with material impact on appropriations or tax revenue forecasts
- Tax Administration Act 1994, a requirement to provide an annual report on the administration of the Inland Revenue Acts, and
- Public Service Act 2020, a requirement to prepare a Long-term insights briefing and uphold the principle of stewardship.

Repeal of the Taxation Principles Reporting Act Repeal Act 2023

The Act contains a provision to repeal itself on 1 January 2025. Having completed its primary task of repealing the Taxation Principles Reporting Act 2023 it has no further purpose and contains no ongoing duties or powers. The Act contains a provision to remove itself from the list of active legislation, removing the need for it to be later included in a Statutes Repeal Bill. The repeal occurs a year after commencement to enable time for people who are interested in the legislation to find it on the main NZ Legislation website. The website also contains an ability to search for a list of repealed Acts.

Further information

For more information, refer: https://www.legislation.govt.nz/act/public/2023/0070/16.0/whole.html#LMS927032

Order in Council – Income Tax (Tax Credit) Order 2023

Order (SL2023/288)

Section MF 7 of the Income Tax Act 2007

The Income Tax (Tax Credit) Order 2023, made on 29 November 2023, increases the Family Tax Credit (FTC) and Best Start Tax Credit (BSTC) amounts in line with inflation. This will take effect from 1 April 2024.

Background

Under the Income Tax Act 2007, the FTC and BSTC payment rates must be adjusted for inflation once the cumulative value of quarterly increases in the Consumers Price Index (CPI) reaches 5%. These inflation-indexed increases ensure FTC and BSTC maintain their real value over time.

The standard process for setting and authorising the rates through an Order n Council is set out in the Income Tax Act 2007 (the Act). The Order in Council must be made no later than 1 December and come into effect and apply from 1 April following that date.

The cumulative CPI threshold released on 17 October 2023 was 5.65% from 1 October 2022 to 30 September 2023, which will automatically trigger a higher rate of WFF payment rates from 1 April 2024.

Key features

The FTC and BSTC have been increased under section MF 7 of the Act. The tax credit amounts per year before and after are provided in the table below:

Tax Credit	Current amount	New amount
Family Tax Credit		
Eldest child	$7,121	$7,524
Subsequent child	$5,802	$6,130
Best Start Tax Credit	$3,632	$3,838

The FTC amounts for the first and subsequent child in sections MD 3(4)(a) and (b) have been increased for inflation in accordance with section MF 7(1)(a) of the Act. The BSTC amount has also been adjusted for inflation under section MF 7(1)(db).

Effective date

The new prescribed tax credit amounts will apply for the 2024–25 and later tax years.

Further information

The new regulations can be found at: https://www.legislation.govt.nz/regulation/public/2023/0288/latest/whole.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**

Product Ruling – BR Prd 23/02

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 Waka Kotahi NZ Transport Agency (Waka Kotahi).

Taxation Laws

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

This Ruling applies in respect of ss 5(11D) – 5(11H), 8(1), 9(1), 17K(10) and 60(1).

The Arrangement to which this Ruling applies

The Arrangement is the National Ticketing Solution to be administered by Waka Kotahi across New Zealand. The National Ticketing Solution will include the:

- sale or transfer of rights to use physical and virtual Transit Cards;
- ability to top up physical and virtual Transit Cards;
- use of Transit Cards or contactless payment cards to pay for transport services;
- ability to purchase Transit Products, including period passes and set trip passes; and
- establishment of Transit Accounts linked to either a Transit Card or a contactless payment card.

The Arrangement is documented in the following agreements:

- the National Ticketing Solution Participation Agreement (the Participation Agreement) dated 14 October 2022, entered into between Waka Kotahi and Participants in the National Ticketing Solution;
- the supplementary agreement to the Participation Agreement documenting additional terms and conditions agreed between the parties (currently draft); and
- the following Master Services Agreements (MSAs) entered into between Waka Kotahi and the Service Providers:
    - Merchant Acquirer MSA dated 17 August 2023;
    - Retail Network Manager MSA dated 1 March 2023;
    - Ticketing Service Provider MSA dated 21 October 2022; and
    - Transit Card Program Manager MSA dated 15 August 2023.

Capitalised terms are as defined in the above agreements.

Further details of the Arrangement are set out below.

The Parties to the National Ticketing Solution

1. Waka Kotahi is the Crown agency responsible for overseeing and implementing the National Ticketing Solution. Waka Kotahi is GST registered and carries on a taxable activity as a Crown agency overseeing the land transportation system in New Zealand.

2. Public Transport Authorities are responsible for procuring, providing and managing public transport services in a region or district. The Public Transport Authorities are:
   - Auckland Transport;
   - Greater Wellington Regional Council;
   - Environment Canterbury; and
   - members of the Regional Consortium comprising 10 local authorities (Northland Regional Council, Waikato Regional Council, Bay of Plenty Regional Council, Taranaki Regional Council, Gisborne District Council, Horizons Regional Council, Hawkes Bay Regional Council, Nelson City Council, Otago Regional Council, and Invercargill City Council).
3. Transport Service Owners include a Public Transport Authority and a Transport Operator that owns and operates a transport service and is contracted to a Transport Service Owner.

The Participation Agreement

4. Waka Kotahi and the Public Transport Authorities have entered into the Participation Agreement, dated 14 October 2022. A Transport Service Owner may also become a participant if it signs on to access the National Ticketing Solution. Together, the Public Transport Authorities and any other Transport Service Owners or Transport Operators that sign on to the Participation Agreement are referred to as "Participants".
5. The Participation Agreement sets out the broad principles on which the National Ticketing Solution will operate. The agreement records the parties' agreement for the governance, cost allocation, transition planning, establishment, implementation, transition and operation of the National Ticketing Solution. The Participation Agreement will be supported by Rules.
6. Relevantly, the National Ticketing Solution is only a ticketing and payment solution. Each Participant remains responsible for the delivery of public transport services (cl 6.3 of the Participation Agreement).
7. No formal agency relationship is established between the parties (cl 28.6 of the Participation Agreement). However, the parties to the Participation Agreement agree to allocate fare revenue to the relevant party or parties who provide the public transport service. Any party that collects payment for the purchase of a Transit Card, a Top-up of a Transit Account and/or the purchase of a Transit Product will release the payment promptly to Waka Kotahi's nominated bank account (cl 9.2 of the Participation Agreement).
8. The supplementary agreement to the Participation Agreement will be entered into between Waka Kotahi and the Participants, agreeing further terms and conditions. The further terms and conditions will establish the following:
   - The Participant is appointed to sell Transit Card Rights and Top-Ups as agent for and on behalf of Waka Kotahi.
   - The Participant agrees that when it sells Transit Products it will receive the sale amounts as stakeholder for the benefit of itself and/or Waka Kotahi.
   - The Participant will pay all amounts received from sales of Transit Card Rights, Top-ups or Transit Products into the account nominated by Waka Kotahi.
   - Waka Kotahi (or its agent) will hold amounts received for Top-ups and Transit Products as stakeholder for the benefit of itself and/or the relevant Participant that supplies the public transport services.
   - The Participant will not treat itself as principal or account for GST for amounts received at the time of sale of any Transit Card Rights or Top-ups. Similarly, the Participant will not account for GST at the time of sale of the Transit Products.
   - Where a customer purchases transport services using a contactless payment card, the fare proceeds will be paid into an account nominated by Waka Kotahi, and Waka Kotahi will receive the fare proceeds as stakeholder for the benefit of itself and/or the relevant Participant that supplies the transportation services. Waka Kotahi agrees it will not treat itself as principal for the supply of the transport, or account for GST on the supply.
   - The Participant agrees it will account for GST on amounts received for the supply of transport paid for by a Transit Card or a contactless payment card on receipt of such amounts from Waka Kotahi as the stakeholder.
   - The Participant agrees it will account for GST on amounts received for the issue of Transit Products when Waka Kotahi releases such amounts from its nominated stakeholder account to a Participant's nominated account.

Services agreements

9. Waka Kotahi also contracts with and manages Service Providers to facilitate the provision of the National Ticketing Solution. Waka Kotahi is the buyer and contracting party under each service contract for the benefit of itself and each Participant under the Participation Agreement.
10. Waka Kotahi has contracted the following service providers:
    - Merchant Acquirer - ASB Bank Limited (ASB);
    - Retail Network Manager - Activata Prepay Limited (Activata);
    - Ticketing Service Provider - Cubic Transportation Systems New Zealand Limited (Cubic); and
    - Transit Card Program Manager - Mastercard Prepaid Management Services (NZ) Limited (MPMS).
11. Under the Merchant Acquirer MSA, ASB is responsible for processing the fare payments received from contactless payment cards and Transit Cards and settling amounts into Waka Kotahi's stakeholder account as merchant.
12. Under the Retail Network Manager MSA, Activata is responsible for physical Transit Card sales and Top-ups through a network of retailers.
13. Under the Ticketing Service Provider MSA, Cubic is responsible for providing the Ticketing Solution platform services and equipment and being the system integrator for the Ticketing Solution.
14. Under the Transit Card Program Manager MSA, MPMS is responsible for manufacturing Transit Cards, replenishing retailer Transit Card stock, and administering Transit Accounts.

The National Ticketing Solution

15. The National Ticketing Solution aims to improve public transport for New Zealanders by having:
    - a standardised approach to paying for public transport, providing a common customer experience no matter where a person is in the country; and
    - flexible options for payment, including new technology.
16. When a customer tags on and off public transport services, Cubic's systems will record the:
    - name of the transport operator;
    - total fare; and
    - date and time of travel.
17. This information will be used to distribute the fare revenue to the relevant Participant.

Fare payment methods

18. The National Ticketing Solution will provide customers with three payment methods for public transport:
    - an existing bank issued contactless payment card (such as a debit card or credit card);
    - a physical Transit Card; or
    - a virtual Transit Card.
19. Customers can use their physical or virtual Transit Card or contactless payment card to "tag on and off" public transport. Tagging on and off refers to the customer's act of scanning a card at a card reader as they board and later alight from public transport. The Applicant expects most customers to use contactless payment cards rather than Transit Cards.
20. In addition, customers will be able to purchase Transit Products that include monthly or weekly passes and set trip passes (for example, 10-trip passes). Transit Products will be:
    - issued in paper form; or
    - issued as a scannable product on a device; or
    - stored in a customer's Transit Account which will be linked to a contactless payment card or a Transit Card.

Transit Cards

21. Customers will be able to purchase the right to use a physical or virtual Transit Card. Transit Cards will be linked to a Transit Account that can be pre-loaded with stored value and/or used to access Transit Products linked to the customer.
22. Transit Cards will be able to be purchased from physical retail stores, an online web portal, a mobile app, ticket vending machines, customer service centres and contact centres.

23. MPMS will be responsible for producing the physical and virtual Transit Cards. This includes ensuring the cards are capable of contactless payments and are linked to Transit Accounts with all the requisite payment abilities.
24. Activata will manage the network of physical retail outlets through which physical Transit Cards can be purchased and topped-up with stored value.
25. When purchased using the mobile app, Transit Cards will be represented as a virtual card, accessed on a mobile device, without the customer needing a physical Transit Card.
26. When a customer receives a Transit Card, the Transit Cards will remain owned by Waka Kotahi which will grant the right to use the card to the customer. Waka Kotahi's ownership of the Transit Cards is set out in cl 23 of the Transit Card Program Manager MSA and will be confirmed in the terms and conditions of use. As the owner of the cards, Waka Kotahi will receive all payment proceeds for the rights to use the Transit Cards.
27. Where MPMS issues a Transit Card to a customer, this will be in its capacity as an agent for Waka Kotahi (cl 14.1 of the Transit Card Program Manager MSA), and it will pay the proceeds into Waka Kotahi's nominated account.
28. Where Activata and its retailers sell the rights to a physical Transit Card, this will be in their capacity as an agent for Waka Kotahi (cl 14 of the Retail Network Manager MSA), and they will pay the proceeds into Waka Kotahi's nominated account. Clause 23.1 of the Retailer Network Manager MSA records that at no time will ownership in the Transit Card pass to Activata or any retailer.
29. Where Transit Cards are issued from a ticket vending machine, kiosk or customer service centre, it will be the relevant Participant's responsibility to ensure that if it collects amounts, then those amounts are passed to Waka Kotahi (cl 9.2 of the Participation Agreement).
30. Where rights in a Transit Card are purchased online or from a contact centre, the sales amounts will be directly passed to Waka Kotahi.

Transit Account Top-ups

31. Customers will be able to top up their Transit Accounts with stored value for future transport use. The stored value in the Transit Accounts will be accessible by the customers using a physical or virtual Transit Card when tagging on and off public transport.
32. Cubic will manage Transit Accounts and be responsible for ensuring Transit Account balances are updated at the time a Top-Up is made.
33. No interest will be payable to or by customers for any positive or negative Transit Account balance. Customers may apply for a refund where they:
    - believe they have been incorrectly charged for a trip; or
    - require a full refund of a balance in a Transit Account (for example if they will no longer be requiring the account for public transport services).
34. The balance in a customer's Transit Account will be able to be used to pay for travel provided by any Transport Operator contracted to the National Ticketing Solution. Given the number of Transport Operators, it will not be possible to determine who the supplier of the transport will be at the time the stored value is loaded into a Transit Account.
35. A Transit Card may also be linked to concessions allowing particular groups discounted or free travel.
36. Top-ups will be able to be made by using physical retail stores, an online web portal, a mobile application, ticket vending machines, customer service centres, a driver console (cash only), ticket kiosks and contact centres.
37. Regardless of how a Top-up is made, the payment will be passed on to a Waka Kotahi nominated stakeholder account, and from there to EML Payment Solutions Limited (the BIN Sponsor) as stakeholder for Waka Kotahi, until the stored value is used to pay for transport.
38. EML Payment Solutions is sub-contracted by MPMS to provide payment solutions. Once transport is taken, the funds will be passed to Waka Kotahi, which (along with Cubic) will facilitate the amount due to each Participant and make payment.

Contactless Payment Cards

39. Customers will be able to use an existing bank issued contactless payment card to pay for public transport. This will be by tagging on and off at card readers installed in the various modes of transport.
40. The contactless payment card may be physical (eg, a debit or credit card) or virtual (eg, where the customer's card is accessed through their mobile device using Google Pay or Apple Pay).

41. Customers will pay for the public transport that they take by way of a charge made directly to the bank account that is linked to their card.
42. The following parties will be involved in supplying and paying for travel under the contactless payment card method:
    - Cubic is responsible for gathering trip data from customers and providing fare calculations and trip information.
    - Mastercard Payment Gateway Services (MPGS) will assist Cubic in processing payments through the payment gateway.
    - ASB is responsible for facilitating payments from customer bank accounts and passing the funds to Waka Kotahi.
    - Waka Kotahi will act as a clearing house by administering fare revenue and paying the appropriate portion of fare revenue earned to each Participant.
    - Transport Service Owners (eg, Public Transport Authorities) will be responsible for the procurement, provision and management of public transport services in a region or district.
43. Customers will not need to set up or register to use a contactless payment card to pay for public transport. Customers will be able to tag on and off public transport with any valid contactless payment card anywhere across the network. However, a customer can choose to register a Transit Account and link their contactless payment card to that account. This will also allow the customer to access Transit Products, such as monthly passes.
44. At the first tag of a contactless payment card on a particular day, a check will be run to ensure the customer's contactless payment card is valid. This check is performed using Cubic's system. When required, Cubic will send a pre-authorisation check to confirm the account is valid. A nominal charge will be applied to the customer's card account (eg, $0.10). This charge will be reversed from the customer's card once the fare charge is made.

Information sharing and payments

45. When a contactless payment card is used to tag on and off at a public transport reader, the relevant trip data will be captured by Cubic's systems.
46. Cubic will record and collate all trips taken by a customer throughout each Transit Day. The Transit Day is likely to be set to start and end at a time when public transport use is minimal (eg, from 3am).
47. At the end of each Transit Day Cubic will aggregate each customer's journeys over the previous 24 hours, calculate the lowest fare, and provide the "end of day fare calculation". Cubic will use this information to generate a payment file that it will pass (via MPGS) to ASB, enabling ASB to send a clearing/settlement file to each customer's respective card scheme operator (for example, Visa or Mastercard) in order to charge the issuing banks for the Transit Day's travel. ASB will credit these amounts into Waka Kotahi's nominated account.
48. At the end of each Transit Day, Cubic will provide a payment file to Waka Kotahi that will detail the amount of fare revenue generated throughout each Transit Day, and the apportionment breakdown of the fare revenue to be paid to each Participant. Waka Kotahi will use this information to facilitate the right payments to the right entity for the transport supplied.
49. It could take two or three days for the above process to be completed and for the Participants to receive payment.
50. Each Transport Service Owner may distribute payments to the various Transport Operators in its regions that have provided the public transport service. Where a Transport Operator is not directly engaged in the National Ticketing Solution, the revenue earned will be in accordance with its usual commercial contracts. Transport Service Owners retain responsibility and accountability for the ongoing management and operation of public transport services.
51. American Express (AMEX) cards will also be able to be used under the contactless payment card payment model. The process as described above will be similar, except AMEX will charge the customer's AMEX customer account and transfer these amounts to Waka Kotahi, rather than ASB fulfilling this role. It is also expected that Union Pay will operate in the same manner as AMEX for their contactless payment cards (agreement still to be signed).

Transit Products

52. Transit Products broadly cover two types of products:
    - fare products, including weekly or monthly passes and set trip passes (such as a 10-trip ticket) purchased using an online portal, mobile application, customer service centre, contact centre, ticket vending machine or ticket kiosk; and
    - smart tickets, being tickets for one transport ride, represented in a customer's Transit Account or physically printed, and purchased from an online web portal, mobile application, customer service centre, ticket vending machine or at the driver console.

53. The revenue from the sale of Transit Products will initially be transferred to Waka Kotahi as stakeholder. This includes where the relevant Participant has sold the Transit Product and collected the proceeds (as stakeholder). On receipt, Waka Kotahi will, based on information Cubic provides, allocate the proceeds and distribute the Transit Product revenue to the relevant Participant.
54. The Participant that owns the Transit Product sold will receive the full payment for that Transit Product at the time the funds are released from Waka Kotahi's stakeholder account.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The terms and conditions of use of a Transit Card will be consistent with the facts set out in the Arrangement.

(b) Final versions of draft agreements will not be materially different to the versions provided to Inland Revenue.

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) The sale of the rights to use a Transit Card is a supply of services and is subject to GST under s 8(1). Under s 60(1), the supplier of these services is Waka Kotahi and not the relevant agent who sells the Transit Cards on behalf of Waka Kotahi.

(b) Under s 5(11G), the topping up of a Transit Account is not treated as a supply of goods or services, and is not subject to GST under s 8(1).

(c) The provision of public transport paid for with a contactless payment card or funds in a Transit Account is a supply of goods or services made by the relevant Participant and is subject to GST under s 8(1).

(d) Under s 9(1), the time of supply for transport services paid for with a contactless payment card or Transit Card will be the time the funds are paid out of Waka Kotahi's stakeholder account to the relevant Participant that provided the service, provided that no invoice is issued for that supply.

(e) Under s 5(11E) the sale of a Transit Product is a supply of a voucher and is subject to GST under s 8(1).

(f) Under s 9(1), the time of supply of each Transit Product will be at the time funds are paid out of Waka Kotahi's stakeholder account to the relevant Participant, provided that no invoice is issued for that supply.

(g) Under s 19K(10), the Participants will not be required to issue taxable supply information for the following taxable supplies:

- the sale of the rights to a Transit Card;
- the supply of a Transit Product; or
- the supply of public transport.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 20 October 2023 and ending on 30 June 2028.

This Ruling is signed by me on the 20th day of October 2023.

James McKeown
Tax Counsel, Tax Counsel Office

Product Ruling – BR Prd 23/03

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 Everlasting Nominees Limited (Everlasting).

Taxation Laws

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

This Ruling applies in respect of ss CA 1(2), CB 1, CB 2, CB 3, CB 4, CB 5, DA 1, DB 23, FB 1B(a), FB 1C(2), FC 1, FC 2, FC 3, GC 1, and YB 21, and subparts ED and YF.

The Arrangement to which this Ruling applies

The Arrangement is the transfer of a Client's Digital Assets from a business of dealing in cryptocurrency, which the Client carries on for the purposes of ss CB 1 and/or CB 5, into the following products provided by Everlasting:

a) **Estate:** The Client's Digital Assets are stored in the Client's (exclusive access) Wallet until any Authorised Instruction for withdrawal is received and verified. The Client does not earn Staking Rewards.

b) **Staking:** Staking is facilitated from the Client's corresponding vault (which has the same security settings as the Wallet). The Client's Digital Assets that are staked and the Staking Rewards earned are subsequently transferred back to the Client's vault and (unless further staking is facilitated) to the Client's corresponding Wallet, where they are stored until an Authorised Instruction for withdrawal is received and verified. Clients retain legal ownership of their Digital Assets throughout the staking process.

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

Documents

1. The following documents provided to Inland Revenue on 4 May 2023 describe the Arrangement, and are collectively referred to as the Contract:
   - Letter of Engagement;
   - General Terms and Conditions Everlasting Nominees Ltd (last updated 24 April 2023) (General Terms);
   - Estate Terms and Conditions Everlasting Nominees Ltd (last updated 24 April 2023) (Estate Terms); and
   - Digital Assets Staking Services Terms and Conditions (Staking Terms).
2. The final executed documentation will not be materially different from the documentation provided to Inland Revenue on 4 May 2023, as set out above.
3. Unless otherwise specified, capitalised terms have the same meaning as defined in the Contract.
4. In addition to defined terms in the Contract, in this Ruling:
   - a reference to a "Client's spouse" means their surviving spouse, de facto partner or civil union partner;
   - a reference to a "Client's will" includes a reference to the rules governing intestacy; and
   - a reference to an "executor" includes an administrator or trustee.

Everlasting Nominees Limited

5. Everlasting was incorporated in New Zealand on 12 August 2022.

The Contract

6. The Clients are individuals (provided they are over the age of 16 years) and/or their spouse, civil union or de facto partner, or a trustee of a trust, who choose to purchase Everlasting's products.
7. In respect of the Estate and Staking products, the Clients enter into the Agreements with Everlasting and, in relation to the Estate product, a Digital Executor. The Digital Executor (unless otherwise agreed by Everlasting) must be a solicitor, financial advice provider, chartered accountant, professional fiduciary or other member of a regulated professional body.

8. The Digital Assets have two data parameters:
   - a public key, which is disclosed to all participants in the system and has encoded information about the Digital Asset such as its ownership, value and transaction history; and
   - a private key, which permits transfers or other dealing in the Digital Asset to be cryptographically authenticated by digital signature.
9. The Clients (or their Authorised Representative) provide Everlasting and/or the Digital Executor (as applicable) with their signed Authorised Instructions in relation to the:
   - carrying out of any action (including staking) affecting the Client's Digital Assets and/or Wallets (Staking Terms cl 4.2 and Estate Terms cl 6.2(a));
   - transfer of the Client's Digital Assets to one or more other wallets that the Client has knowledge and control of (Estate Terms cl 6.1(b));
   - transfer of the Client's Digital Assets to their beneficiaries' wallets on the Client's death or incapacitation (Estate Terms cl 6.1(c)); and
   - issuance of a new Client Key or revocation of a Permissioned Key (General Terms cl 11.1).

Wallets and Permissioned Keys

10. Using a third-party software development platform, Everlasting establishes the Wallet(s) for the Client's Digital Assets on behalf of the Client. The smart contract that gives effect to the Wallet has programmable rules that hold the Client's Digital Assets at the contract and it only has a public key (being the address).
11. Each Wallet will have at least five individual private cryptographic Permissioned Keys (either pre-existing and/or created for the purposes of the Agreements) associated with it (Estate Terms cl 3.2(a)–(c)):
    - Everlasting Keys (two): The Everlasting Keys can only be used by Everlasting for the limited purposes of providing Estate Services in accordance with the Estate Terms and to give effect to Authorised Instructions.
    - Client Keys (two): The Client Keys are retained and controlled by the Client and will comprise their pre-existing key or a key created by the Client specifically for the purposes of the Estate Terms.
    - Digital Executor Key (one): The Digital Executor Key is retained and controlled by the Digital Executor (as either a pre-existing key or one created specifically for the purposes of the Estate Terms). The Digital Executor Key can only be used for the purpose of giving effect to Authorised Instructions.
12. In some instances (eg when spouses, civil union partners or de facto partners enter into the Agreements in relation to Digital Assets that are relationship property), there may be more than five Permissioned Keys. However, there will never be more Everlasting Keys or Digital Executor Keys than Client Keys.

Deposit of Digital Assets into Wallet

13. The Client is responsible for transferring their Digital Assets into the Wallet.

Withdrawal transactions where the Client is alive and not incapacitated

14. To withdraw the Digital Assets from the Client's Wallet, more than half of the total keys are required and at least one of those Keys must be a non-Client Key. Before the Digital Asset can be withdrawn from the Wallet, the Client must first load the transaction into the Wallet using a Client Key. Two other Permissioned Keys (usually the other Client Key and an Everlasting Key) must subsequently authorise the withdrawal. Before Everlasting uses an Everlasting Key to withdraw the Digital Asset, it completes various due diligence checks (including identity verification and liveness tests) to establish that the Client has requested the withdrawal.
15. Other than on the Client's death or incapacitation, Everlasting will only authorise transactions from the Wallet to the vault or to another wallet or vault that has not been established under the General Terms if it is satisfied the Client has knowledge of and control over this other wallet or vault. Should the Client then wish to on-transfer the Digital Asset to a third party, the Client (without Everlasting's involvement) must transfer their Digital Assets to that third party from their wallet that has not been established under the General Terms.
16. The Digital Executor Key is not usually used to authorise a withdrawal from the Wallet unless the Client has lost control over their Client Keys (and a withdrawal is required before that Client Key has been decommissioned and new Client Key created) or the Client has died or become incapacitated.

Vault and staking where the Client is alive and not incapacitated

17. In relation to the Staking services, using a third-party platform, Everlasting (on behalf of the Client) establishes one or more vaults to facilitate staking. The smart contract that gives effect to the Client's vault inherits the same security settings as the Client's Wallet(s). A Wallet will only be able to transact with the corresponding vault if the Client has loaded the transaction to the vault and, provided Everlasting is satisfied with the due diligence checks, the other Client Key(s) and Everlasting Key are used to authorise the transaction.
18. Once the Client's Digital Assets are transferred into the corresponding vault (referred to as Staked Assets), they are transferred to a global deposit contract (a smart contract), which issues a "Deposit Receipt". The Deposit Receipt establishes:
    - that the Client has at least 32 ETH to stake;
    - that the Client's Digital Assets originated from the Client's Wallet;
    - that the Client's Digital Assets are locked-up in the global deposit contract;
    - the unique validator node key that identifies the validator node that is coupled to the Staking Rewards; and
    - the withdrawal address (a public key) to receive any Staking Rewards.
19. Everlasting appoints an entity with the necessary infrastructure (including access to Nodes, computer hardware and software) to help facilitate the staking services (Staking Participant). No Digital Assets or Permissioned Keys are provided to the Staking Participant.
20. Everlasting provides the deposit receipt to the Staking Participant, which then registers the Deposit Receipt on the Ethereum Blockchain. Once accepted as a valid receipt, the validator node key participates in the security of the network by signing messages and attestations and participating in sync committees in return for rewards that accrue, net of any 'slashing' when the blockchain detects inconsistencies in the validator activity. The Staking Rewards accumulate in the Client's validator balance which is updated at least once per epoch (384 seconds) for all active validators. However, the balance in the Client's Wallet does not change.
21. Everlasting monitors the staking process and engages with the Staking Participant on behalf of the Client to ensure that the staking is occurring as intended.
22. Unilateral withdrawals of the Staked Assets and/or Staking Rewards can be made from the validator balance, so that the Staked Assets and/or Staking Rewards are transferred back to the Client's vault and the Client's Wallet.

Relationship property

23. During the term of the Arrangement, the Digital Assets may be the subject of a settlement of relationship property.

Death or incapacitation

24. To the extent that legal title to a Client's Digital Assets is held by Everlasting or the Digital Executor, Everlasting or the Digital Executor (as applicable) holds that title for the Client as a bare trustee (General Terms cl 8.5(b)).
25. On the verification of the Client's death or incapacitation, Everlasting will transfer the Digital Assets in accordance with the Authorised Instructions from the Client's Wallet to another wallet that the Client's beneficiaries have knowledge of and control over (Estate Terms cls 6.1(c) and 7.2)).
26. Where a Client dies without a valid will, Everlasting is entitled to (Estate Terms cl 7.3):
    - treat any person entitled to inherit the Digital Assets as the Client's Authorised Representative, provided Everlasting is satisfied that the person is entitled to inherit the relevant Digital Asset; and/or
    - facilitate, at the Client's cost, an order from the High Court of New Zealand to have an administrator appointed to oversee the inheritance of the Digital Assets.
27. If the Client becomes Mentally Incapable without valid enduring power(s) of attorney in place, Everlasting is entitled to (Estate Terms cl 7.4):
    - treat any person entitled to apply to the court for appointment as the Client's property manager and/or welfare guardian as the Client's Authorised Representative, provided that Everlasting is satisfied that the person is entitled to make such an application; and/or
    - facilitate, at the Client's cost, an order from the court to have a property manager and/or welfare guardian appointed to oversee the management of the Client's Digital Assets.

28. On the Client's death or incapacitation, the following may occur:
    - Everlasting may deduct or set off, from any Digital Assets transferred or otherwise dealt with, the fees specified in the Fee Schedule, as well as any fees, disbursements, taxes or other sums that are due and outstanding to Everlasting or to any related company of Everlasting or the Digital Executor and any costs incurred in facilitating any court applications or making inquiries.
    - Unless the Client's Authorised Representative has access to the Client Keys, the Client Keys become dormant, and the Everlasting Keys (two) and the Digital Executor Key (one) are used to transact with the Wallet and carry out the Client's Authorised Instructions.
29. In limited circumstances, on the Client's death or incapacitation, the Client's Authorised Representative may provide an Authorised Instruction to Everlasting to maintain the Client's Wallet, vault or Permissioned Keys so that the Client's estate can continue to benefit from Everlasting's products. In these circumstances, the Client's Authorised Representative will get new Permissioned Keys to replace the Client Keys.

Termination

30. Everlasting may suspend or terminate the Client's access to the Services with immediate effect where (General Terms cl 15.2; Estate Terms cl 9.2; Staking Terms cl 6.2):
    - there is a material or persistent breach by the Client of the Estate, Staking or General Terms, which is either incapable of remedy or (if capable of remedy) has not been remedied within a reasonable time after Everlasting's notice to the Client specifying the default and requiring it to be remedied; or
    - any Wallet associated with the Client is engaged in any activity in violation of applicable laws.
31. Either Everlasting or the Client may terminate the Contract, in whole or in part, with or without cause, by giving the requisite written notice to the other. The Client cannot terminate without cause prior to the end of the Minimum Period. If the Client chooses to terminate the engagement and cease using the Services, the Client must sign an exit signature and broadcast an exit transaction to Ethereum. If by the Termination Date the Client has not given instructions to Everlasting regarding how or where to deliver the Digital Asset, Everlasting will hold the Digital Asset on trust as bare trustee for the Client until it is given Authorised Instructions. On termination, the following occurs:
    - Under the General and Estate Terms, any Everlasting Keys for the Wallet(s) will be revoked.
    - Under the Staking Terms, the Client's Keys for the Wallet(s) will no longer be functional. Following delivery of the Digital Asset in accordance with the Authorised Instructions, (to the extent not automatically revoked) Everlasting revokes the Everlasting Keys relating to that Wallet.

Fees payable to Everlasting

32. In consideration for the Services, the Client pays Everlasting fees as set out in the Contract. The fees may be payable in ETH, stablecoin or fiat currency depending on the Client's preference.

Other clauses

33. Under the General Terms, the following applies:
    - To the extent there is a bare trust and Everlasting has or is deemed to have custody of the Digital Assets under that bare trust, it is required to segregate each Client's Digital Assets such that they can be separately identified from any other Client's digital assets (General Terms cl 8.5(c)).
    - Everlasting may take such steps that it determines, in its sole discretion, may be necessary or advisable to maintain and protect the security of the Client's Digital Assets, the Wallet(s) and Everlasting Keys (General Terms cl 8.6).
    - The Client is solely responsible for the payment of any applicable taxes with respect to their Digital Assets, including any gain in the value of their Digital Assets (General Terms cl 4.4).

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Client transfers the Digital Assets into an Everlasting product for the secure, long-term and self-custodial holding of their Digital Assets, including Staking Rewards (where relevant).

(b) The Digital Assets do not meet the requirements of s EW 5(3BAB).

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) For the purposes of the Arrangement, Everlasting and the Digital Executor are nominees as defined in s YB 21.

(b) Under subpart YF, any amount of income derived or expenditure incurred by a Client under the Arrangement must be converted into New Zealand dollars for tax purposes.

(c) When a Client's Digital Assets are initially transferred into an Everlasting Wallet, the Client will:

  (i) derive income on the market value of the Digital Assets at the Commencement Date under ss CB 1 and/or CB 5, and s GC 1; and

  (ii) be allowed a deduction for the cost (if any) of the Digital Assets in that income year under s DB 23 and subpart ED.

(d) Where a Client purchases the Staking Product:

  (i) The Client will derive income under s CA 1(2), CB 1 or CB 3 when Staking Rewards are transferred to the vault. The amount of income derived is the market value of the Staking Rewards on that date.

  (ii) The Client can deduct, under s DA 1, the portion of the Service Fee related to the Staking Services (as set out in the Letter of Engagement or Fee Schedule). The expenditure is deductible in the income year that the Client has a definitive commitment to pay for the Staking Services.

(e) Sections CB 1, CB 2, CB 3, CB 4 and CB 5 do not apply where a Client's Digital Assets (including any Staking Rewards) are transferred out of an Everlasting Wallet:

  (i) to another wallet that the Client legally owns (whether governed by the Contract or not), and on the transfer out of the Client's other wallet to another person for consideration, provided that the transfer does not form part of any new business or profit-making scheme; or

  (ii) to another person for no consideration:

    - where the Client is incapacitated and a transfer is made in accordance with their Authorised Instructions under cl 6.1(c) of the Estate Terms;
    - on a "settlement of relationship property" as defined in s FB 1B(a); or
    - under the Client's will.

(f) A transfer of Digital Assets (including Staking Rewards) out of a Client's Everlasting Wallet to their spouse under the Client's will (including any intervening transfer to an executor) is treated as a settlement of relationship property under s FC 3.

(g) Where a transfer of Digital Assets (including Staking Rewards) out of a Client's Everlasting Wallet is a "settlement of relationship property" (as defined in s FB 1B(a) or as provided in Ruling (f) above), the value of the transfer is the cost of the Digital Assets to the Client (on the date on which the Client acquired those Digital Assets) under s FB 1C(2). For the avoidance of doubt the cost of Digital Assets transferred by the Client into an Everlasting product is the market value of the Digital Assets as at the Commencement Date.

(h) For all other transfers out of a Client's Everlasting Wallet to another person for no consideration, the value of the transfer is the market value of the Digital Assets (or Staking Rewards) on the date of the transfer under s FC 2. This includes the following transfers where the Client is a trustee:

  (i) the transfer of Digital Assets on a distribution to a beneficiary of the trust (unless the beneficiary provides arm's length consideration for the Digital Assets) under s FC 1(1)(c); and

  (il) a settlement by the trustee on the trustee of another trust (if authorised under a trust instrument as a power of advancement or resettlement, or under s 64 of the Trusts Act 2019 as the payment or application of capital money or other capital assets) under s FC 1(1)(f).

For the avoidance of doubt, this Ruling does not consider the application of the Trust rules in subpart HC.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 8 November 2023 and ending on 8 November 2028.

This Ruling is signed by me on the 8th day of November 2023.

Howard Davis
Group Leader, Tax Counsel Office

Product Ruling – BR Prd 23/04

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 Everlasting Nominees Limited (Everlasting).

Taxation Laws

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

This Ruling applies in respect of ss CA 1(2), CB 1, CB 2, CB 3, CB 4, CB 5, DA 1, FB 1B(a), FB 1C(2), FC 1, FC 2, FC 3 and YB 21, and subpart YF.

The Arrangement to which this Ruling applies

The Arrangement is the transfer of a Client's Digital Assets into the following products provided by Everlasting, where the Client does not hold the Digital Assets in a business of dealing in cryptocurrency for the purposes of ss CB 1 and/or CB 5, and the Client's Digital Assets were not originally acquired for the dominant purpose of disposal:

a) **Estate:** The Client's Digital Assets are stored in the Client's (exclusive access) Wallet until any Authorised Instruction for withdrawal is received and verified. The Client does not earn Staking Rewards.

b) **Staking:** Staking is facilitated from the Client's corresponding vault (which has the same security settings as the Wallet). The Client's Digital Assets that are staked and the Staking Rewards earned are subsequently transferred back to the Client's vault and (unless further staking is facilitated) to the Client's corresponding Wallet where they are stored until an Authorised Instruction for withdrawal is received and verified. Clients retain legal ownership of their Digital Assets throughout the staking process.

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

Documents

1. The following documents provided to Inland Revenue on 4 May 2023 describe the Arrangement, and are collectively referred to as the Contract:
   - Letter of Engagement;
   - General Terms and Conditions Everlasting Nominees Ltd (last updated 24 April 2023) (General Terms);
   - Estate Terms and Conditions Everlasting Nominees Ltd (last updated 24 April 2023) (Estate Terms); and
   - Digital Assets Staking Services Terms and Conditions (Staking Terms).
2. The final executed documentation will not be materially different from the documentation provided to Inland Revenue on 4 May 2023, as set out above.
3. Unless otherwise specified, capitalised terms have the same meaning as defined in the Contract.
4. In addition to defined terms in the Contract, in this Ruling:
   - A reference to a "Client's spouse" means their surviving spouse, de facto partner or civil union partner;
   - a reference to a "Client's will" includes a reference to the rules governing intestacy; and
   - a reference to an "executor" includes an administrator or trustee.

Everlasting Nominees Limited

5. Everlasting was incorporated in New Zealand on 12 August 2022.

The Contract

6. The Clients are individuals (provided they are over the age of 16 years) and/or their spouse, civil union or de facto partner, or a trustee of a trust, who choose to purchase Everlasting's products.

7. In respect of the Estate and Staking products, the Clients enter into the Agreements with Everlasting and, in relation to the Estate product, a Digital Executor. The Digital Executor (unless otherwise agreed by Everlasting) must be a solicitor, financial advice provider, chartered accountant, professional fiduciary or other member of a regulated professional body.
8. The Digital Assets have two data parameters:
    - a public key, which is disclosed to all participants in the system and has encoded information about the Digital Asset such as its ownership, value and transaction history; and
    - a private key, which permits transfers or other dealing in the Digital Asset to be cryptographically authenticated by digital signature.
9. The Clients (or their Authorised Representative) provide Everlasting and/or the Digital Executor (as applicable) with their signed Authorised Instructions in relation to the:
    - carrying out of any action (including staking) affecting the Client's Digital Assets and/or Wallets (Staking Terms cl 4.2 and Estate Terms cl 6.2(a));
    - transfer of the Client's Digital Assets to one or more other wallets that the Client has knowledge and control of (Estate Terms cl 6.1(b));
    - transfer of the Client's Digital Assets to their beneficiaries' wallets on the Client's death or incapacitation (Estate Terms cl 6.1(c)); and
    - issuance of a new Client Key or revocation of a Permissioned Key (General Terms cl 11.1).

Wallets and Permissioned Keys

10. Using a third-party software development platform, Everlasting establishes the Wallet(s) for the Client's Digital Assets on behalf of the Client. The smart contract that gives effect to the Wallet has programmable rules that hold the Client's Digital Assets at the contract and it only has a public key (being the address).
11. Each Wallet will have at least five individual private cryptographic Permissioned Keys (either pre-existing and/or created for the purposes of the Agreements) associated with it (Estate Terms cl 3.2(a)–(c)):
    - Everlasting Keys (two): The Everlasting Keys can only be used by Everlasting for the limited purposes of providing Estate Services in accordance with the Estate Terms and to give effect to Authorised Instructions.
    - Client Keys (two): The Client Keys are retained and controlled by the Client and will comprise their pre-existing key or a key created by the Client specifically for the purposes of the Estate Terms.
    - Digital Executor Key (one): The Digital Executor Key is retained and controlled by the Digital Executor (as either a pre-existing key or one created specifically for the purposes of the Estate Terms). The Digital Executor Key can only be used for the purpose of giving effect to Authorised Instructions.
12. In some instances (eg when spouses, civil union partners or de facto partners enter into the Agreements in relation to Digital Assets that are relationship property), there may be more than five Permissioned Keys. However, there will never be more Everlasting Keys or Digital Executor Keys than Client Keys.

Deposit of Digital Assets into Wallet

13. The Client is responsible for transferring their Digital Assets into the Wallet.

Withdrawal transactions where the Client is alive and not incapacitated

14. To withdraw the Digital Assets from the Client's Wallet, more than half of the total keys are required and at least one of those Keys must be a non-Client Key. Before the Digital Asset can be withdrawn from the Wallet, the Client must first load the transaction into the Wallet using a Client Key. Two other Permissioned Keys (usually the other Client Key and an Everlasting Key) must subsequently authorise the withdrawal. Before Everlasting uses an Everlasting Key to withdraw the Digital Asset, it completes various due diligence checks (including identity verification and liveness tests) to establish that the Client has requested the withdrawal.
15. Other than on the Client's death or incapacitation, Everlasting will only authorise transactions from the Wallet to the vault or to another wallet or vault that has not been established under the General Terms if it is satisfied the Client has knowledge of and control over this other wallet or vault. Should the Client then wish to on-transfer the Digital Asset to a third party, the Client (without Everlasting's involvement) must transfer their Digital Assets to that third party from their wallet that has not been established under the General Terms.

16. The Digital Executor Key is not usually used to authorise a withdrawal from the Wallet unless the Client has lost control over their Client Keys (and a withdrawal is required before that Client Key has been decommissioned and new Client Key created) or the Client has died or become incapacitated.

Vault and staking where the Client is alive and not incapacitated

17. In relation to the Staking services, using a third-party platform, Everlasting (on behalf of the Client) establishes one or more vaults to facilitate staking. The smart contract that gives effect to the Client's vault inherits the same security settings as the Client's Wallet(s). A Wallet will only be able to transact with the corresponding vault if the Client has loaded the transaction to the vault and, provided Everlasting is satisfied with the due diligence checks, the other Client Key(s) and Everlasting Key are used to authorise the transaction.
18. Once the Client's Digital Assets are transferred into the corresponding vault (referred to as Staked Assets), they are transferred to a global deposit contract (a smart contract), which issues a "Deposit Receipt". The Deposit Receipt establishes:
    - that the Client has at least 32 ETH to stake;
    - that the Client's Digital Assets originated from the Client's Wallet;
    - that the Client's Digital Assets are locked-up in the global deposit contract;
    - the unique validator node key that identifies the validator node that is coupled to the Staking Rewards; and
    - the withdrawal address (a public key) to receive any Staking Rewards.
19. Everlasting appoints an entity with the necessary infrastructure (including access to Nodes, computer hardware and software) to help facilitate the staking services (Staking Participant). No Digital Assets or Permissioned Keys are provided to the Staking Participant.
20. Everlasting provides the deposit receipt to the Staking Participant, which then registers the Deposit Receipt on the Ethereum Blockchain. Once accepted as a valid receipt, the validator node key participates in the security of the network by signing messages and attestations and participating in sync committees in return for rewards that accrue net of any 'slashing' when the blockchain detects inconsistencies in the validator activity. The Staking Rewards accumulate in the Client's validator balance which is updated at least once per epoch (384 seconds) for all active validators. However, the balance in the Client's Wallet does not change.
21. Everlasting monitors the staking process and engages with the Staking Participant on behalf of the Client to ensure that the staking is occurring as intended.
22. Unilateral withdrawals of the Staked Assets and/or Staking Rewards can be made from the validator balance, so that the Staked Assets and/or Staking Rewards are transferred back to the Client's vault and the Client's Wallet.

Relationship property

23. During the term of the Arrangement, the Digital Assets may be the subject of a settlement of relationship property.

Death or incapacitation

24. To the extent that legal title to a Client's Digital Assets is held by Everlasting or the Digital Executor, Everlasting or the Digital Executor (as applicable) holds that title for the Client as a bare trustee (General Terms cl 8.5(b)).
25. On the verification of the Client's death or incapacitation, Everlasting will transfer the Digital Assets in accordance with the Authorised Instructions from the Client's Wallet to another wallet that the Client's beneficiaries have knowledge of and control over (Estate Terms cls 6.1(c) and 7.2)).
26. Where a Client dies without a valid will, Everlasting is entitled to (Estate Terms cl 7.3):
    - treat any person entitled to inherit the Digital Assets as the Client's Authorised Representative, provided Everlasting is satisfied that the person is entitled to inherit the relevant Digital Asset; and/or
    - facilitate, at the Client's cost, an order from the High Court of New Zealand to have an administrator appointed to oversee the inheritance of the Digital Assets.

27. If the Client becomes Mentally Incapable without valid enduring power(s) of attorney in place, Everlasting is entitled to (Estate Terms cl 7.4):
    - treat any person entitled to apply to the court for appointment as the Client's property manager and/or welfare guardian as the Client's Authorised Representative, provided that Everlasting is satisfied that the person is entitled to make such an application; and/or
    - facilitate, at the Client's cost, an order from the court to have a property manager and/or welfare guardian appointed to oversee the management of the Client's Digital Assets.
28. On the Client's death or incapacitation, the following may occur:
    - Everlasting may deduct or set off, from any Digital Assets transferred or otherwise dealt with, the fees specified in the Fee Schedule, as well as any fees, disbursements, taxes or other sums that are due and outstanding to Everlasting or to any related company of Everlasting or the Digital Executor and any costs incurred in facilitating any court applications or making inquiries.
    - Unless the Client's Authorised Representative has access to the Client Keys, the Client Keys become dormant, and the Everlasting Keys (two) and the Digital Executor Key (one) are used to transact with the Wallet and carry out the Client's Authorised Instructions.
29. In limited circumstances, on the Client's death or incapacitation, the Client's Authorised Representative may provide an Authorised Instruction to Everlasting to maintain the Client's Wallet, vault or Permissioned Keys so that the Client's estate can continue to benefit from Everlasting's products. In these circumstances, the Client's Authorised Representative will get new Permissioned Keys to replace the Client Keys.

Termination

30. Everlasting may suspend or terminate the Client's access to the Services with immediate effect where (General Terms cl 15.2; Estate Terms cl 9.2; Staking Terms cl 6.2):
    - there is a material or persistent breach by the Client of the Estate, Staking or General Terms, which is either incapable of remedy or (if capable of remedy) has not been remedied within a reasonable time after Everlasting's notice to the Client specifying the default and requiring it to be remedied; or
    - any Wallet associated with the Client is engaged in any activity in violation of applicable laws.
31. Either Everlasting or the Client may terminate the Contract, in whole or in part, with or without cause, by giving the requisite written notice to the other. The Client cannot terminate without cause prior to the end of the Minimum Period. If the Client chooses to terminate the engagement and cease using the Services, the Client must sign an exit signature and broadcast an exit transaction to Ethereum. If by the Termination Date the Client has not given instructions to Everlasting regarding how or where to deliver the Digital Asset, Everlasting will hold the Digital Asset on trust as bare trustee for the Client until it is given Authorised Instructions. On termination, the following occurs:
    - Under the General and Estate Terms, any Everlasting Keys for the Wallet(s) will be revoked.
    - Under the Staking Terms, the Client's Keys for the Wallet(s) will no longer be functional. Following delivery of the Digital Asset in accordance with the Authorised Instructions, (to the extent not automatically revoked) Everlasting revokes the Everlasting Keys relating to that Wallet.

Fees payable to Everlasting

32. In consideration for the Services, the Client pays Everlasting fees as set out in the Contract. The fees may be payable in ETH, stablecoin or fiat currency depending on the Client's preference.

Other clauses

33. Under the General Terms, the following applies:
    - To the extent there is a bare trust and Everlasting has or is deemed to have custody of the Digital Assets under that bare trust, it is required to segregate each Client's Digital Assets such that they can be separately identified from any other Client's digital assets (General Terms cl 8.5(c)).
    - Everlasting may take such steps that it determines, in its sole discretion, may be necessary or advisable to maintain and protect the security of the Client's Digital Assets, the Wallet(s) and Everlasting Keys (General Terms cl 8.6).
    - The Client is solely responsible for the payment of any applicable taxes with respect to their Digital Assets, including any gain in the value of their Digital Assets (General Terms cl 4.4).

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Client transfers the Digital Assets into an Everlasting product for the secure, longterm and self-custodial holding of their Digital Assets, including Staking Rewards (where relevant).

(b) The Digital Assets do not meet the requirements of s EW 5(3BAB).

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) For the purposes of the Arrangement, Everlasting and the Digital Executor are nominees as defined in s YB 21.

(b) Under subpart YF, any amount of income derived or expenditure incurred by a Client under the Arrangement must be converted into New Zealand dollars for tax purposes.

(c) Where a Client purchases the Staking Product:

  (i) The Client will derive income under s CA 1(2), CB 1 or CB 3 when Staking Rewards are transferred to the vault. The amount of income derived is the value of the Staking Rewards on that date.

  (ii) The Client can deduct, under s DA 1, the portion of the Service Fee related to the Staking Services (as set out in the Letter of Engagement or Fee Schedule). The expenditure is deductible in the income year that the Client has a definitive commitment to pay for the Staking Services.

(d) A Client's Digital Assets (including Staking Rewards) are not acquired for the purpose of disposal under s CB 4, where the Client:

  (i) acquires the Digital Assets for the purpose of transferring those assets into an Everlasting Wallet; or

  (ii) did not acquire the Digital Asset for the dominant purpose of disposal.

  For the avoidance of doubt, Staking Rewards earned in the Everlasting Staking product are not acquired for the dominant purpose of disposal.

(e) Sections CB 1, CB 2, CB 3, CB 4 and CB 5 do not apply where a Client's Digital Assets (including any Staking Rewards) are transferred into an Everlasting Wallet, or out of an Everlasting Wallet:

  (i) to another wallet that the Client legally owns (whether governed by the Contract or not), and on the transfer out of the Client's other wallet to another person for consideration, provided that the transfer does not form part of any new business or profit-making scheme; or

  (ii) to another person for no consideration:

    - where the Client is incapacitated and a transfer is made in accordance with their Authorised Instructions under cl 6.1(c) of the Estate Terms;
    - on a "settlement of relationship property" as defined in s FB 1B(a); or
    - under the Client's will.

(f) A transfer of Digital Assets (including Staking Rewards) out of a Client's Everlasting Wallet to their spouse, under the Client's will (including any intervening transfer to an executor) is treated as a settlement of relationship property under s FC 3.

(g) Where a transfer of Digital Assets (including Staking Rewards) out of a Client's Everlasting Wallet is a "settlement of relationship property" (as defined in s FB 1B(a) or as provided in Ruling (f) above), the value of the transfer is the cost (if any) of the Digital Assets to the Client (on the date on which the Client first acquired those Digital Assets) under s FB 1C(2).

(h) For all other transfers out of a Client's Everlasting Wallet to another person for no consideration, the value of the transfer is the market value of the Digital Assets (including Staking Rewards) on the date of the transfer under s FC 2. This includes the following transfers where the Client is a trustee:

(i) the transfer of Digital Assets on a distribution to a beneficiary of the trust (unless the beneficiary provides arm's length consideration for the Digital Assets) under s FC 1(1)(c); and

(ii) a settlement by the trustee on the trustee of another trust (if authorised under a trust instrument as a power of advancement or resettlement, or under s 64 of the Trusts Act 2019 as the payment or application of capital money or other capital assets) under s FC 1(1)(f).

For the avoidance of doubt, this Ruling does not consider the application of the Trust rules in subpart HC.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 8 November 2023 and ending on 8 November 2028.

This Ruling is signed by me on the 8th day of November 2023.

Howard Davis

Group Leader, Tax Counsel Office

Product Ruling – BR Prd 23/05

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 Everlasting Nominees Limited (Everlasting).

Taxation Laws

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

This Ruling applies in respect of ss CA 1(2), CB 1, CB 2, CB 3, CB 4, CB 5, DA 1, DB 23, FB 1B(a), FB 1C(2), FB 2, FC 1, FC 2, FC 3, FC 4, GC 1, and YB 21, and subparts ED and YF.

The Arrangement to which this Ruling applies

The Arrangement is the transfer of a Client's Digital Assets into the following products provided by Everlasting, where the Client does not hold the Digital Assets in a business of dealing in cryptocurrency for the purposes of ss CB 1 and/or CB 5, but the Client's Digital Assets were originally acquired for the dominant purpose of disposal:

a) **Estate:** The Client's Digital Assets are stored in the Client's (exclusive access) Wallet until any Authorised Instruction for withdrawal is received and verified. The Client does not earn Staking Rewards.

b) **Staking:** Staking is facilitated from the Client's corresponding vault (which has the same security settings as the Wallet). The Client's Digital Assets that are staked and the Staking Rewards earned are subsequently transferred back to the client's vault and (unless further staking is facilitated) to the Client's corresponding Wallet where they are stored until an Authorised Instruction for withdrawal is received and verified. Clients retain legal ownership of their Digital Assets throughout the staking process.

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

Documents

1. The following documents provided to Inland Revenue on 4 May 2023 describe the Arrangement, and are collectively referred to as the Contract:
   - Letter of Engagement;
   - General Terms and Conditions Everlasting Nominees Ltd (last updated 24 April 2023) (General Terms);
   - Estate Terms and Conditions Everlasting Nominees Ltd (last updated 24 April 2023) (Estate Terms); and
   - Digital Assets Staking Services Terms and Conditions (Staking Terms).
2. The final executed documentation will not be materially different from the documentation provided to Inland Revenue on 4 May 2023, as set out above.
3. Unless otherwise specified, capitalised terms have the same meaning as defined in the Contract.
4. In addition to defined terms in the Contract, in this Ruling:
   - a reference to a "Client's spouse" means their surviving spouse, de facto partner or civil union partner;
   - a reference to a "Client's will" includes a reference to the rules governing intestacy; and
   - a reference to an "executor" includes an administrator or trustee.

Everlasting Nominees Limited

5. Everlasting was incorporated in New Zealand on 12 August 2022.

The Contract

6. The Clients are individuals (provided they are over the age of 16 years) and/or their spouse, civil union or de facto partner, or a trustee of a trust, who choose to purchase Everlasting's products.

7. In respect of the Estate and Staking products, the Clients enter into the Agreements with Everlasting and, in relation to the Estate product, a Digital Executor. The Digital Executor (unless otherwise agreed by Everlasting) must be a solicitor, financial advice provider, chartered accountant, professional fiduciary or other member of a regulated professional body.
8. The Digital Assets have two data parameters:
    - a public key, which is disclosed to all participants in the system and has encoded information about the Digital Asset such as its ownership, value and transaction history; and
    - a private key, which permits transfers or other dealing in the Digital Asset to be cryptographically authenticated by digital signature.
9. The Clients (or their Authorised Representative) provide Everlasting and/or the Digital Executor (as applicable) with their signed Authorised Instructions in relation to the:
    - carrying out of any action (including staking) affecting the Client's Digital Assets and/or Wallets (Staking Terms cl 4.2 and Estate Terms cl 6.2(a));
    - transfer of the Client's Digital Assets to one or more other wallets that the Client has knowledge and control of (Estate Terms cl 6.1(b));
    - transfer of the Client's Digital Assets to their beneficiaries' wallets on the Client's death or incapacitation (Estate Terms cl 6.1(c)); and
    - issuance of a new Client Key or revocation of a Permissioned Key (General Terms cl 11.1).

Wallets and Permissioned Keys

10. Using a third-party software development platform, Everlasting establishes the Wallet(s) for the Client's Digital Assets on behalf of the Client. The smart contract that gives effect to the Wallet has programmable rules that hold the Client's Digital Assets at the contract and it only has a public key (being the address).
11. Each Wallet will have at least five individual private cryptographic Permissioned Keys (either pre-existing and/or created for the purposes of the Agreements) associated with it (Estate Terms cl 3.2(a)–(c)):
    - Everlasting Keys (two): The Everlasting Keys can only be used by Everlasting for the limited purposes of providing Estate Services in accordance with the Estate Terms and to give effect to Authorised Instructions.
    - Client Keys (two): The Client Keys are retained and controlled by the Client and will comprise their pre-existing key or a key created by the Client specifically for the purposes of the Estate Terms.
    - Digital Executor Key (one): The Digital Executor Key is retained and controlled by the Digital Executor (as either a pre-existing key or one created specifically for the purposes of the Estate Terms). The Digital Executor Key can only be used for the purpose of giving effect to Authorised Instructions.
12. In some instances (eg when spouses, civil union partners or de facto partners enter into the Agreements in relation to Digital Assets that are relationship property), there may be more than five Permissioned Keys. However, there will never be more Everlasting Keys or Digital Executor Keys than Client Keys.

Deposit of Digital Assets into Wallet

13. The Client is responsible for transferring their Digital Assets into the Wallet.

Withdrawal transactions where the Client is alive and not incapacitated

14. To withdraw the Digital Assets from the Client's Wallet, more than half of the total keys are required and at least one of those Keys must be a non-Client Key. Before the Digital Asset can be withdrawn from the Wallet, the Client must first load the transaction into the Wallet using a Client Key. Two other Permissioned Keys (usually the other Client Key and an Everlasting Key) must subsequently authorise the withdrawal. Before Everlasting uses an Everlasting Key to withdraw the Digital Asset, it completes various due diligence checks (including identity verification and liveness tests) to establish that the Client has requested the withdrawal.
15. Other than on the Client's death or incapacitation, Everlasting will only authorise transactions from the Wallet to the vault or to another wallet or vault that has not been established under the General Terms if it is satisfied the Client has knowledge of and control over this other wallet or vault. Should the Client then wish to on-transfer the Digital Asset to a third party, the Client (without Everlasting's involvement) must transfer their Digital Assets to that third party from their wallet that has not been established under the General Terms.

16. The Digital Executor Key is not usually used to authorise a withdrawal from the Wallet unless the Client has lost control over their Client Keys (and a withdrawal is required before that Client Key has been decommissioned and new Client Key created) or the Client has died or become incapacitated.

Vault and staking where the Client is alive and not incapacitated

17. In relation to the Staking services, using a third-party platform, Everlasting (on behalf of the Client) establishes one or more vaults to facilitate staking. The smart contract that gives effect to the Client's vault inherits the same security settings as the Client's Wallet(s). A Wallet will only be able to transact with the corresponding vault if the Client has loaded the transaction to the vault and, provided Everlasting is satisfied with the due diligence checks, the other Client Key(s) and Everlasting Key are used to authorise the transaction.
18. Once the Client's Digital Assets are transferred into the corresponding vault (referred to as Staked Assets), they are transferred to a global deposit contract (a smart contract), which issues a "Deposit Receipt". The Deposit Receipt establishes:
    - that the Client has at least 32 ETH to stake;
    - that the Client's Digital Assets originated from the Client's Wallet;
    - that the Client's Digital Assets are locked-up in the global deposit contract;
    - the unique validator node key that identifies the validator node that is coupled to the Staking Rewards; and
    - the withdrawal address (a public key) to receive any Staking Rewards.
19. Everlasting appoints an entity with the necessary infrastructure (including access to Nodes, computer hardware and software) to help facilitate the staking services (Staking Participant). No Digital Assets or Permissioned Keys are provided to the Staking Participant.
20. Everlasting provides the deposit receipt to the Staking Participant, which then registers the Deposit Receipt on the Ethereum Blockchain. Once accepted as a valid receipt, the validator node key participates in the security of the network by signing messages and attestations and participating in sync committees in return for rewards that accrue net of any 'slashing' when the blockchain detects inconsistencies in the validator activity. The Staking Rewards accumulate in the Client's validator balance which is updated at least once per epoch (384 seconds) for all active validators. However, the balance in the Client's Wallet does not change.
21. Everlasting monitors the staking process and engages with the Staking Participant on behalf of the Client to ensure that the staking is occurring as intended.
22. Unilateral withdrawals of the Staked Assets and/or Staking Rewards can be made from the validator balance, so that the Staked Assets and/or Staking Rewards are transferred back to the Client's vault and the Client's Wallet.

Relationship property

23. During the term of the Arrangement, the Digital Assets may be the subject of a settlement of relationship property.

Death or incapacitation

24. To the extent that legal title to a Client's Digital Assets is held by Everlasting or the Digital Executor, Everlasting or the Digital Executor (as applicable) holds that title for the Client as a bare trustee (General Terms cl 8.5(b)).
25. On the verification of the Client's death or incapacitation, Everlasting will transfer the Digital Assets in accordance with the Authorised Instructions from the Client's Wallet to another wallet that the Client's beneficiaries have knowledge of and control over (Estate Terms cls 6.1(c) and 7.2)).
26. Where a Client dies without a valid will, Everlasting is entitled to (Estate Terms cl 7.3):
    - treat any person entitled to inherit the Digital Assets as the Client's Authorised Representative, provided Everlasting is satisfied that the person is entitled to inherit the relevant Digital Asset; and/or
    - facilitate, at the Client's cost, an order from the High Court of New Zealand to have an administrator appointed to oversee the inheritance of the Digital Assets.
27. If the Client becomes Mentally Incapable without valid enduring power(s) of attorney in place, Everlasting is entitled to (Estate Terms cl 7.4):
    - treat any person entitled to apply to the court for appointment as the Client's property manager and/or welfare guardian as the Client's Authorised Representative, provided that Everlasting is satisfied that the person is entitled to make such an application; and/or

- facilitate, at the Client's cost, an order from the court to have a property manager and/or welfare guardian appointed to oversee the management of the Client's Digital Assets.

28. On the Client's death or incapacitation, the following may occur:
    - Everlasting may deduct or set off from any Digital Assets transferred or otherwise dealt with, the fees specified in the Fee Schedule, as well as any fees, disbursements, taxes or other sums that are due and outstanding to Everlasting or to any related company of Everlasting or the Digital Executor and any costs incurred in facilitating any court applications or making inquiries.
    - Unless the Client's Authorised Representative has access to the Client Keys, the Client Keys become dormant, and the Everlasting Keys (two) and the Digital Executor Key (one) are used to transact with the Wallet and carry out the Client's Authorised Instructions.
29. In limited circumstances, on the Client's death or incapacitation, the Client's Authorised Representative may provide an Authorised Instruction to Everlasting to maintain the Client's Wallet, vault or Permissioned Keys so that the Client's estate can continue to benefit from Everlasting's products. In these circumstances, the Client's Authorised Representative will get new Permissioned Keys to replace the Client Keys.

Termination

30. Everlasting may suspend or terminate the Client's access to the Services with immediate effect where (General Terms cl 15.2; Estate Terms cl 9.2; Staking Terms cl 6.2):
    - there is a material or persistent breach by the Client of the Estate, Staking or General Terms, which is either incapable of remedy or (if capable of remedy) has not been remedied within a reasonable time after Everlasting's notice to the Client specifying the default and requiring it to be remedied; or
    - any Wallet associated with the Client is engaged in any activity in violation of applicable laws.
31. Either Everlasting or the Client may terminate the Contract, in whole or in part, with or without cause, by giving the requisite written notice to the other. The Client cannot terminate without cause prior to the end of the Minimum Period. If the Client chooses to terminate the engagement and cease using the Services, the Client must sign an exit signature and broadcast an exit transaction to Ethereum. If by the Termination Date the Client has not given instructions to Everlasting regarding how or where to deliver the Digital Asset, Everlasting will hold the Digital Asset on trust as bare trustee for the Client until it is given Authorised Instructions. On termination, the following occurs:
    - Under the General and Estate Terms, any Everlasting Keys for the Wallet(s) will be revoked.
    - Under the Staking Terms, the Client's Keys for the Wallet(s) will no longer be functional. Following delivery of the Digital Asset in accordance with the Authorised Instructions, (to the extent not automatically revoked) Everlasting revokes the Everlasting Keys relating to that Wallet.

Fees payable to Everlasting

32. In consideration for the Services, the Client pays Everlasting fees as set out in the Contract. The fees may be payable in ETH, stablecoin or fiat currency depending on the Client's preference.

Other clauses

33. Under the General Terms, the following applies:
    - To the extent there is a bare trust and Everlasting has or is deemed to have custody of the Digital Assets under that bare trust, it is required to segregate each Client's Digital Assets such that they can be separately identified from any other Client's digital assets (General Terms cl 8.5(c)).
    - Everlasting may take such steps that it determines, in its sole discretion, may be necessary or advisable to maintain and protect the security of the Client's Digital Assets, the Wallet(s) and Everlasting Keys (General Terms cl 8.6).
    - The Client is solely responsible for the payment of any applicable taxes with respect to their Digital Assets, including any gain in the value of their Digital Assets (General Terms cl 4.4).

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The Client transfers the Digital Assets into an Everlasting product for the secure, long term and self-custodial holding of their Digital Assets, including Staking Rewards (where relevant).

(b) The Digital Assets do not meet the requirements of s EW 5(3BAB).

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) For the purposes of the Arrangement, Everlasting and the Digital Executor are nominees as defined in s YB 21.

(b) Under subpart YF, any amount of income derived or expenditure incurred by a Client under the Arrangement must be converted into New Zealand dollars for tax purposes.

(c) For the purposes of this Ruling, a "settlement of relationship property" is defined in s FB 1B(a), and includes under s FC 3(2), the transfer of Digital Assets to the Client's spouse under the Client's will (including the intervening transfer to an executor) where only "close relatives" of the Client are beneficially entitled under the will to any other "tax-base property" (as those terms are defined in s FC 1(2)).

Rulings (d) to (f) apply in respect of a Client's Staking Rewards:

(d) A Client who purchases the Staking Product:

  (i) will derive income under s CA 1(2), CB 1 or CB 3 when Staking Rewards are transferred to the vault. The amount of income derived is the market value of the Staking Rewards on that date; and

  (ii) can deduct, under s DA 1, the portion of the Service Fee related to the Staking Services (as set out in the Letter of Engagement or Fee Schedule). The expenditure is deductible in the income year that the Client has a definitive commitment to pay for the Staking Services.

(e) Sections CB 1, CB 2, CB 3, CB 4 and CB 5 do not apply where a Client's Staking Rewards are transferred into an Everlasting Wallet, or out of an Everlasting Wallet:

  (i) to another wallet that the Client legally owns (whether governed by the Contract or not), and on the transfer out of the Client's other wallet to another person for consideration, provided that the transfer does not form part of any new business or profit-making scheme; or

  (ii) to another person for no consideration:

    - where the Client is incapacitated and a transfer is made in accordance with their Authorised Instructions under cl 6.1(c) of the Estate Terms;
    - on a "settlement of relationship property" as defined in s FB 1B(a); or
    - under the Client's will.

(f) Transfers of Staking Rewards are:

  (i) where the transfers are a "settlement of relationship property", treated under s FB 1C(2) as being acquired by the transferee at cost on the date on which those Staking Rewards were transferred to the Client's vault; and

  (ii) for all other transfers, treated under s FC 2(1) as being acquired by the transferee at market value on the date of the transfer.

Rulings (g) to (l) apply in respect of the transfer of a Client's Digital Assets excluding Staking Rewards:

(g) Sections CB 1, CB 2, CB 3, CB 4 and CB 5 do not apply where a Client's Digital Assets are transferred:

  (i) into an Everlasting Wallet; and/or

  (ii) out of an Everlasting Wallet to another wallet that the Client legally owns (which is not governed by the Contract).

(h) Where a Client's Digital Assets are transferred to another person for consideration, the Client:

  (i) derives income at the time of transfer under s CB 4; and

  (ii) will be allowed a deduction for the cost (if any) of the Digital Assets in that income year under s DB 23 and subpart ED.

(i) If a Client is incapacitated and their Digital Assets are gifted to another person in accordance with their Authorised Instructions under cl 6.1(c) of the Estate Terms:

(i) the Client derives an amount of income on the market value of the Digital Assets at the time of transfer under ss CB 4 and FC 2(1);

(ii) the Client will be allowed a deduction for the cost of the Digital Assets in that income year under s DB 23 and subpart ED; and

(iii) the transferee acquires the Digital Assets at market value on the date of the transfer under s FC 2(1).

(j) Where a Client's Digital Assets are transferred on a "settlement of relationship property":

(i) the Client and, where relevant, an executor are treated as disposing of Digital Assets, and the Client's spouse is treated as acquiring them, for the cost (if any) of the Digital Assets to the Client under s FB 2(2); and

(ii) if the Client's spouse subsequently disposes of the Digital Assets, they will derive income under s FB 2(3).

(k) Where a Client's Digital Assets are transferred under the Client's will to an executor for the benefit of a Client's spouse and those Digital Assets are not treated as a "settlement of relationship property" in Ruling (j):

(i) the Client is treated as disposing of the Digital Assets, and the executor is treated as acquiring them, at market value immediately before the death of the Client under s FC 2;

(ii) that market value of the Digital Assets will be income of the Client under s CB 4;

(iii) the Client will be allowed a deduction for the cost of the Digital Assets in that income year under s DB 23 and subpart ED; and

(iv) under s FC 2, the Client's spouse is treated as acquiring the Digital Assets at market value on the date they are transferred to them by the executor.

(l) Where a Client's Digital Assets are transferred under the Client's will to an executor for the benefit of a beneficiary who is not the client's spouse, then:

(i) under s FC 2, the transfer of the Digital Assets is treated as a disposal by the Client and an acquisition by the executor at market value immediately before the death of the Client;

(ii) the market value of the Digital Assets will be income of the Client under s CB 4;

(iii) the Client will be allowed a deduction for the cost of the Digital Assets in that income year under s DB 23 and subpart ED;

(iv) where each beneficiary of the Client is a "close relative" as defined in s FC 1(2) or a person exempt under ss CW 41 to CW 43, then:

(A) the subsequent transfer of the Digital Assets by the executor to the beneficiary is subject to s FC 4 (provided that no life interest in or trust over the Digital Assets is created and the net income of the estate is distributed in accordance with s FC 4(3)); and

(B) the beneficiary is treated under s FB 1C as acquiring the Digital Assets at market value immediately before the death of the Client; and

(v) where Ruling (l)(iv) does not apply, the beneficiary is treated as acquiring the Digital Assets at market value on the date of transfer by the executor.

(m) Where the Client is a trustee, the following transfers of Digital Assets (including Staking Rewards) from an Everlasting Wallet will occur at market value on the date of the transfer under s FC 2(1):

(i) the transfer of Digital Assets on a distribution to a beneficiary of the trust (unless the beneficiary provides arm's length consideration for the Digital Assets) under s FC 1(1)(c); and

(ii) a settlement by the trustee on the trustee of another trust (if authorised under a trust instrument as a power of advancement or resettlement, or under s 64 of the Trusts Act 2019 as the payment or application of capital money or other capital assets) under s FC 1(1)(f).

For the avoidance of doubt, this Ruling does not consider the application of the Trust rules in subpart HC.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 8 November 2023 and ending on 8 November 2028.

This Ruling is signed by me on the 8th day of November 2023.

Howard Davis

Group Leader, Tax Counsel Office

Product Ruling – BR Prd 23/06

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 WorkRide Limited (WorkRide).

Taxation Laws

All legislative references are to the Income Tax Act 2007 (ITA) or the Goods and Services Tax Act 1985 (GSTA) unless otherwise stated.

This Ruling applies in respect of ss BG 1, CX 2 and CX 19D of the ITA and ss 6, 8, 10(2), 20 and 76 of the GSTA.

The Arrangement to which this Ruling applies

The Arrangement is WorkRide's provision of self-powered or low-powered commuting vehicles (Equipment) to the employees of WorkRide's customers, where the employees agree to a temporary reduction in salary in return for the temporary lease of Equipment and the opportunity to own the Equipment at the end of the lease period. Examples of Equipment are bicycles, electric bicycles, scooters and electric scooters.

The paragraphs below set out further details of the Arrangement.

The parties to the Arrangement

1. The parties to the Arrangement are as follows:
    - WorkRide is a New Zealand resident (by incorporation) that facilitates the provision of the Equipment to the Employee (the Services), in consideration for the payment of a service fee (Service Fee) by the Employer. WorkRide is GST registered.
    - Employer is a New Zealand resident employer that has contracted with WorkRide to facilitate the provision of Equipment to Employees who participate in the Arrangement.
    - Employee is a New Zealand resident employee of the Employer who participates in the Arrangement and reduces their gross annual earnings under a Salary Sacrifice Agreement.
    - Retail Partner is a GST-registered, third-party retail partner that has contracted with WorkRide to sell Equipment to WorkRide for use in the Arrangement.
    - Third-Party Financier is an independent third-party lender that may enter into a financing contract with the Employer to fund the Service Fee payable by the Employer to WorkRide under the terms of the Customer Master Services Agreement.

Relevant agreements

2. The following agreements form part of the Arrangement:
    - Customer Master Services Agreement (MSA) is an agreement between WorkRide and the Employer about the Services (version 2.2 provided to Inland Revenue on 16 November 2023).
    - WorkRide Lease Agreement (Lease Agreement) is a service-level lease agreement between WorkRide and the Employee specifying the parties' obligations concerning the lease of the Equipment over the term of the Lease Agreement (version 2.2 provided to Inland Revenue on 16 November 2023).
    - Salary Sacrifice Agreement is an agreement between the Employer and Employee under which the Employee's annualised salary or wages are reduced for the term of the salary sacrifice which is not longer than the period of the Lease Agreement (except in instances where the term is extended due to Employee absence or where an Employee's salary falls below the minimum wage).
    - Next Steps Deed is an agreement between WorkRide and the Employee to transfer the ownership of the Equipment at the end of the Lease Agreement (version 2.2 provided to Inland Revenue on 16 November 2023).

Employee benefit scheme

3. WorkRide will contract with Retail Partners to supply Equipment on an 'as required' basis. An Employer will engage with WorkRide by entering into the MSA. In consideration for the Services, the Employer (or a Third-Party Financier on behalf of the Employer) will pay a Service Fee to WorkRide. The Service Fee that the Employer (or Third-Party Financier) pays to WorkRide for the Services is calculated with reference to the total cost of the Equipment to WorkRide. The Employer will usually inform Employees of the opportunity to participate in the Arrangement.
4. An Employee who wishes to participate in the Arrangement will raise a request for WorkRide to provide the Equipment to the Employee. After WorkRide and the Employer approve the Employee's request, the Employee will enter into the Lease Agreement with WorkRide. Under the Lease Agreement, the Employee:
   a) may not profit from, transfer, sell or otherwise dispose of the Equipment;
   b) agrees to retain possession of the Equipment for the term of the lease;
   c) acknowledges to WorkRide that they will use the Equipment mainly for commuting to and from, or between the Employer's workplace; and
   d) agrees to use the Equipment mainly for commuting to and from, or between the Employer's workplace.
5. The Service Fee that the Employer must pay is equivalent to or less than the cost of the Equipment and the Employer pays the entire Service Fee at the outset to WorkRide. Once the Employer pays the entire Service Fee, WorkRide will acquire legal ownership of the Equipment from the Retail Partner and enable the Employee to collect the Equipment.
6. To participate in the Arrangement, the Employer and Employee agree to reduce the Employee's annualised gross salary or wages for a period of time under a Salary Sacrifice Agreement. The Employer and the Employee will together agree on the amount of the reduction in the Employee's annualised gross salary or wages. The amount of the salary sacrificed will not exceed the amount of the Service Fee.
7. Once the Employee has collected the Equipment from the Retail Partner, the Lease Agreement begins. If the Employee's employment with the Employer ends while the Lease Agreement is in force, the Lease Agreement will terminate with immediate effect when the employment ends.
8. Towards the end of the Lease Agreement, WorkRide will contact the Employee to discuss the Employee's options for ownership of the Equipment after the Lease Agreement ends. The Employee may (but is not required to) execute a Next Steps Deed to keep the Equipment for no consideration. Under the Next Steps Deed:
   a) WorkRide gifts the Equipment to the Employee; and
   b) the Employee acknowledges, represents and warrants that the gifted Equipment will be used predominantly for the purpose of commuting to and from, or between the Employee's workplace.

   Alternatively, the Employee can return the Equipment to WorkRide and then full legal title remains with WorkRide.
9. Where the Employee executes the Next Steps Deed, the parties will not enter into the Arrangement more than once over the estimated useful life of the Equipment (as determined by the Commissioner's Table of Depreciation Rates), as measured from the day the Lease Agreement takes effect, unless there are justified reasons for early replacement. Such reasons may include but are not limited to:
   - theft or destruction of the Equipment;
   - excessive wear and tear – the Employee has used the Equipment more intensively than typical use, resulting in wear and tear that affects the Equipment's functionality or safety;
   - change in user needs – the Employee's needs change because their commute changes, with the result that they need different Equipment;
   - accidental damage – the Employee damages the Equipment in a way that affects its functionality or safety and repair is impractical;
   - health or physical considerations – the Equipment no longer suits the Employee's physical needs or health conditions; or
   - regulatory compliance – local regulations or laws change with the result that the Employee needs different Equipment to comply with safety or other legal requirements.
10. For the avoidance of doubt, this ruling does not consider or rule upon the validity of WorkRide's template Salary Sacrifice Agreement provided to Inland Revenue on 15 August 2023.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

(a) The cost of the Equipment will not exceed the maximum allowable cost specified in any regulations the Governor-General makes under s CX 19D(3) of the ITA.

(b) The Equipment will meet any requirements for vehicles specified in any regulations the Governor-General makes under s CX 19D(3) of the ITA.

(c) The Employer is GST registered.

(d) The Salary Sacrifice Agreement that an Employer and Employee enter into is a valid salary sacrifice under relevant law.

(e) Any MSA, Lease Agreement and Next Steps Deed (if applicable) entered into by the parties will be materially the same as the versions provided to Inland Revenue on 16 November 2023.

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) The provision of the Equipment to the Employee under the Lease Agreement and, if applicable, the Next Steps Deed, is excluded from being a fringe benefit under s CX 19D of the ITA and is therefore not a fringe benefit under s CX 2 of the ITA.

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

(c) The Employer can claim the GST charged on the supply of the Services by WorkRide (being the facilitation of the Arrangement) as input tax (as defined under s 3A(1)(a) of the GSTA) under s 20(3) and 20(3C) of the GSTA to the extent to which the Services are used for making taxable supplies.

(d) The sacrifice of salary under a Salary Sacrifice Agreement is consideration for a taxable supply by the Employer to the Employee under s 8 of the GSTA of procuring the provision of the Equipment to the Employee. The value of the supply for the purposes of s 10(2) of the GSTA is the amount of the salary sacrificed.

(e) Section 76 of the GSTA does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 December 2023 and ending on 30 November 2026.

This Ruling is signed by me on the 1st day of December 2023.

Howard Davis

Tax Counsel Office

INTERPRETATION STATEMENT

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

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

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

Some interpretation statements may be accompanied by a fact sheet summarising and explaining the main points. Any fact sheet should be read alongside its corresponding interpretation statement to completely understand the guidance. Fact sheets are not binding on the Commissioner. Check **taxtechnical.ird.govt.nz/publications** for any fact sheets accompanying an interpretation statement.

IS 23/11: Income tax: Income – when gifts are assessable income

Issued | Tukuna: 5 December 2023

A gift is not usually subject to income tax. This interpretation statement considers the circumstances in which a gift is subject to income tax in the recipient's hands.

The statement applies both to monetary gifts and to non-monetary gifts that are convertible to money. It does not apply to gifts that are not subject to income tax but may be family scheme income for the purposes of Working for Families tax credits.

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

REPLACES | WHAKAKAPIA

- Assessability of gifts received by volunteer workers in NZ, *Tax Information Bulletin* Vol 6, No 3 (September 1994): 8.
- Cash gifts received by voluntary workers, *Tax Information Bulletin* Vol 4, No 5 (December 1992): 42

Summary | Whakarāpopoto

1. Broadly, income tax legislation taxes "income". Gifts are not usually subject to income tax in the recipient's hands because, generally, they are made as a mark of affection, esteem or respect for an individual and do not have the character of "income".[1] However, in some circumstances a gift may be assessable income in the recipient's hands. This interpretation statement considers those circumstances.
2. In this statement, a "gift" refers to the receipt of an amount in money or money's worth that the payer makes voluntarily by way of benefaction and the payer receives no material benefit or advantage in return.[2] A gift for the purposes of this statement may include koha.[3]
3. A gift may be liable to income tax if it is a person's income under a provision in Part C. The specific provisions of Part C relevant to gifts include amounts derived:
   - from a business (s CB 1);
   - from carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit (s CB 3) (a profit-making activity);
   - in connection with employment (s CE 1); and
   - in undertaking a voluntary activity (s CO 1, subject to s CW 62B which exempts reimbursements of expenditure).

1 For a discussion of the character of "income" in relation to "income under ordinary concepts" see from [160].

2 See QB 16/05: Income Tax – Donee organisations and gifts, *Tax Information Bulletin* Vol 28, No 7 (August 2016): 33.

3 See IR 278 Payments and gifts in the Māori community or IR 382 Ngā utu me ngā koha i te hapori Māori: Donations (koha) (ird.govt.nz).

4. In addition, a gift may be income under the ordinary meaning of the word "income" (ie, income under ordinary concepts) and liable to income tax under s CA 1(2). Section CA 1(2) is a "catch-all" provision and likely to apply only in the alternative to other specific provisions in Part C.
5. Whether a gift is assessable to the recipient must be objectively decided on a case-by-case basis, considering all the circumstances of how and why the gift was made. Each gift must be considered on its own facts.

Employment income

6. Decided court cases show the courts consider a number of factors when deciding whether a voluntary payment such as a gift is employment income of the person receiving the gift. The following are some factors that support a conclusion that a gift is employment income:
    - The amount of the payment reflects the extent of any services provided.
    - The payment is made in the hope of future services or to encourage further efforts by employees.
    - The recipient's employment agreement contemplates the payment (although a payment of employment income could be under the terms of a separate agreement).
    - The payment has recurred, or it is foreseeable that it will recur, rather than being a one-off payment.
    - The payment is related to duties that are expected of the employee (although if an employee willingly does something beyond their usual duties and is paid for that, the range of duties is enlarged to encompass it).
    - The payments are commonplace as a matter of practice in the occupation, profession or industry.
    - The gift is one commonly provided to the holder of a position or office that has a degree of continuance and independence from the current incumbent.
7. The following factors support a conclusion that the gift is not employment income:
    - The payer expresses the payment in terms of a mere personal gift. However, the payer's motive is seldom determinative. Simply stating a payment is a personal gift does not rule out the possibility that it is employment income.
    - The recipient has already been fully remunerated for any services to which the payment might be related.
    - The employment relationship has ended at the time of the payment and is unlikely to resume (although a payment may be employment income where it is connected with a past, present or future employment relationship).
    - The payer is not a person with whom the taxpayer has an employment relationship. However, a payment may be employment income even where the payer is a person with whom the recipient has no employment relationship.
8. The following are some factors that are not necessarily relevant to the issue:
    - The employment is unpaid.
    - The recipient of the payment had to be an employee to be eligible for the payment.

Business or profit-making activity

9. A gift that the payer makes as a mark of affection, esteem or respect for an individual is a "mere gift" and is not business income or income from a profit-making activity. The fact that a gift is received in this context by a non-individual, does not necessarily exclude the payment from being a "mere gift".
10. Gifts are business income or income from a profit-making activity when they are a **financial** product of the business or profit-making activity. That is, where the payment can be attributed to the activities or specific work the recipient has carried out.
11. The collective understanding of the parties as to how and why the payment was made may be determinative of the character of the payment.
12. The motive of the payer is relevant, but on its own it will seldom be determinative. However, a gift may be assessable income from a business or profit-making activity if the payer has an interest in the business or the activity continuing and makes the payment with the intent of helping the business or activity.
13. Decided court cases show courts consider there are a number of factors when deciding whether a gift is business income or income from a profit-making activity. For example, the following factors support a view that a gift is income of a business or profit-making activity:

- The payer and recipient are both carrying on a business or profit-making activity.
- The recipient cannot continue to carry on the activity without the payment.
- The recipient is not a charity.

14. The following are some factors that support a conclusion that a gift is not business income or income from a profit-making activity:
    - The gift is unexpected or unsolicited.
    - The gift is made in recognition of past services that have been fully remunerated for at the time.
    - The gift is made in recognition of, or consolation for, the severance of a business connection that has no prospect of resuming. However, a gift promised while the business connection is current that would otherwise be assessable income, does not cease to be assessable income solely because it is paid after the connection is severed.
    - The business or profit-making activity had ended at the time of the payment.
    - The recipient is unaware of how the payer calculated the amount of the gift.
    - The calculation of the payment is not linked to trading between the parties.
    - The parties undertake no correspondence, bargaining or negotiations with each other.
15. Where a charity achieves its charitable object by carrying on a business, gifts to that charity may be described as intended to supplement its trade receipts or helping it to carry out its business activity. However, this alone is not determinative of whether the gifts are income of the business activity.
16. For more guidance on gifts received by online content creators carrying on a business or profit-making activity, see IS 21/01: Content creators – tax issues.[4]

Voluntary activities

17. A gift is income under s CO 1 when the gift and the activity of the recipient have a sufficient connection. This means, s CO 1 raises considerations similar to those involved in addressing the question of whether gifts are "a product of" or "in connection with" an employment activity.
18. The following are some relevant factors that support a view that s CO 1 applies:
    - The amount of the gift reflects the amount of the recipient's personal exertions in undertaking the voluntary activity.
    - The payer makes the gift as a quid pro quo in the hope that the recipient will undertake future activities or to encourage them to make further efforts.
    - The gift has recurred or has a foreseeable element of recurrence rather than being a one-off payment.
    - Such gifts are expected or asked for or are commonplace as a matter of practice in undertaking the voluntary activity.
19. The following are some relevant factors that support a view that s CO 1 does not apply:
    - The receipt is expressed in terms of being a mere personal gift inspired by personal goodwill rather than as consideration for the voluntary activities the recipient has undertaken.
    - The voluntary activity had ended at the time the payer made the gift.

Income under ordinary concepts

20. "Income" under ordinary concepts does not have a precise meaning in tax law. It is decided per ordinary concepts and usages.
21. Generally, "income" is:
    - something that comes in (ie, it does not include a savings in expenditure);
    - ascertained and judged in relation to the recipient (rather than the payer);
    - often shown by its periodicity, regularity and recurrence;
    - something that the recipient beneficially receives; and
    - a gain from carrying on an organised activity where the gain is, in a relevant sense, a product of that activity.

4 IS 21/01: Content creators – tax issues, *Tax Information Bulletin* Vol 33, No 10 (November 2021): 33 at [31]-[37] and example 7.

22. The courts have usually adopted a process of "characterisation" in which they weigh up a number of factors to decide whether an amount is income in a particular case. Several factors may be influential. Different factors in the same case can point in different directions and some factors may have greater relevance in some cases than in others. If the presence or absence of a particular factor is determinative in one case this does not mean that factor will be determinative in other circumstances.
23. While income is decided from the recipient's perspective:
    - it is still necessary to consider the relationship between the payer and recipient;
    - the motive of the payer and whether a receipt was paid voluntarily or not is relevant, but not determinative; and
    - the motive of the payer is only significant to the extent that it bears on the character of the payment in the recipient's hands.
24. In many cases, a payment that occurs periodically and regularly and recurs is income because these qualities allow receipts to become part of the funds the recipient may expect to depend on for meeting living expenses. However, a lump-sum payment is income if, at the time of the payment, the payment is the first of a series of expected periodic and regular payments.
25. If a taxpayer expects that, because of their activity, they will receive gifts that will provide for the maintenance of the taxpayer and their family, this may show the payments will be income. This is more likely where multiple payers are involved, or the taxpayer is actively soliciting gifts.
26. Also relevant is whether the receipt is an expected periodic payment that the payer makes for the purpose of the recipient using it for their living costs.
27. In the Commissioner's view, a series of gifts may be income under ordinary concepts under s CA 1(2) where:
    - The series of gifts fulfils the notion of "an income". That is, the gifts have the necessary periodicity, and the payer makes them for the recipient to rely upon, or intends the recipient to rely on them, for regular living expenses and they are so relied upon by the recipient.
    - The necessary periodicity of the payments refers to payments made with such regularity, recurrence, amount and frequency that they amount to "an income".
    - The payments are periodic and made with the intention of providing an income when they began (or this has been established over the passage of time) to the extent that the recipient could reasonably have expected to rely on the payments for their living costs.
    - The recipient relies on the payments for their financial support.
    - The payments are connected with some activity or personal exertion of the recipient, even though that exertion or activity does not necessarily arise in the context of an employment relationship (past, present or future) and does not amount to a business or a profit-making activity.

Introduction | Whakataki

What this statement is about

28. This interpretation statement provides guidance on when gifts are income in a range of circumstances. In particular, it considers the circumstances in which gifts may be assessable under Part C as income:
    - from employment activities;
    - from carrying on a business or a profit-making undertaking or scheme (a profit-making activity);
    - from a voluntary activity; or
    - under ordinary concepts.
29. This statement applies, therefore, to a range of entities and individuals that are receiving gifts in circumstances where assessable income under Part C may arise. This will be particularly pertinent for not-for-profit entities that are not registered charities and may commonly receive gifts but, due to their unregistered status, do not have an income tax exemption.
30. However, gifts that are not assessable income under Part C can still be family scheme income for the purposes of the Working for Families entitlements and tax credits for families arising under subparts MA to MG and MZ of the Act. This statement does not consider such gifts.

31. Non-cash or in-kind gifts that are not convertible to money are not "amounts" of income (see [44] below). Non-cash gifts may be subject to fringe benefit tax (FBT) where they are benefits provided in connection with employment. FBT is not the focus of this statement.

A "mere gift" is not assessable in the recipient's hands

32. Income tax "is a tax on income".[5] Voluntary payments, such as gifts, are not usually taxed in the recipient's hands because often they do not have the character of "income".

33. However, in certain circumstances, this is not the case. For instance, in *Hayes v FCT* Fullagar J distinguished between a "mere gift" and a gift that can be regarded as income:[6]

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

34. On this reasoning, Fullagar J's view is as follows:

- In the simple case of a voluntary payment of money or transfer of property from one person to another, the payment or transfer will not be income of the recipient.
- Further facts may, however, show the payment or transfer is "so related to", or a product of, an income-earning activity the recipient is carrying on (eg, employment, a business activity or a profit-making activity). If so, it may be concluded that the payment or transfer gives rise to income in the recipient's hands.

35. When considering whether a gift was income from employment, Viscount Cave LC referred to a "mere gift" in *Seymour v Reed* as follows:[7]

> The question, therefore, is whether the sum … fell within the description, … of "salaries, fees, wages, perquisites, or profits whatsoever therefrom" …. These words and the corresponding expressions contained in the earlier statutes (which were not materially different) have been the subject of judicial interpretation in cases which have been cited to your Lordships; and it must now, **I think, be taken as settled that they include all payments made to the holder of an office or employment as such, that is to say, by way of remuneration for his services, even though such payments may be voluntary, but that they do not include a mere gift or present (such as a testimonial) which is made to him on personal grounds and not by way of payment for his services.** [Emphasis added]

36. Further, in G v CIR, McCarthy J made a distinction between a "personal gift", and one made in relation to the activities of the recipient:[8]

> Each gift must be considered on its own facts, the test being whether on the one hand the gift was made in relation to the activities of the appellant of the income producing character which I have discussed, or whether it was a personal gift made purely as a mark of affection, esteem or respect.

37. Thus a "mere gift" is one that someone makes as a mark of personal affection, esteem or respect for the recipient and is not assessable income in the recipient's hands.

38. However, further facts may reveal that the gift is not a mere gift in this sense. What the courts have seen as relevant further facts are considered later in this statement. Where a gift is assessable income, it is because it can be shown that some specific provision in the Act makes it taxable.[9] This means the gift must come within a provision in Part C. Part C includes specific provisions that capture common sources of income relevant to a gift, including an amount derived:

- in connection with employment (s CE 1);
- from a business (s CB 1);
- from carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit (s CB 3); and
- by a person from undertaking a voluntary activity (s CO 1).

5 *London County Council v Attorney-General* [1901] AC 26 (PC) per Lord Macnaghten at 35.

6 *Hayes v FCT* (1956) 11 ATD 68 (HCA) at 72.

7 *Seymour v Reed (Inspector of Taxes)* [1927] All ER Rep 294 (HL) at 297.

8 *G v CIR* [1961] NZLR 994 (SC) at 999.

9 *G v CIR* (SC) at 997. See also *Federal Coke Co Pty Ltd v FCT* (1977) 15 ALR 449 (FCA) at 460–461 and *Stedeford v Beloe* [1932] AC 277 (HL) at 390.

39. Part C includes a "catch-all" provision that includes items of "income" that do not necessarily fall within other specific provisions in Part C. That provision is s CA 1(2) (income under ordinary concepts).

40. The following analyses focus on the factors that the courts have found relevant when considering whether a voluntary payment (including a gift) is assessable income in the recipient's hands. Each analysis focuses on where one of the specific provisions in Part C mentioned at [38] and [39] above, may apply.

Analysis | Tātari – Income from employment

41. The question of when a gift is assessable as employment income arises if the circumstances surrounding the making of the gift include the existence of an employment relationship relevant to the person receiving the gift. That relationship may be relevant whether it is a past, present or future relationship.

Legislation

42. An amount is employment income if it comes within s CE 1(1):

> **CE 1 Amounts derived in connection with employment**
>
> Income
>
> (1) The following amounts derived by a person in connection with their employment or service are income of the person:
>
> (a) salary or wages or an allowance, bonus, extra pay, or gratuity:
> (b) expenditure on account of an employee that is expenditure on account of the person:
> (bb) the value of accommodation referred to in sections CE 1B to CE 1E:
> (c) [Repealed]
> (d) a benefit received under an employee share scheme:
> (e) directors' fees:
> (f) compensation for loss of employment or service:
> (g) any other benefit in money.

43. A gift could potentially come within s CE 1(1) as salary, wages, a bonus or gratuity (para (a)) or as "any other benefit in money" (para (g)). In either case, the gift would need to be an amount derived in connection with the taxpayer's employment or service. The following paragraphs examine each of these elements:

- an "amount" (see [44])
- "derived" (see [45])
- "in connection with" (see from [46])
- the taxpayer's "employment or service" (see from [48]).

44. Section YA 1 defines an "amount" as including "an amount in money's worth". This means that the gift must be in money or be something that can be converted into money (ie, money's worth). Something that can be converted into money is something capable of "being sold, surrendered, assigned or mortgaged for money or money's worth".[10] Part C refers to amounts of income, including income from employment but, generally, non-monetary or in-kind gifts arising in an employment context are considered under the FBT rules.

45. Section BD 3(1) requires income to be allocated to an income year when it is "derived". Briefly, an employee generally derives income on a cash basis when they receive it (ie, when it is paid). Alternatively, they derive the income when it is credited in their account or is in some other way dealt with in their interest or on their behalf (s BD 3(4)). In a gift context, this means the recipient must have received the gift, or it must have been dealt with for their benefit in some other way.

46. The gift needs to be "in connection with" the relevant employment activity. This means the employment relationship must be the substantial reason for the gift.[11] However, there is no requirement to show that, "but for" the employment relationship, the payment would not have arisen. That is, the fact that a recipient of a payment had to be an employee, is not determinative by itself (see [85] below).

10 *Dawson v CIR* (1978) 8 ATR 605 (SC) per McMullin J at 613.

11 See BR Pub 09/02: Federal Insurance Contributions (FICA) – Fringe Benefit Tax (FBT) Liability, *Tax Information Bulletin* Vol 21, No 4 (June 2009): 2 at 7–8.

47. Also, on some occasions the courts have considered the employment relationship was no more than part of the background facts or a "mere historical connection". In this situation, the employment connection was not sufficient to mean the voluntary payment was employment income.[12]

48. The phrase "employment or service" used in s CE 1(1) is a "compendious expression", meaning that the two terms refer to the same concept.[13] Therefore, the phrase does not refer to anything beyond what "employment" is commonly understood to encompass.

49. Section CE 1 does not specify that the employee's employer must be the one who pays the employment income. Section YA 1 defines "employer" and "employee" in terms of their relationship with a PAYE income payment (either as payer or recipient of such payments). These terms are not defined in terms of any relationship between the payer and recipient. Although, for the recipient to be an "employee" such a relationship must exist, it may not necessarily be with the payer of a gift. So, the Act could treat a payer of a PAYE income payment (including a gift) to be an employer even though, at law, they have no employment relationship with the recipient of the payment.

A selection of examples from the courts

50. The Aotearoa New Zealand courts have produced limited examples related to gifts and income, including gifts and employment income. For this reason, it is necessary to look to overseas jurisdictions for guidance. In particular, cases in Australia and the United Kingdom that involve voluntary payments, not necessarily gifts. In some cases, they involve non-cash gifts that may be subject to FBT in Aotearoa New Zealand, rather than giving rise to employment income.

51. However, broadening the inquiry into examples from the courts in this way, establishes a body of cases from which it is possible to discern common themes and factors. A selection of these case examples is discussed next before the common factors are summarised (see from [83] below).

Cases where the courts considered receipts were income

52. The following are some cases where the courts have considered a voluntary payment was employment income.[14]

Laidler v Perry (HL): Gift vouchers given to employees

53. *Laidler v Perry* involved gift vouchers a company gave to 2,300 of its employees at Christmas.[15] Each year the gift was enclosed with a letter from the Board of Directors of the company conveying Christmas greetings and expressing the Board's thanks for the recipient's past services and its confidence that the company's good relations with the recipient would continue.

54. The House of Lords concluded the gifts were employment income of the recipients. The main reason for this decision was that the gifts were paid for the purpose of obtaining beneficial results for the company in the future (ie, some future quid pro quo from the recipients) rather than as personal gifts. Such gifts are likely to be subject to FBT in Aotearoa New Zealand if they are not able to be redeemed for cash.

Wright v Boyce (EWCA): Gifts to huntsman

55. *Wright v Boyce* involved cash gifts that a huntsman received under a long-standing custom of providing such gifts following the annual Boxing Day hunt.[16] The court considered the gifts were employment income.

56. Although personal regard for the huntsman influenced to some extent the making of the gifts, this personal regard had its origins in the way in which the huntsman performed his duties and providing the gifts followed the custom of making such gifts to the huntsman each year. The court held the huntsman received the gifts in his role as huntsman. There was no evidence to show the gifts were made personally to him. The consequence was that the object of the gifts was the huntsman by virtue of his office, though personal consideration may have entered into the matter, particularly in deciding on the amount of the gifts.

12 See *FCT v Rowe* (1995) 131 ALR 622 (FCA) per Drummond J at 644 and *FCT v Dixon* (1952) 10 ATD 82 (HCA) (*Dixon's case*) per Dixon CJ and Williams J at 84.

13 *Reid v CIR* [1986] 1 NZLR 129 (CA) per Richardson J at 135.

14 This and later sections generally set out the selected cases in the order of the date of the decisions, from the most recent to the oldest.

15 *Laidler v Perry (Inspector of Taxes)* [1965] 2 All ER 121 (HL).

16 *Wright v Boyce (Inspector of Taxes)* [1958] 2 All ER 703 (EWCA).

***Moorhouse v Dooland* (EWCA): Professional cricket player's receipts from spectator collections**

57. *Moorhouse v Dooland* involved funds collected from spectators at cricket matches and provided to a professional cricket player as contemplated by the player's employment contract.[17] Under the player's employment contract, spectators at matches in which he played could be asked to contribute money to special collections for "meritorious performance". This occurred at 11 out of 25 matches in which the player played in one season. The court considered the funds were employment income.
58. The court considered the fact that the player's employment contract contemplated the collections was particularly important. It also considered that the contract obliged the player to play to his best ability and so receive the collections as a result. The regular occurrence of the collections was another relevant factor.

***Calvert v Wainwright* (EWHC): Gratuities received by a taxi driver**

59. *Calvert v Wainwright* involved customer's tips received by a taxi driver.[18] The driver was employed by a taxi company and the terms of the driver's employment contract had nothing in it on the matter of gifts received from clients.
60. The court considered tips and gratuities received as a reward for services rendered by people other than the driver's employer are employment income "if given in the ordinary way as a reward for services". The court contrasted this situation with gifts made to a person for personal reasons (ie, "mere gifts") "irrespective of and without regard" to the question of whether the driver had rendered any services.
61. In Aotearoa New Zealand, employees should return tips or gratuities received as a reward for services in their annual income tax returns. This applies whether the customer makes them directly to the employee or they are placed in a common pool to be passed on and shared amongst several employees.

***Weston v Hearn* (EWHC): Long-service gifts to employees**

62. *Weston v Hearn* involved gifts of fixed-term savings certificates to employees in recognition of their long service.[19] The court considered the gifts were bonuses given for past services and employment income.
63. The court considered that, while the gifts may have been intended to be personal gifts, such an intention cannot make a payment non-assessable if, in fact, the payment is remuneration for services provided.

***Mudd v Collins* (EWHC): Payment for services outside of employee's usual duties**

64. In *Mudd v Collins* the taxpayer was employed as the secretary and a director of a company.[20] The taxpayer negotiated the sale of a branch of the company's business for which the company paid him a commission. The taxpayer argued the payment was not employment income on the ground that negotiating the sale was not part of his duties as secretary or as a director. The taxpayer contended, amongst other things, that the payment was a gift.
65. Rowlatt J held the payment was part of the taxpayer's profit from his office and assessable income, saying:[21]

> **It seems to me quite clear on all the authorities that a voluntary payment, such as this was, does not necessarily thereby cease, by reason of its voluntary character, to be a profit of the office;** but the whole point made by Mr. Allen in the argument which he addressed to me, which did not suffer from its shortness because it was extremely clear and good, was that, as this could not be said to be in respect of a duty involved in his secretaryship and directorship, offices which received their own salary for the performance of those duties, therefore it could not be a profit of his office. Now I do not think that is so. **It seems to me that if an officer is willing to do something outside the duties of his office, to do more than he is called upon to do by the letter of his bond, and his employer gives him something in that respect, that is a profit; it becomes a profit of his office, which is enlarged a little so as to receive it.** [Emphasis added]

66. On this reasoning, a payment made as a reward for services an employee performs beyond their normal duties will not be a mere gift. It is assessable as employment income as if the employee's normal duties had expanded to include the extra services.

17 *Moorhouse (Inspector of Taxes) v Dooland* [1955] 1 All ER 93 (EWCA).
18 *Calvert (Inspector of Taxes) v Wainwright* (1947) 27 TC 475 (EWHC).
19 *Weston v Hearn (Inspector of Taxes); Carmouche v Hearn (Inspector of Taxes)* [1943] 2 All ER 421 (EWHC).
20 *Mudd v Collins (Inspector of Taxes)* (1925) 9 TC 297 (EWHC).
21 At 300.

***Blakiston v Cooper* (HL): Easter offerings received by vicar**

67. *Blakiston v Cooper* involved Easter cash offerings that parishioners provided to the parish's vicar.[22] Providing the Easter offerings to the vicar each year was usual practice, following the written request of the bishop of the diocese. Parishioners did not provide offerings in recognition of any special need or the vicar's personal circumstances.
68. The House of Lords considered the receipts to be income from the vicar's office of employment as vicar, rather than mere gifts to the vicar personally.

Cases where courts considered receipts were not income

***Scott v FCT* (HCA): Gift to lawyer from client**

69. *Scott v FCT* involved a gift from a client to their long-serving family lawyer.[23] The court considered that the gift was a genuine gift, insufficiently connected to the services that the lawyer had performed for the client over the years. The lawyer had been fully remunerated for those services at the time. The fact that providing those services prompted the gift was not, by itself, determinative.

***Louisson v C of T* (CA): Payments to former employee serving in armed forces**

70. *Louisson v C of T* involved monthly payments that a former employer made to the taxpayer to make up the difference between the amount of the taxpayer's previous salary and their military pay they received while serving in the armed forces during World War 2.[24]
71. The court considered the receipts were not employment income from either the taxpayer's former employment or their current employment in the armed forces and were a series of mere gifts. The court considered the payments were not related to any service, employment or something of this nature between the taxpayer and their former employer.
72. The decision in this case on employment income is consistent with the Australian High Court decision in *Dixon's case* involving similar facts.

***Dixon's case* (HCA): Payments to former employee serving in armed forces**

73. In *Dixon's case* the High Court of Australia considered the income tax treatment of payments made in the same circumstances as those in *Louisson v C of T* (CA). The court considered the payments were not income from employment but were income derived from all sources.[25]
74. The court accepted that a payment of employment income need not come from the employer.[26] However, it had difficulty in agreeing the payments were "in respect of or in relation, directly or indirectly" to any employment. The court considered that merely having a historical employment relationship was not sufficient to meet the provision. It considered that employment income must relate to either some present services or immediately past services where the income arises at the termination of employment – and neither of these conditions arose in this case.

***Hayes v FCT* (HCA): Gift of shares**

75. *Hayes v FCT* (HCA) involved a gift of shares from a person with personal and professional relationships with the taxpayer.[27] At various times the taxpayer had been a professional advisor to, an employee of, or a director or shareholder of a company owned by the person making the gift. The company owner sold all their interests in their company to another company and received shares in the other company as consideration. They then gifted some of the other company's shares to various people, including the taxpayer.
76. The court noted that the taxpayer was fully remunerated for any services at the time they performed them. For the gift to be considered employment income, there needed to be "a real relation between the receipt and the employment or services", which the court concluded did not exist in this case.

22 *Blakiston v Cooper (Surveyor of Taxes)* [1909] AC 104 (HL).
23 *Scott v FCT* (1966) 14 ATD 289 (HCA). See further discussion of this case in relation to income under ordinary concepts from [187].
24 *Louisson v C of T* [1943] NZLR 1 (CA).
25 See further discussion of this case in relation to income under ordinary concepts from [173].
26 At 85.
27 See further discussion of this case in relation to income under ordinary concepts from [190].

***Benyon v Thorpe* (EWHC): Voluntary pension payments to retired employee**

77. *Benyon v Thorpe* involved voluntary pension payments that a company paid to a retired former employee.[28] The court concluded the payments were a series of mere gifts and the former employment relationship was just a part of the background facts.

78. Although the gift was motivated by a past employment relationship, the employment relationship was not a substantial reason for the payments. Also, the former employee had been fully remunerated for any past employment services at that time.

***Seymour v Reed* (HL): Professional cricket player's receipts from benefit match**

79. *Seymour v Reed* involved the proceeds of a benefit cricket match provided to a professional cricket player. The House of Lords considered the proceeds were a personal gift to the player and not employment income.

80. The court considered it was relevant that the holding of benefit matches was at the absolute discretion of the club and were usually a one-off affair to provide funds for a player's retirement. The match proceeds included collections from spectators being funds they provided as appreciation of the player's personal qualities and any club contribution could be seen in the same light.

***Cowan v Seymour* (EWCA): Voluntary payments on winding up of company**

81. In *Cowan v Seymour*, shareholders made a voluntary cash payment to the company's former secretary out of the surplus that came from winding up the company.[29] The taxpayer had acted as secretary and liquidator for the company without reward. The court considered the payment from the shareholders was not employment income. It was a mere gift.

82. It was relevant that another person received an equal amount from the shareholders even though they had not provided equal services to the company. The court also considered it relevant that the taxpayer's employment relationship with the company had stopped by the time of the payment and the shareholders' resolution making the payment was expressed in terms of a personal gift.

Summary of the relevant factors to consider

83. From these cases and others, several common factors the courts have considered relevant are evident. First, some common factors support a conclusion that a gift is employment income:

- The amount of the payment reflects the extent of the services the taxpayer has provided to which the payment can be related.[30]
- The payment is made as a quid pro quo in the hope of future services from the employee or to encourage further efforts.[31]
- The payment is a product of, or contemplated by, the terms or implied terms of the recipient's employment agreement.[32] However, a payment made under the terms of an agreement separate from the employment agreement may still be treated as employment income.[33]
- The payment had recurred or has a foreseeable element of recurrence, rather than being a one-off payment.[34]
- The employee's services to which the payment can be related are commonly within the range of duties expected of the employee or the range of activities that the employer carries on.[35] However, if an employee willingly does something beyond their usual duties and is paid for that, their employment duties are enlarged to encompass it.[36]

28 *Benyon (Inspector of Taxes) v Thorpe* (1928) 14 TC 1 (EWHC).

29 *Cowan v Seymour (Inspector of Taxes)* [1920] 1 KB 500 (EWCA).

30 *Cowan v Seymour* (EWCA) per Younger LJ at 517. See also *Moore v Griffiths (Inspector of Taxes)* [1972] 3 All ER 399 (EWHC) at 410–411.

31 *Laidler v Perry* (HL) per Lord Reid at 125, Lord Morris of Borth-Y-Gest at 127 and Lord Donovan at 128, *Seymour v Reed* (HL) per Viscount Cave LC at 297.

32 *Moorhouse v Dooland* (EWCA) per Evershed MR at 97, *Seymour v Reed* (HL) per Viscount Cave LC at 297. See also *Kelly v FCT* (1985) 80 FLR 155 (WASC) at 161 and *Corbett v Duff; Dale v Duff; Freebery v Abbott* [1941] 1 All ER 512 (EWHC) at 514.

33 See *Clayton (Inspector of Taxes) v Gothorp* [1971] 2 All ER 1311 (EWHC).

34 *Moorhouse v Dooland* (EWCA) per Jenkins LJ at 104 and *Seymour v Reed* (HL) per Viscount Cave LC at 297 and Lord Phillimore at 303. See also *Moore v Griffiths* (EWHC) at 411.

35 See *Naismith v CIR* (1981) 5 NZTC 61,046 (HC) at 61,049 and 61,051 and *Case 18/95* 95 ATC 208 (AAT) at [11] and [46].

36 *Mudd v Collins* (EWHC) at 300.

- Such payments (including tips or gratuities) are expected or asked for or are commonplace as a matter of practice in the occupation, profession or industry.[37]
- The payment is one commonly provided to the recipient, not as a personal gift, but because they are the employee that is the current holder of an office (ie, they hold a position or office that has a degree of continuance and an independent existence from them personally).[38]

84. Other common factors support a conclusion that the gift is not employment income:
    - The payer expressed the payment in terms of a mere personal gift rather than as consideration for services the taxpayer had provided or would provide.[39] However, the motives of the payer, while relevant, are seldom determinative because the test is objective, not subjective.[40] Even where the payer's intention in making the payment is to make a gift, the payment may still be employment income. Stating such an intention as the reason for making the payment does not alter this outcome.[41]
    - The recipient of the payment has already been fully remunerated for any employment services they provided to which the payment is related.[42]
    - The employment relationship has ended at the time of the payment and is unlikely to resume.[43] However, a payment may be employment income where it is in connection with a past, present or future employment relationship.[44]
    - The taxpayer does not have an employment relationship with the person making the payment.[45] However, in some circumstances, a payment may be employment income even though the recipient has no employment relationship with the person making the payment.[46]

85. Finally, the following are some factors that are not necessarily relevant to the issue:
    - The employment is unpaid.[47]
    - The recipient of the payment had to be an employee to be eligible for the payment.[48]

37 *Scott v FCT* (HCA) at 293 and *Calvert v Wainwright* (EWHC) at 478. See also *Corbett v Duff* (EWHC) at 514, *Davis (Inspector of Taxes) v Harrison* [1927] All ER Rep 743 (EWHC) at 746–747 and *Moore v Griffiths* (EWHC) at 411.

38 *Blakiston v Cooper* (HL) and *Wright v Boyce* (EWCA). See also *Herbert v McQuade* [1902] 2 KB (EWCA).

39 *Cowan v Seymour* (EWCA) per Younger LJ at 517. See also *Moore v Griffiths* (EWHC) at 411 and *Bridges (Inspector of Taxes) v Hewitt; Bridges (Inspector of Taxes) v Bearsley* [1956] 3 All ER 789 (EWCA) at 798.

40 *Hayes v FCT* (HCA) at 72–73. See also *FCT v Blake* 84 ATC 4661 (QSC) at 4664.

41 *Weston v Hearn* (EWHC) at 422.

42 *Scott v FCT* (HCA) at 291, *Hayes v FCT* (HCA) at 70–71 and *Benyon v Thorpe* (EWHC) at 14. See also *Naismith v CIR* (HC) at 61,051, *Case 18/95* (AAT) at [44] and *Hochstrasser (Inspector of Taxes) v Mayes* [1959] 3 All ER 817 (HL) per Viscount Simonds at 822, Lord Radcliffe at 823 and Lord Cohen at 825.

43 *Louisson v C of T* (CA) per Myers CJ and Northcroft J at 9, *Cowan v Seymour* (EWCA) per Lord Sterndale at 508–509, 510 and Aitkin LJ at 511–512. See also *FCT v Rowe* (FCA) per Burchett J at 635 and Drummond J at 644 and *Moore v Griffiths* (EWHC) at 410–411.

44 See *Clayton v Gothorp* (EWHC) at 1320, *Louisson v C of T* (CA), *Hayes v FCT* (HCA), *Laidler v Perry* (HL), *Bridges v Bearsley* (EWCA) and *Weston v Hearn* (EWHC).

45 *Cowan v Seymour* (EWCA) per Lord Sterndale at 509.

46 *Dixon's case* (HCA) per Dixon CJ and Williams J at 85, *Calvert v Wainwright* (EWHC) at 477. See also *FCT v Rowe* (FCA) per Drummond J at 643 and *Kelly v FCT* (WASC).

47 *Cowan v Seymour* (EWCA) per Lord Sterndale at 508–509.

48 See *Case 18/95* (AAT) at [46], *Clayton v Gothorp* (EWHC) at 1320, *Pritchard (Inspector of Taxes) v Arundale* [1971] 3 All ER 1018 (EWHC) at 1019 and *Hochstrasser v Mayes* (HL) per Lord Radcliffe at 823.

Example | Tauira

Tauira | Example 1: Employment – gifts from employer and staff to current employee

A dealer in fine arts employs Aroha as the company accountant. Aroha has recently completed 30 years' service with the company. The Board of Directors of the company resolved to recognise this milestone. At a celebratory morning tea for all staff, the chair of the Board acknowledged Aroha's diligence and her dedication to the company over the last three decades and expressed the Board's desire that such devotion would continue into future decades. She presented Aroha with a gift of a framed limited-edition print.

The gift in recognition of long service was voluntarily made by the company. Aroha's employment contract does not contemplate such gifts and the company had no other obligation to make it.

Aroha's colleagues like and respect her. Unprompted by the company, they took the opportunity of the special morning tea to present her with a card signed by all the staff and a gift of cash. The cash gift is the proceeds of a collection among other employees of the company. The managing director and chair of the Board also contributed to this collection.

These events have the following income tax implications:

- As a one-off non-monetary gift, the value of the frame print is not employment income in Aroha's hands but as it is related to her employment it may be a benefit that is subject to the fringe benefit tax rules.
- The proceeds of the staff collection (including those from the directors acting in their own capacities) are not assessable income in Aroha's hands. Although the event recognising her long-service prompted the collection and she only received it because she was an employee, the gift is the sum of many mere gifts by her colleagues, which they made out of personal affection, esteem and regard and not as a payment for services.

Analysis | Tātari – Income from a business or a profit-making undertaking or scheme

86. The question of when a gift can be assessable income from a business or profit-making activity arises if the circumstances surrounding the making of the gift include the existence of a business or a profit-making activity relevant to the person receiving the gift.

Legislation

87. An amount is income if it comes within s CB 1:

> CB 1 Amounts derived from business
>
> *Income*
>
> (1) An amount that a person derives from a business is income of the person.
>
> *Exclusion*
>
> (2) Subsection (1) does not apply to an amount that is of a capital nature.

88. Under s CB 1 amounts derived from a "business" are income. A "business" is relevantly defined in s YA 1 as:

> **business—**
>
> (a) includes any profession, trade, or undertaking carried on for profit:
>
> ...

89. An amount is also income if it comes within s CB 3:

> **CB 3 Profit-making undertaking or scheme**
>
> An amount that a person derives from carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit is income of the person.

90. Under s CB 3, an amount derived from carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit is assessable income. As mentioned at [44] an "amount" is defined as including "an amount in money's worth" meaning income under ss CB 1 or CB 3 can include non-cash amounts.

91. An undertaking or scheme is a plan of action or enterprise directed at profit that is something less than a business to which s CB 1 applies. In either case, the activity must be carried on for a profit, which means much the same issues arise, so this statement considers the two provisions together.

92. All the cases show that, depending on the circumstances, gifts and other voluntary payments made to a recipient that is carrying on a business activity can have the character of income, despite the voluntary nature of the payment. A selection of case examples is discussed next before any common factors considered by the courts are summarised (see from [138] below).

A selection of examples from the courts

93. There are fewer examples from the courts on gifts and business or profit-making activities in comparison with the previous issue on employment income. Mostly, cases involve business activities and voluntary payments, not necessarily gifts. Some examples are discussed next.

Cases where courts considered receipts were income

FCT v Stone (HCA): Prizes and grants received by a professional athlete

94. *FCT v Stone* involved a professional athlete who sought to exclude prizes and grant monies from the income she gained from athletic activities on the basis they were in the nature of gifts.[49] The court held the grants were business income because they were a financial product of the taxpayer's athletics activities where those activities were a business. The court said:

> 61. … But gratuitous payments may form part of a taxpayer's assessable income. The grant made by QAS, though not recurrent, was paid in recognition of the taxpayer's athletic success in achieving selection for a national athletics team. It was as much a financial product of her athletics activities as her winning a prize in competition, or a sponsor agreeing to pay her to have her endorse the sponsor's product.

95. The court considered it was the business activity that supplied the "unifying ingredient" that made these receipts income, whereas they would not have the character of income when considered individually:

> 106. … Prizes, in particular, depend upon providence, are usually intermittent and ordinarily lack periodicity and regularity. They depend upon so many chance factors that they would not normally take on the character of "income" without some additional unifying ingredient.
>
> 107. It is the interposition of the postulate of the taxpayer's "business" that affords that additional ingredient that helps to link the several receipts and to colour them — each of them reinforcing the conclusion of the character of "income" that might not otherwise have been drawn reviewing them individually.

96. From this, the court concluded that to decide the question of whether a receipt, including a voluntary payment, is business income it is necessary to consider whether the receipt is "a financial product of" the business activity. If so, gifts and other voluntary payments can be considered business income even though individually they would not have the character of income.

McGowan v Brown and Cousins (EWHC): Voluntary payment from third party received by real estate agency

97. In *McGowan v Brown and Cousins*, the taxpayer company ran a real estate agency business.[50] The taxpayer negotiated the purchase of a site for a building company to develop. The taxpayer did not receive adequate remuneration for this work because it expected the building company would engage it later for the more lucrative work of selling the developed properties. However, the building company on-sold the undeveloped site to another developer who refused to engage the taxpayer. However, to preserve the other developer's business standing and image the other developer agreed to make a voluntary payment to the taxpayer. The amount of the payment was increased after the taxpayer protested at the amount first proposed.

98. The taxpayer argued the payment was not the direct product of the taxpayer's business activities because it was a voluntary payment from someone that was not a client. The Crown argued the payment was compensation for the loss of an opportunity to make future profits and, therefore, was business income.

49 *FCT v Stone* 2005 ATC 4,234 (HCA).

50 *McGowan (Inspector of Taxes) v Brown and Cousins (trading as Stuart Edwards)* [1977] 3 All ER 844 (EWHC).

99. Templeman J considered whether the payment could be attributed to specific work the taxpayer carried out. He stated:[51]

> As a result of all the authorities it seems to me that the broad line of distinction, so far as taxability on this kind of voluntary gift is concerned, is a distinction which takes its origin in the question of whether the payment is attributable to specific work carried out by the recipient. If work is carried out then the payment, although voluntary, is made because payment has been earned. If the payment does not relate to specific past work, then the payment is made, not because payment has been earned by work, but because the payment is intended for a deserving recipient.

100. In conclusion, Templeman J considered the payment was earned:[52]

> **In the present case it seems to me that the gift was plainly earned and not merely deserved.** It was earned because the gift was compensation for the loss of an opportunity to earn selling profits and the taxpayers were morally entitled to that opportunity because their past services as purchasing agents had been inadequately remunerated. The gift was not unexpected and was not unsolicited. The gift was in fact, although via [the other developer], ultimately referable to the work which the taxpayers carried out in the acquisition of the site. …
>
> **In my judgment, the important question is not who pays the gift but whether the estate agents had earned the gift by virtue of work which had been carried out or whether they had deserved the gift. Earning in this sense cannot mean a legal obligation because it is the nature of a gift that there is no legal obligation. If they earned a gift, then the gift is taxable, no matter who pays it. On the other hand, if they deserved a gift then the gift is not taxable, no matter who paid it.** Once one comes to the conclusion that in the present case the taxpayers earned the gift, they were entitled to look to somebody for some remuneration for their work which had been inadequately paid for in the first instance, then it follows that the £2,500 is taxable…. [Emphasis added]

101. On this reasoning, Templeman J's criterion was to decide if the gift was earned or deserved. A gift earned is assessable as business income while a gift merely deserved is not. Also, earning a payment did not require a legal obligation for the recipient to be paid for the work it had carried out. In this case, the taxpayer had earned the gift because of its earlier work for which it was not adequately remunerated at the time and, therefore, the receipt was business income. Another factor that the court considered relevant was that the taxpayer expected and asked for the payment.

***Commissioners of Inland Revenue v Falkirk Ice Rink Ltd* (Ct Sess (Scotland)): Gift to operator of commercial ice-rink**

102. In *Commissioners of Inland Revenue v Falkirk Ice Rink Ltd* the taxpayer owned and operated an ice rink on a commercial basis, which included providing facilities for playing curling.[53] The taxpayer leased rooms at the ice rink to a curling club and incurred the additional costs of ensuring the ice was of sufficient quality for the sport. Club members were entitled to discounted admission fees to the facilities.

103. Members of the curling club made a gift of £1,500 to the taxpayer for the purpose of helping the taxpayer to continue to provide, and to improve, the curling facilities available to the club. They imposed no obligation on the taxpayer to do so.

104. The court held that the gift was income arising as a product of the taxpayer carrying on their business. Lord President Emslie said:[54]

> In spite of the fact that there was no agreement between the Respondent and the club requiring the club to make any such payment to the Respondent and that the payment was not in respect of services rendered by the Respondent to the club in the past and that the Respondent gave no undertaking in return for the donation, I am of opinion that the payment was made in order that the Respondent might use it in their business and that in substance and in form it was a payment made to a trading company artificially to supplement its trading revenue from curling and in order, in the interests of the club and its members, to preserve the Respondent's ability to continue to provide curling facilities in the future. In its quality and nature this payment was of a business nature. It was accordingly a trading receipt in the hands of the Respondent and the question of law should be answered in the negative.

105. Lord Avonside considered that the club made the payment in its own interests in view of the close connection between the club and the continued existence of the trading activities of the recipient:[55]

> In my opinion, in this case, the payment was made by the club in the interest of its members in view of the close connection between the continued existence of activities of the club and the continued existence of the trade of the Respondent and, in particular, in the hope and expectation that the payment of £1,500 would enable or encourage the Respondent to continue to carry on one of its trading activities, the provision of ice for curling, which was proving at the date of payment to be unprofitable. The payment was made because it was believed that there was danger of the Respondent ceasing to carry on that trading activity and

51 At 850–851.

52 At 852.

53 *Commissioners of Inland Revenue v Falkirk Ice Rink Ltd* (1975) 51 TC 42 (Ct Sess (Scotland)).

54 At 49–50.

55 At 56.

> its purpose clearly was designed to supplement the trading receipts derived by the Respondent from that branch of its trade and to assist in enabling the Respondent to carry on that branch of its trade to its advantage.

106. The court considered the voluntary nature of the payment "was neutral". That is, it carried no weight in deciding whether the payment was, or was not, business income. When it considered the whole of the relevant facts and the circumstances of the making of the payment, however, the court concluded that the gift was business income. The following specific facts were influential:
    - The activities of the club and the business activities were closely connected. Notably, the club or its members were both customers and potential customers of the taxpayer for the purpose of curling.
    - The taxpayer was making a loss on supplying curling facilities.
    - The club was concerned that the taxpayer would not continue to supply curling facilities in the absence of a gift.
    - The circumstances showed the club made the gift to a trading company to supplement the company's trading revenue that it gained from providing curling facilities. Its purpose in doing so was to help the trading company to continue to provide those facilities.
    - Business income could arise although the payer was not making the payment for services that the recipient provided to the payer.

***British Commonwealth International Newsfilm Agency Ltd v Mahany* (HL): Promoters' contribution to a company**

107. In *British Commonwealth International Newsfilm Agency Ltd v Mahany*, the taxpayer was a company that the Rank Organisation and the BBC formed (together 'the promoters').[56] They formed the company for the non-commercial purpose of supplying visual news suitable for British viewers at a time when America was the only source of visual news.
108. As part of the process of forming the company, a trust deed was established to run for an initial 5 years and then at will. The deed included various matters governing the taxpayer's operations. These arrangements catered for the expectation that the taxpayer's early activities would not be profitable. In anticipation of this, the promoters agreed that each would pay to the company an additional subscription equal to one-half of the amount of the deficit.
109. The case concerned one such payment the Rank Organisation made. The taxpayer company considered the payment was not a trade receipt and emphasised that it was paid without conditions or stipulations or in return for any consideration.
110. The House of Lords decided that the payment was business income. It considered the following facts were among those supporting this view:
    - The payer and the taxpayer were both traders.
    - The taxpayer could not continue to carry on its business without the payment.
    - The taxpayer was not carrying on a charitable venture.
    - Although the aim of the promoters was not commercial gain, the trust deed had an expiry date, and the parties could modify it.

***G v CIR* (SC): Individual taxpayer's evangelical activities were a business**

111. In *G v CIR*, the taxpayer was wholly engaged in evangelical activity and supported himself and his family from the voluntary and unsolicited gifts that the activity generated.
112. Despite this finding, the court did distinguish some gifts on the basis that it considered them to be personal gifts made purely as a mark of affection, esteem or respect. The court said:[57]

> Though I have held that the appellant was carrying on a business for pecuniary profit, it does not follow that every gift received by him was assessable. Each gift must be considered on its own facts, the test being whether on the one hand the gift was made in relation to the activities of the appellant of the income producing character that I have discussed, or whether it was a personal gift made purely as a mark of affection, esteem or respect.

113. In this respect the court was expressing the same test discussed in the previous section that arises when an individual receives gifts in the context of an employment relationship. Accordingly, in the Commissioner's view, where the taxpayer is an individual and is undertaking a business activity, the question as to whether a gift is income involves much the same considerations as those that arise where the taxpayer is an employee. This includes considering whether the gift was made in relation to the activities of the recipient or as a mark of personal affection, esteem or respect (ie, is a "mere gift").

56 *British Commonwealth International Newsfilm Agency Ltd v Mahany (HM Inspector of Taxes)* [1963] 1 All ER 88 (HL).

57 At 999.

The Squatting Investment Co Ltd v FCT (HCA) and FCT v Squatting Investment Co Ltd (PC): A wool grower receives a lump-sum

114. In *FCT v Squatting Investment Co Ltd* the High Court of Australia considered that a single lump-sum receipt by the company was not income in the hands of the taxpayer company.[58] It received the lump-sum as a result of a series of events that originated in arrangements made during World War 2 between the United Kingdom and Commonwealth countries, including Australia. Under these arrangements, the United Kingdom bought each country's export wool clip at a fixed rate.

115. The taxpayer was involved in the business of wool growing and had wool subject to these arrangements. At the end of the war, the arrangement was unwound generating a surplus that the Australian government voluntarily passed back to wool growers. The majority of the High Court considered the portion of the surplus the taxpayer received was not assessable to the taxpayer because it was nothing more than a gift.

116. The Federal Commissioner of Taxation successfully appealed to the Privy Council.[59] The Privy Council determined the receipt was income under s 25(1)(a) of the Income Tax Assessment Act 1936 (Cth) (the Australian equivalent of s CA 1(2) (income under ordinary concepts)). The Privy Council said:[60]

> **It is well settled that a voluntary payment may be subject to income tax in the hands of the recipient.** … **What, then, is the nature of the payment now in question, and in what capacity did the respondents receive it? Having regard to the whole history of the matter,** beginning with the Wool Purchase Arrangement and the Regulations of 1939, continuing with the submission of wool for appraisement by the respondents and the classification of that wool as participating wool, and ending with the payment of the sum in question pursuant to s. 7 of the Act of 1948**, their Lordships come to the conclusion that the payment must be regarded as an additional payment voluntarily made to the respondents for wool supplied** for appraisement or, if the compulsory acquisition can properly be described as a sale, a voluntary addition made by the Commonwealth to the purchase price of the wool. …
>
> **The respondents were in business as wool suppliers at all material times, and the payment was made to them, not because of any personal qualities, but because they, among others, supplied participating wool.** They supplied the wool in the course of their trade and this further payment was made to them because they supplied it. In the present case the respondents were still trading when the payment was made. **It was in their hands a trade receipt of an income nature.** [Emphasis added]

117. The Federal Commissioner of Taxation had argued in the alternative that the payment was income under s 26(a) (the Australian equivalent of s CB 3 (profit-making undertaking or scheme)). The Privy Council, having found the payment was income under s 25(1)(a), did not address s 26(a). However, the Privy Council considered the payment was a trade receipt, so it seems likely that if it had found the receipt was not income under s 25, the Federal Commissioner of Taxation may have succeeded with the alternative argument.

118. As this case shows, the Privy Council considered it was well settled that a voluntary payment can be subject to income tax in the recipient's hands. It also determined the matter by considering the whole of the circumstances relating to the payment, including the history and background under which the payment arose, the nature of the payment and the capacity in which the taxpayer received it.

Cases where courts considered receipts were not income

Murray v Goodhews (EWCA): Voluntary payment received following termination of tenancies

119. In *Murray v Goodhews*, the taxpayer company carried on the business of running licensed premises comprising several public houses with restaurants.[61] It held most of these premises under tied tenancies with a brewery company. The brewery company decided to terminate some of the leases within the terms of the tenancy agreements. It made several unsolicited voluntary payments after terminating the leases, even though it was not under any obligation to do so.

120. The court held the payments to the taxpayer were not trading receipts. Buckley LJ considered that certain facts were crucial to this conclusion:[62]

- The taxpayer was unaware of how the brewery company calculated the amounts of the payments.
- The brewery company and the taxpayer undertook no correspondence, bargaining or negotiations over the payments.

58 *The Squatting Investment Co Ltd v FCT* (1953) 10 ATD 126 (HCA).

59 *FCT v Squatting Investment Co Ltd* (1954) 10 ATD 361 (PC).

60 At 370–371.

61 *Murray (Inspector of Taxes) v Goodhews* [1978] 2 All ER 40 (EWCA).

62 At 42.

- The amounts of the payments had no connection with any profits earned by the taxpayer's businesses run from the properties where the leases were terminated.
- The calculation of the payment was not linked to any future trading relations between the brewery company and the taxpayer. The parties continued to have an ongoing business connection in respect of other properties.

121. In assessing the character of a voluntary payment, Buckley LJ considered:[63]
    - All the relevant circumstances must be considered.
    - Each case must be considered on its own facts.
    - Whether an amount is income depends on the nature of the receipt in the recipient's hands.
    - The purpose for which the payer makes the payment and the terms on which they made the payment are relevant considerations.
    - The motive of the payer is only significant to the extent that it bears, if at all, on the character of the payment in the recipient's hands.

***Federal Coke Co Pty Ltd v FCT* (FCA): Receipt from cancellation of supply contract**

122. In *Federal Coke Co Pty Ltd v FCT* the taxpayer received payments following the cancellation of a supply contract between the taxpayer's subsidiary and a third-party. The court considered the payments were "broadly in the nature of a gift being a sum received without compensation".[64] The court concluded the payments were not business income as they were not "a product of" the taxpayer's own business or income producing activities.[65]

123. The court also said that where the recipient of a payment provides consideration for the receipt, that consideration will be the "touchstone" for ascertaining whether the receipt is on revenue account or not. However, when there is no consideration, the "how and why" of the receipt may reveal the matter, particularly if there is a consensus between the payer and recipient. The motive or intention of the payer alone is not determinative but, depending on the circumstances, may have some significance.[66]

***Simpson v John Reynolds (Insurances) Ltd* (EWCA): Voluntary payment received following termination of business relationship**

124. In *Simpson v John Reynolds & Co (Insurances) Ltd* a company was operating the business of an insurance broker.[67] A long-standing client company had been forced to end its business relationship with the brokerage when another company took over the client company. The client company paid the brokerage a gift of £5,000 in five annual instalments.

125. The Crown argued the receipts were trading receipts because, among other things, the taxpayer was a limited liability company and the client company had not made the gift merely out of personal affection or regard. The court concluded that the payments were not business income based on a number of relevant factors summarised at [129] below. In reaching that conclusion, Walton J discounted to some degree the fact that the gift was made to a company, saying:[68]

> Counsel for the Crown, however, relied on six indicia which he said showed that [the gifts] were trading receipts: … (6) the fact that the gift was to a limited liability company. …
>
> So far as (6) is concerned, the fact that the gift was to a limited liability company, the force of that, which in other circumstances I can readily envisage might be very considerable, is removed when once it is understood that this company was, in popular parlance, Mr Shaw's family company.

126. Accordingly, Walton J at least does not discount entirely the possibility that a family-owned company might receive a gift that the payer makes out of personal affection or respect for the individual owners of the company.

127. Also, Russell LJ rejected as a general proposition that where the taxpayer's business continued and a gift arose because of a business connection, the gift must be business income because the payer did not make it merely out of personal affection or regard:[69]

63 At 46.
64 At 460.
65 At 461.
66 At 472–474.
67 *Simpson (Inspector of Taxes) v John Reynolds & Co (Insurances) Ltd* [1975] 2 All ER 88 (EWCA).
68 At 92–93.
69 At 91.

> The Crown contended, as I understand it, as a general proposition, that in the case of a business connection that was a trade connection, and the trade of the donee as a whole continued with persons other than the donor, a gift made for the reasons given in the present case must be caught; for it was not made merely out of personal affection or regard. Or, the Crown submitted, that viewed as a whole the circumstances of this case showed that this sum did accrue or arise from the trade. For my part, I am unable to accept this.

128. The fact that the company was a family company was just one of several relevant factors or components that the court and Walton J, in particular, considered. The case does suggest, however, that a gift to a non-individual could be considered a "mere gift".

129. Primarily, the court found that the gifts in this case were not business income based on the following factors:

- The payment was unsolicited.
- The payment was made after a business connection had ended.
- The payment was made in recognition of past services that had been fully remunerated for at the time.
- The payment was made as consolation for the fact that the recipient would provide no future services.
- There was no suggestion that the business connection might resume in the future.

Epping Forest (HL): Contributions to a charitable fund

130. The *Epping Forest* case involved a charitable fund set up under the Epping Forest Act 1878.[70] The City of London Corporation regulated and managed the fund in its capacity as the Conservators of Epping Forest (the conservators). The Epping Forest Act 1878 also required the City of London Corporation, in its own capacity (the corporation), to contribute such amounts as were necessary to the income of the fund.

131. The case concerned the question of whether the payments the corporation made to the conservators were "annual payments" under Case III of Schedule D of the Income Tax Act 1918. If so, the conservators were entitled to a tax refund for the payments. Other payments Schedule D included as assessable income were amounts from carrying on a trade (Case I) and income from carrying on an enterprise analogous to a trade (Case VI). If the payments came under Case I or Case VI as trade or trade-like receipts, the taxpayer was not entitled to a tax refund.

132. The court analysed the nature of the payments with reference to the circumstances of how and why the payments arose. For instance, Lord Normand canvassed in detail the history leading to the passing of the Epping Forest Act 1878, analysed provisions of that Act and considered the case largely hinged on the proper construction of that Act.[71]

133. Lord Reid considered that the payments were not trade receipts because no consideration passed from the conservators to the corporation. Lord Reid stated:[72]

> But, in my judgment, the payments in this case are not trading receipts in the hands of the conservators, even if they are carrying on a trade or something in the nature of a trade. Trading receipts are generally received in return for something done or provided by the recipient for the payer, but, as I have said, that does not appear to me to be the case here.

134. The Crown submitted that, even if the court found that the conservators had not supplied services to the corporation, the payments could still be trade receipts. In this regard, the Crown cited two cases that it considered as decisive in its favour.[73] Both cases involved subsidy payments made to commercial traders. Neither taxpayer in those cases was a charity and there was no consideration of annual payments under Case III. Both Lord Normand and Lord Reid distinguished these cases on their facts. After reviewing the cases, Lord Reid contrasted them with the facts of the case before him, saying:[74]

> In my opinion, the payments in the present case were not of a business nature—they were of a benevolent nature—and they were not primarily made to assist in carrying on any trade or business—they were made primarily to achieve a public benefit of a charitable nature.

135. Lord Reid also considered that, if the conservators, as a charity, were subject to tax on the basis that all receipts were trading receipts, regardless of whether consideration was provided to the payer (ie, including subscriptions or gifts, as contended by the Crown) anomalous results could arise. He said:[75]

70 *Inland Revenue Commissioners v City of London Corporation (as the Conservators of Epping Forest)* (1953) 1 All ER 1075 (HL) (*Epping Forest*).

71 At 1,077 and 1,083.

72 At 1,087.

73 *Lincolnshire Sugar Co Ltd v Smart* [1937] 1 All ER 413 (HL) and *Pontypridd & Rhondda Joint Water Board v Ostime* [1946] 1 All ER 668 (HL).

74 At 1,089.

75 At 1,089.

> If the appellants are right, the result would be far-reaching and, in my opinion, anomalous. Many, if not all, subscriptions to a charity which achieves its charitable object by trading could properly be described as intended to supplement its trading receipts, or to assist it in carrying on its trade, but if that were the sole criterion, the result would be an unreal distinction between charities which do not trade and those which do: … .

136. Lord Reid considered that, where a charity obtained its charitable object by trading, any gift the charity received might be seen as supplementing its trading receipts. But, if the sole criterion were the mere presence of a trading activity, the same receipt would be treated differently in the hands of a charity, depending on whether the charity carried on a trade or trade-like activity. For this reason, where a charity trades to achieve its charitable object receives a gift, that gift is not necessarily business income simply because a business activity exists.

137. The court considered the payments were not business income. It reached this conclusion because not all receipts of a business are necessarily income from that activity, rather than because a charity could not derive business income. This is particularly so where the recipient provides no services or consideration to the payer.

Summary of the relevant factors to consider

138. To decide whether a gift is income from a business or profit-making activity carried on by the recipient, it is necessary to consider all the relevant circumstances.[76] Each gift must be considered on its own facts.[77]

139. It is relevant to consider whether the gift was made as a mark of affection, esteem or respect for an individual:

- If the taxpayer that is carrying on a business or profit-making activity is an individual and the payer makes the gift as a mark of affection, esteem or respect for that individual (ie, it is a "mere gift"), the gift is not income.[78]
- Where a non-individual carrying on a business or profit-making activity receives a gift, that fact does not necessarily exclude them from receiving a "mere gift".[79]

140. If there is no consideration involved that can be used to decide the character of the receipt, as usually arises with gifts, the collective understanding of the parties as to how and why the payment was made may be determinative.[80] However, the motive of the payer is relevant, but only to the extent that it bears on the character of the payment in the recipient's hands.[81]

141. The courts have referred to the relevant concern in this context in terms of considering whether the receipt is:

- in relation to the activities of the taxpayer of an income-producing character;[82] or
- a financial product of that activity.[83]

142. The following factors support a conclusion that a gift is business income or income from a profit-making activity:[84]

- The payment is made with the intent of benefiting the business or activity.
- The payer has an interest in the recipient continuing the business or activity they are carrying out.
- The payer and recipient are both carrying on a business or profit-making activity.
- The recipient could not continue to carry on the activity without the payment.
- The recipient is not a charity (see, however, Epping Forest (HL), and the view that the recipient's status as a charity may be a neutral factor).

76 *Murray v Goodhews* (EWCA) per Buckley LJ at 46, *G v CIR* (SC) at 1,001, *FCT v Stone* (HCA) per Kirby J at 4,251, *Federal Coke Co Pty Ltd v FCT* (FCA) per Brennan J at 472, *FCT v Squatting Investment Co Ltd* (PC) at 371 and *Commissioners of Inland Revenue v Falkirk Ice Rink Ltd* (Ct Sess (Scotland)) per Lord President Emslie at 47–48.

77 G v CIR (SC) at 999.

78 *G v CIR* (SC) at 1,000, *McGowan v Brown and Cousins* (EWHC) at 850–851.

79 *Simpson v John Reynolds & Co (Insurances) Ltd* (EWCA) per Walton J at 93.

80 *Federal Coke Co Pty Ltd v FCT* (FCA) per Brennan J at 472–474.

81 *Murray v Goodhews* (EWCA) at 46.

82 *G v CIR* (SC) at 999.

83 *FCT v Stone* (HCA) at [61].

84 *Commissioners of Inland Revenue v Falkirk Ice Rink Ltd* (Ct Sess (Scotland) and *British Commonwealth International Newsfilm Agency v Mahany* (HL).

143. The following factors support the view that a gift is not business income or income from a profit-making activity:[85]
    - The gift is unexpected or unsolicited.
    - The gift is made in recognition of past services that had been fully remunerated for at the time.
    - The gift is made in recognition of, or as consolation for, the severance of a business connection that has no prospect of resuming. However, where the payer promises a gift while a business connection is current and that gift would otherwise be assessable income, it does not cease to be assessable income solely because it is paid after the connection is severed.
    - The business or activity ended at the time of the payment.
    - The recipient is unaware of how the payer calculated the amount of the gift.
    - The calculation of the payment is not linked to any past or future trading relations between the parties.
    - The parties undertook no correspondence, bargaining or negotiations about the payment.
144. Where a charity achieves its charitable object by carrying on a business, gifts it receives may be described as intended to supplement its trade receipts or helping it to carry out its business activity. However, this alone is not determinative of whether the gifts are income of the business activity.[86]

Examples | Tauira

Example | Tauira 2: Business – individuals

Kelly and his partner have recently invested all their life savings and borrowed extensively to set up, in partnership, a state-of-the-art kitchen joinery business. The business operates from premises constructed on land next to the couple's home on a rural property located close to a major city.

After the business has been in operation for just a few months, a severe weather event causes widespread flooding, destroying property in the entire valley where the couple lives. Their home, business premises and all the expensive joinery machinery are severely damaged.

The local media cover the young couple's story sympathetically, describing the damage they experienced and the resulting emotional and economic impact on their lives and their business aspirations. This prompts many offers of help and the couple receives gifts of money from family, friends, complete strangers and former clients.

In many instances the gifts are made anonymously. Some gifts come with no message or have a message that expresses a general desire to help the couple. No message states that the main reason for making the gift is to help with the couple's business.

The media coverage also prompts the supplier of kitchen hardware to the couple's business to offer a discount on the amount due on the couple's latest order that was in transit at the time of the flood. The supplier usually only offers this discount to more high-volume customers.

The gifts from family and friends are not business receipts because they are "mere gifts" made out of personal affection, esteem and regard and do not have the character of income.

Gifts from strangers and former clients are also "mere gifts" made out of esteem and regard. The gifts from former clients were not linked to providing any further business goods or services and it is presumed that those former clients fully remunerated the couple for any earlier business transactions at the time. Where people make gifts because some service they have received inspires their goodwill and gratitude, those gifts may still be "mere gifts".

The supplier discount is not income because the character of income is that it is something that comes in. Income does not include a savings in an amount of an outgoing.

85 *Simpson v John Reynolds & Co (Insurances) Ltd* (EWCA) and *Murray v Goodhews* (EWCA).

86 *Epping Forest* (HL).

Example | Tauira 3: Business – unregistered charity

A: Trading activity related to charitable object

XDenta Charitable Trust Board (XDenta) is a charitable trust registered under the Charitable Trusts Act 1957. XDenta is not a registered charity under the Charities Act 2005. As an unregistered charity, XDenta's income is not exempt from income tax under the Income Tax Act 2007.

XDenta's object is to contribute to the relief of poverty through helping to improve the dental health of the community in a defined geographical area of Aotearoa New Zealand. It achieves this object by running a dental practice aimed at providing affordable dental treatment for low-income working families, older people and welfare beneficiaries. After assessing the needs of its customers, it then charges them for dental services at usual commercial rates or discounted rates or makes no charge.

Under XDenta's business model, it must regularly top-up its business income by soliciting additional funds through grants, bequests and gifts. It solicits gifts at an annual gala event and street appeal. XDenta receives gifts from:

- members of the public who have no association with XDenta (ie, they have never been clients);
- former clients who may have received free or discounted dental services in the past; and
- current clients who voluntarily donate towards dental services XDenta intends to provide at a discounted rate or for no charge at the time it provides those services.

The gifts from members of the public are unlikely to be business income as they are unrelated to the business activity and are not a product of that activity. Although the gifts could be described as supplementing the business income of XDenta or as helping it to carry on its trade, this is not the sole criterion. Either of these descriptions alone do not establish that the gifts are business income.

Gifts from former clients are also unlikely to be business income. However, this depends on the exact circumstances of each gift. For instance, if XDenta provided the free or discounted dental services immediately before the client made the gift, that gift may fall within business income. A number of factors may then be relevant in these circumstances. Such as, the delay between the treatment and the gift, the relative values of the treatment and gift and whether the services were free or discounted.

Gifts that current clients make because of current services XDenta is providing are business income.

B: Trading activity unrelated to charitable object

In this variation on the facts, XDenta conducts a business activity of providing wholesale dental products and supplies to dental practices in Aotearoa New Zealand. This activity is unrelated to its charitable object. XDenta carries on this activity aiming to generate a trading surplus to use to achieve its object.

XDenta distributes the surplus to fund the dental treatment of the needy in its community on a case-by-case basis. As before, XDenta solicits additional funds, including gifts.

Gifts XDenta receives are unlikely to be business income where the business is unrelated to the charity's object. This is because it is more likely that the payer of a gift will make the gift because they intend to help XDenta's charitable objects than because they want to promote the business activity. In other words, the circumstances surrounding how and why the gift arose are more likely to show that the gift is not a product of the unrelated business activity.

However, each gift needs to be considered on its own facts. Gifts will be income in this variation if XDenta receives the payments in relation to, or as a product of, the business activity.

Analysis | Tātari – Income from voluntary activities

145. The question of when a gift can be assessable from a voluntary activity arises if the circumstances surrounding the making of the gift includes the existence of some activity undertaken by the person receiving the gift.

Legislation

146. An amount is income from a voluntary activity if it comes within s CO 1:

> **CO 1 Income from voluntary activities**
>
> *Income*
>
> (1) An amount derived by a person in undertaking a voluntary activity is income of the person.
>
> *Relationship with section CW 62B*
>
> (2) This section is overridden by section CW 62B (Voluntary activities).

147. Section CW 62B overrides s CO 1:

> **CW 62B Voluntary activities**
>
> *Exempt income*
>
> (1) When a volunteer, in undertaking a voluntary activity, derives an amount that is a reimbursement payment to cover actual expenses incurred by them, the amount is exempt income of the volunteer.
>
> *Estimated expenditure*
>
> (2) For the purposes of subsection (1)—
>
> (a) a person may make a reasonable estimate of the amount of expenditure likely to be incurred by the volunteer for which reimbursement is payable; and
>
> (b) the amount estimated is treated as if it were the amount incurred.
>
> *Payments partly reimbursement and partly honorarium*
>
> (3) If the person paying the amount to the volunteer makes a payment to them that is only partly a reimbursement of expenses, the person must identify the portion of the amount that is the reimbursement, and treat the remainder as an honorarium, being a schedular payment to which the PAYE rules apply.
>
> *Who is a volunteer?*
>
> (4) For the purposes of this section, a **volunteer** means a person who freely undertakes an activity in New Zealand—
>
> (a) chosen either by themselves or by a group of which they are a member; and
>
> (b) that provides a benefit to a community or another person; and
>
> (c) for which there is no purpose or intention of private pecuniary profit for the person.
>
> *Honoraria*
>
> (5) For the purposes of this section, an **honorarium** means an amount that a person receives for providing services that—
>
> (a) is paid at a rate that is less than the market rate for providing the services; and
>
> (b) is an amount for which, in the normal course, no payment is fixed for the services provided.
>
> *Nature of reimbursement payment*
>
> (6) For the purposes of this section, it does not matter whether—
>
> (a) an amount of a reimbursement payment is paid in 1 sum or not:
>
> (b) the amount is paid during an income year or at the end of an income year.
>
> *Relationship with section RD 8(3)*
>
> (7) A determination made by the Commissioner under section RD 8(3) (Schedular payments) may apply to modify an amount of expenditure under this section.

148. Any amount of income arising under s CO 1 is treated as exempt income where the amount is a reimbursement payment to cover actual expenses a volunteer incurred in line with s CW 62B. As this statement focuses on when gifts may be assessable income, it does not consider the application of s CW 62B other than to the extent that it relates to the interpretation of s CO 1.

149. In that regard, ss CO 1 and CW 62B do not refer to each other and, apart from the term "income", share no other defined terms. For this reason, a person deriving assessable income under s CO 1 need not be a "volunteer" as defined in s CW 62B(4) or receive an "honorarium" as defined in s CW 62B(5).

150. In addition, while the tone of s CW 62B implies that a "person" for the purposes of the income tax exemption is a natural person, such a limitation, if it exists for s CW 62B, does not apply to s CO 1. A "person" is defined in s 13 (Definitions of terms for all legislation) of the Legislation Act 2019 as including "a corporation sole, a body corporate, and an unincorporated body". Section AA 3(2) of the Income Tax Act 2007 refers to the Legislation Act 2019, particularly in relation to the use of the term "person".[87]

151. While both provisions refer to a "voluntary activity", this term is not defined in the legislation. The *Concise Oxford English Dictionary* defines "voluntary" as:[88]

> **voluntary** ⇨ **adj. 1** done, given, or acting of one's own free will … **2** working or done without payment.

152. Further, the *Concise Oxford English Dictionary* defines "activity" as:

> **activity** ⇨ **n.** … **1** a condition in which things are happening or being done. … **2** an action taken in pursuit of an objective.

153. From these dictionary definitions, a "voluntary activity" is some action or actions that a person freely undertakes to achieve something that is not in response to any legal obligation and without expectation of payment. However, it does not necessarily have to be an activity that would qualify a person to be a "volunteer" under s CW 62B(4). That is, for the purposes of s CO 1 a voluntary activity need not be carried out only within Aotearoa New Zealand. Nor does it need to be an activity that provides a benefit to a community or another person.

154. However, according to these dictionary definitions, an activity that someone is required to undertake would not be a voluntary activity. This would include an activity someone must undertake to fulfil the conditions of an employment contract. It would not include an activity someone undertakes to generate a trade receipt as part of a business or profit-making activity based on the reasoning that commercial transactions would normally be undertaken under contract requiring some activity to ensure the contract is performed. For the same reason, a voluntary activity would not include an activity someone undertakes as part of a profit-making undertaking or scheme. In any event, a person would usually undertake any of these activities with the expectation of payment.

155. Sections CO 1 and CW 62B were added to the Act in 2009.[89] They have not been the subject of any decided court cases. However, the Commissioner considers for a gift to be income under s CO 1 it needs to have a sufficient connection to the activity of the person receiving the gift. This is based on a plain reading of the words of s CO 1 that refer to an amount derived "in undertaking" (ie, taking on or carrying out) a voluntary activity. That is, there must be a causal link between the amount derived and the carrying out of the voluntary activity.

156. This means s CO 1 requires considerations similar to those involved in addressing the question of whether gifts are "a product of" or "in connection with" an employment activity as discussed above from [83] to [85].

157. As mentioned at [44] an "amount" is defined as including "an amount in money's worth" meaning income under s CO 1 can include non-cash amounts.

Summary of the relevant factors to consider

158. By adapting the factors relevant to the employment situation to the context of a voluntary activity and s CO 1, the following factors support a conclusion that a gift is income under s CO 1:

- The amount of the gift reflects the amount of the recipient's personal exertion in undertaking the voluntary activity.
- The payer makes the gift as a quid pro quo in the hope that the recipient will undertake future activities or to encourage them to make further efforts.
- The gift has recurred or has a foreseeable element of recurrence rather than being a one-off payment.
- Such gifts are expected or asked for or are commonplace as a matter of practice in undertaking the voluntary activity.

87 See also "New legislation, Income Tax Act 2004" *Tax Information Bulletin* Vol 16, No 5 (June 2004): 46 at 70–71.

88 *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011).

89 Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009: ss 27 and 50.

159. The following factors support a conclusion that a gift is not income under s CO 1:

- The receipt is expressed in terms of being a mere personal gift inspired by personal goodwill rather than as consideration for the voluntary activities the recipient has undertaken.
- The recipient is not undertaking the voluntary activity at the time the gift is made.

Examples | Tauira

Example | Tauira 4: Voluntary activities – individual

James works in paid employment 4 days a week and works 1 day a week as an unpaid volunteer in a youth counselling service run by his church. Occasionally, he receives gifts of money. His church, individuals and other organisations in the community that he is in contact with through his volunteer work make some of these gifts, expressing them in terms of recognising him for his services. James also occasionally receives gifts of money from his parents because of their respect and admiration for what he is doing.

James should include the gifts he receives from the church, individuals and other organisations in the community as part of his assessable income each year. They are his assessable income under s CO 1 because they are amounts he derives from undertaking a voluntary activity.

The gifts from James's parents are not assessable income. Those gifts are not sufficiently connected to his voluntary work and are "mere gifts" that his parents make as marks of personal affection, esteem or regard.

Example | Tauira 5: Voluntary activities – unregistered charity

Nala Charitable Trust Board (Nala) is a charitable trust registered under the Charitable Trusts Act 1957. Nala is not a registered charity under the Charities Act 2005. As an unregistered charity, Nala's income is not exempt from income tax under the Income Tax Act 2007.
Nala's overall object is to act as a Christian-based humanitarian aid organisation in Africa. It does not carry out any activities within Aotearoa New Zealand other than soliciting gifts by promoting its overseas activities at regular fundraising events held at various venues around the country.
Nala's activities in Africa and New Zealand means it is carrying out a "voluntary activity" for the purposes of s CO 1. It is a "person", as defined, and it is deriving amounts as a result of undertaking that activity. Under s CO 1, it is not required to carry out the voluntary activity within any particular country.
Accordingly, the gifts Nala receives are assessable income under s CO 1.

Analysis | Tātari – Income under ordinary concepts

160. As noted at [39], s CA 1(2) applies as a catch-all provision to include items of income that do not necessarily fall within another specific provision in Part C. For this reason, it is necessary to consider the question of whether a gift can be assessable as income under ordinary concepts in all cases.

Legislation

161. An amount is income if it is income under ordinary concepts as s CA 1(2) provides:

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

162. The role of s CA 1(2) is to be a residual or catch-all provision:[90]

> [It] ensures that where any transaction gives rise to an amount that is of an income nature, that amount will be gross income even where that amount would not otherwise fall within the scope of any other specific gross income provision.

90 Taxation (Core Provisions) Act 1996 *Tax Information Bulletin* Vol 8, No 9 (November 1996): 2 at 14 (concerning s CD 5 of the Income Tax Act 1994, a predecessor of s CA 1(2)).

163. In *Reid v CIR* (CA), Richardson J considered that an amount was assessable income under s 65(2)(l) of the Income Tax Act 1976 (a predecessor of s CA 1(2)) if the amount was income under ordinary concepts and no other specific provision in Part C of the Act applied.[91]

164. As mentioned at [44] an "amount" is defined as including "an amount in money's worth" meaning income under s CA 1(2) can include non-cash amounts.

A selection of examples from the courts

165. There are a few examples where the courts overseas have considered whether a voluntary payment or a gift is income under ordinary concepts. In several cases, this has been an alternative argument to more specific income provisions applying.

Cases where the courts considered receipts were income

FCT v Blake (QSC): Ex-gratia payments to retired bank employee

166. In *FCT v Blake* the Queensland Supreme Court considered the income tax treatment of regular ex-gratia payments that a retired bank employee received from his former employer. The bank made the payments to subsidise its superannuation scheme payments as compensation for cost-of-living increases. The bank included the subsidy payments with its regular fortnightly payments to the taxpayer from its superannuation fund.

167. The taxpayer argued that the subsidies were personal gifts. The Federal Commissioner of Taxation successfully argued the subsidies were income according to ordinary concepts. The court considered the payments were designed to protect the standard of living of retired employees, noting that the bank's superannuation fund rules apparently did not allow for inflation-indexed payments. Carter J said:[92]

> Therefore, the directors of the Bank voluntarily took a series of decisions which were designed to protect to some extent the standard of living of those former employees now living in retirement. There was no attempt to discriminate between them. Irrespective of their individual financial status, those in receipt of a pension payment from the Fund had that payment increased or supplemented by an increment, the measure of which was selected by their former employer. **As a result of it, the amount of money available to the taxpayer for his daily living was increased. In my view it accords with ordinary concepts and usages to include it in that which one normally regards as one's income and at the same time it accords with modern day usages to say that the payment in this case was, in the tax year in question, a regular increment to that which was admittedly the taxpayer's income and was itself income. The payment is in my view income "according to ordinary principles"** and falls "within the natural understanding of gross income" (per Dixon C.J. and Williams J. in F.C. of T. v. Dixon (1952) 86 C.L.R. 540 at p. 555). It falls within "the general conception of income" (per Fullagar J. in Hayes v. F.C. of T. (1956) 96 C.L.R. 47 at p. 53). It was "income according to ordinary concepts" (per Deane J. in F.C. of T. v. Harris 80 ATC 4238 at p. 4244). It is a receipt "which by reasonable understanding might fairly be regarded as income" (per Starke J. in Resch v. F.C. of T. (1941-1942) 66 C.L.R. 198 at p. 213). **The test is fundamentally an objective one** (per Fullagar J. in Hayes v. F.C. of T. (supra) at p. 55). [Emphasis added]

168. Accordingly, Carter J considered the payment was income under ordinary concepts on the strength of several authorities, including cases discussed from [173] below. Carter J also confirmed the test is an objective one.

169. Consistent with these other authorities, Carter J considered the fact that the payment was voluntary was relevant, but not decisive. Carter J continued, saying:[93]

> What factor will have greater relevance in one case and what may be seen as being more relevant in another will vary from case to case. **I do not understand the authorities taking collectively to establish a fixed set of criteria against which a particular receipt has to be measured in order to determine whether it qualifies as income or not. The cases identify some of the considerations which have been referred to and which will be useful in arriving at a result, such as, the periodical nature of the payment, the recipient's reliance or otherwise on the payment for regular expenditure on himself and his dependants, the expressed object of the payment and its effect in the hands of the recipient, the relationship, if any, between the payment and the taxpayer's employment or former employment. These considerations form part only of the litany of useful criteria.** [Emphasis added]

170. Carter J considered there was no fixed set of criteria against which a particular receipt was measured to decide if the receipt is income under ordinary concepts. But he noted the courts have identified several matters as being useful to consider, including:

- whether the receipts were regular;
- the effect of the receipts in the recipient's hands, including whether the recipient relied on them for living expenses;

91 At 136.

92 At 4,664.

93 At 4,664.

- the purpose of the payments; and
- the relationship between the recipient and the source of the payments (including whether the payer made them voluntarily).

171. Carter J considered the factors did not have equal weight or relevance and that one factor alone will not be determinative.

172. Carter J also distinguished the case before him from *FCT v Harris* (FCA) which involved similar facts but the court in that case considered the payment was not income. He made this distinction because the factors mentioned at [170] above were absent in that case.[94]

***Dixon's case* (HCA): Payments to former employee serving in armed forces**

173. This statement covered *Dixon's case* above in relation to employment income (from [73]). The High Court of Australia rejected the Federal Commissioner of Taxation's argument that the payments were income from employment under s 26(e) of the Income Tax Assessment Act 1936 (Cth). However, the court agreed the payments were income derived from all sources under s 25(a) (ie, income under ordinary concepts).

174. The majority of the court considered that the amounts were income under ordinary concepts because they were an expected periodic payment that the taxpayer could depend on for living expenses.[95]

175. Fullagar J said:[96]

> **It seems to me that the appellant's receipts from** [his former employer] **must be regarded as having the character of income. They were regular periodical payments — a matter which has been regarded in the cases as having some importance in determining whether particular receipts possess the character of income or capital in the hands of the recipient,** see eg *Seymour v Reed* (1927) AC 554, at p 570 and *Atkinson v Federal Commissioner of Taxation* (1951) 84 CLR 298. **This consideration, while not unimportant, is not decisive. What is, to my mind, decisive is that the expressed object and the actual effect of the payments made was to make an addition to the earnings, the undoubted income, of the respondent.** What the employing firm decided to do, and what it really did, in relation to the respondent and others in the same position, was "to make up the difference between their present rate of wages and the amount they will receive". **What is paid is not salary or remuneration, and it is not paid in respect of or in relation to any employment of the recipient. But it is intended to be, and is in fact, a substitute for — the equivalent pro tanto of — the salary or wages which would have been earned and paid if the enlistment had not taken place. As such, it must be income, even though it is paid voluntarily and there is not even a moral obligation to continue making the payments. It acquires the character of that for which it is substituted and that to which it is added.** [Emphasis added]

176. The court appears to assume that the taxpayer relied on the payments for financial support on the basis that the payments kept his income at its former level.[97] Accordingly, the express objective of the payments and the actual effect of the payments (in maintaining the taxpayer's former income) were important additional facts, along with the periodic nature of the payments.

177. Earlier in his judgment, Fullagar J considered that income under ordinary concepts could arise from personal exertion, even though the income was not employment income under s 26(e).[98] Fullagar J saw the payments as income under ordinary concepts because they, in effect, took the place of employment income that would have arisen from the taxpayer's personal exertions, if he had not enlisted.

178. The majority (Dixon CJ, Williams and Fullagar JJ) considered the payments were income under ordinary concepts because:
- the payments were expected, regular and periodic;
- the former employer made the payments for the purpose of adding to the earnings of the taxpayer and so they financially supported the taxpayer;
- the recipient could rely on the payments for financial support and the court assumed he did rely on them in this way;
- the payments substituted for income from employment and acquired the character of that income; and
- the payments arose from the taxpayer's personal exertion that would have taken place, if he had not enlisted (Fullagar J).

94 At 4,665.
95 At 86.
96 At 92.
97 At 85.
98 At 90.

179. *Dixon's* case suggests that regular periodic gifts can be income under ordinary concepts where the recipient expects them, the payer pays them for the purpose of adding to the recipient's earnings and the recipient relies on the payments (or such reliance can be inferred). However, in the Commissioner's view, the circumstances surrounding the taxpayer's present and previous employment also have a bearing on the outcome of the case and any proposition that may be extracted from it.

180. In the Commissioner's view, it is unlikely that a court in Aotearoa New Zealand would consider the periodicity of a series of gifts by itself means the gifts are income where the recipient does not undertake some activity or personal exertion. As the next case shows, there is authority for the view that a series of gifts can each be seen as a "mere gift" and not assessable, despite the element of periodicity.

Cases where the courts considered receipts were not income

FCT v Harris (FCA): Ex-gratia payments to retired bank employee

181. In *FCT v Harris* a retired bank employee received the first of what was intended to be annual ex-gratia payments from his former employer to top-up his pension.[99] The taxpayer did not expect or ask for the payment and the bank made the payment because it was concerned about the effects of inflation on its retired employees. Therefore, the bank made the payment with the intention of supplementing the pension and to help pensioners with their living costs. The taxpayer, however, had other employment and did not need the payment to support himself.

182. The majority of the court held that the payment was not of an income nature for three main reasons. First, the bank made the payment in a lump sum. The payment was not a regular amount the taxpayer received as a periodic supplement to income that the taxpayer relied on to meet regular expenses. Second, the bank did not make the payment in consideration for any income-producing activity. Third, it did not make the payment as a substitute for lost salary or wages. The taxpayer had no expectation of receiving the payment or receiving similar payments in the future.

183. The payment could not, in any relevant sense, be said to be the product of the taxpayer's earlier employment. Instead, the payment was in the nature of a gift and was of a capital nature. This was the case even though the payment was a supplement to income. Bowen CJ considered it was not a case where the motives of the bank were influential in deciding the quality of the payment in the recipient's hands. He stated:[100]

> In this case, the payment made to Mr Harris by the Bank was not designed to bring the pension up to any particular figure; it was simply an ex gratia payment made in accordance with the bounty of the Bank as one lump sum during the income year to assist him because of the effects of inflation.
>
> It appears to me that the circumstances of this case are insufficient to lead to the conclusion that a gift, not normally to be regarded as being of an income nature, should be so regarded because the Bank as payer intended it to be, and it in fact was, a supplement to the taxpayer's pension.

184. Fisher J dismissed the Federal Commissioner of Taxation's argument that the payment in issue was not a single lump sum but the first of a series:[101]

> However, we were pressed with a further submission, namely that we should not consider the payment as a single lump sum but rather, in the light of the payments in subsequent years, as the first of a series of payments. **If this contention is acceptable, then I would agree that there are cogent arguments to the effect that as the first of a series of periodical and regular payments it falls, in the light of other circumstances, into the category of income rather than capital.** …
>
> **In the present case the payments in subsequent years can, in my opinion, only be taken into account to confirm any suggestion made or indication given in relation to the first payment that the taxpayer could expect to receive in the future annual supplementations of his pension to compensate for the impact of inflation. In my opinion, after reading carefully the memoranda of March and April 1976 there was no such suggestion or indication from which the taxpayer could anticipate receipt of a like payment each year thereafter.** In particular there was nothing which could reasonably suggest to him that the payment in question was the first of a series of annual payments. [Emphasis added]

185. On this reasoning, Fisher J would have been inclined to treat the payment as having the character of income on the basis that it was periodic considering the other circumstances of the payment. However, this view depended on the facts establishing that, at the time the payment was made, it was to be the first in a series of periodic payments. In this case, the facts did not establish this.

99 *FCT v Harris* (1980) 30 ALR 10 (FCA).

100 At 17.

101 At 25–26.

186. As mentioned at [172] above, this case was distinguished in a later case involving similar pension top-up payments (*FCT v Blake* (QSC)).

***Scott v FCT* (HCA): Gift to lawyer from client**

187. In *Scott v FCT*, the High Court of Australia considered whether a gift that a solicitor received from one of his long-standing clients was assessable. At [69] above, this case is mentioned in connection with gifts and employment income. The court considered the gift was not assessable either as employment or service income, or as income under ordinary concepts.

188. In relation to the concept of income under ordinary concepts, the court stated:[102]

> **I return to the general concept of income. Whether or not a particular receipt is income depends on its quality in the hands of the recipient. It does not depend upon whether it was a payment or provision that the payer or provider was lawfully obliged to make. The ordinary illustrations of this are gratuities regularly received as an incident of a particular employment. On the other hand, gifts of an exceptional kind, not such as are a common incident of a man's calling or occupation, do not ordinarily form part of his income.** Whether or not a gratuitous payment is income in the hands of the recipient is thus a question of mixed law and fact. The motives of the donor do not determine the answer. They are, however, a relevant circumstance.
>
> ... **An unsolicited gift does not, in my opinion, become part of the income of the recipient merely because generosity was inspired by goodwill and the goodwill can be traced to gratitude engendered by some service rendered.** It was said for the Commissioner that if a service was such as the recipient was ordinarily employed to give in the way of his calling, and the gift was a consequence, however indirect, of the donor's gratitude and appreciation of that service, then it must necessarily be part of the donee's income derived from the practice of his calling, and caught by s 26(e). But as thus expressed, this proposition is, I think, a mistaken simplification. It was based upon the fact that in *Hayes v Federal Commissioner of Taxation* (1956) 6 AITR 248 at p 255; 96 CLR 47 at p 56, Fullagar J regarded as decisive that it was impossible to relate the receipt of the shares there given to any income-producing activity on the part of the recipient. In the present case the taxpayer was engaged in an income-producing activity, his practice as a solicitor, to which it was said the gift could be related. **But because the absence of a particular element was decisive in favour of the taxpayer in one case it does not follow that the presence of that element is decisive in favour of the Commissioner in another case. The relation between the gift and the taxpayer's activities must be such that the receipt is in a relevant sense a product of them.** ... [Emphasis added]

189. Accordingly, the court considered:

- The inquiry is into the quality of the receipt in the recipient's hands.
- The fact that the payer makes the payment voluntarily is not determinative.
- The motives of the payer are relevant, but not determinative.
- The question of whether a receipt is income must depend on a consideration of the whole of the circumstances as to how and why the payment came about.
- An unsolicited gift does not have the character of income just because the payer is inspired to make it out of gratitude for some service the recipient has provided.
- A number of factors influence the answer in a particular case and the absence of a particular factor that was decisive in favour of the taxpayer in one case does not mean the presence of that factor in another determines that case against the taxpayer.
- A mere connection with an income-earning activity is not enough. The relationship between the payment and the income-earning activity must be sufficiently strong.

***Hayes v FCT* (HCA): Gift of shares**

190. In *Hayes v FCT*, the High Court of Australia considered the income tax treatment of a gift of shares from an individual (the payer) to the taxpayer. This case was mentioned at [33] above, in relation to "mere gifts" and, at [75] above, in relation to employment income. The payer had a personal relationship and a previous professional relationship with the taxpayer. The taxpayer had been, at various times, an employee of, a professional advisor to, or a director or a shareholder of, a company the payer owned.

191. The Federal Commissioner of Taxation argued the receipt was income under ordinary concepts or, alternatively, it was income from employment or services. The court found the value of the gift was not assessable income on either ground.

192. Fullagar J noted the history of the taxpayer's involvement in various roles with the payer's company. He noted that, apart from some services of a trifling nature that the taxpayer performed without reward for a period, there was no suggestion

102 At 293–294.

that he had not been fully remunerated for his services at the time he performed them. Fullagar J concluded the receipt of the shares was "a simple gift of property" and not a receipt of income.[103]

193. The court considered the role of the payer's motive in making the payment was relevant, but not determinative because the test was an objective one.[104]

194. The following points can be taken from Fullagar J's comments:

- The conclusion on whether a voluntary payment or transfer of property is income will depend on the strength of the relationship between the payment and the income-earning activity. There must be a real relationship between the receipt and the employment or services.
- The test to be applied is an objective one.

***Stedeford v Beloe* (HL): Voluntary pension payments to retired school principal**

195. *Stedeford v Beloe* concerned the assessability of payments that a retired principal received from his former employer. The governing body of the school granted the principal a pension out of school funds on his retirement. The school had no formal pension scheme in place and the payments were not made under any contract. They could have been stopped at any time.

196. The House of Lords concluded the payments were not assessable as employment income under Schedule D of the Income Tax Act 1918. Viscount Dunedin concluded that for the payments to be income they needed to be a "real profit" and a mere voluntary gift is not such a profit. Viscount Dunedin said:[105]

> Now it must be a real profit under Schedule D, and it has been held again and again that a mere voluntary gift is not such a profit because it is not, in the true sense of the word, income. It is merely a casual payment which depends upon somebody else's good will.

197. Lord Warrington of Clyffe stated:[106]

> Then is it a profit or gain under Schedule D? This question can, in my opinion, be answered in only one way. Here each payment is wholly voluntary. The case is only an instance of a succession of voluntary payments, each of which is voluntary and none of which need necessarily be continued.

198. On this basis, the House of Lords considered that a series of gifts the payer made out of goodwill and that had no certainty of continuing, is not a "real profit" (ie, not "income"). As discussed from [173] above in relation to *Dixon's case*, however, there may be circumstances in which a series of gifts is income under ordinary concepts.

Summary of the relevant factors to consider

199. "Income" does not have a precise meaning in tax law. It is not a "term of art" and must be determined in accordance with the "ordinary concepts and usages of mankind".[107] As a result, the courts have not provided a comprehensive judicial definition of the term or any rigid test to apply to determine if a particular receipt is income. Instead, the courts have usually adopted a process of "characterisation" in which they weigh up a number of factors to decide whether an amount constitutes income in a particular case.

200. To decide whether a voluntary payment or gift is assessable to the recipient, it is necessary to consider all the circumstances of how and why the gift was made.[108] The issue is decided on a case-by-case basis and some factors may have greater relevance in some cases than in others.[109] Some factors point in one direction, and some in another.[110] If the presence or absence of a particular factor is determinative in one case, this does not mean the same factor will be determinative in other circumstances.[111] Several factors can influence the answer in a particular case. The test is an objective one.[112]

103 At 70–71.

104 At 72–73.

105 At 390.

106 At 391.

107 *Scott v C of T* (1935) 35 SR (NSW) 215 (NSWSC) per Jordan CJ at 219 and as cited by Richardson J in *Reid v CIR* (CA) at 136.

108 *Scott v FCT* (HCA) at 293. See also *The Squatting Investment Co Ltd v FCT* (HCA) per Kitto J at 146, *Reid v CIR* (CA) per Richardson J at 138 and *Murray v Goodhews* (EWCA) per Buckley LJ at 46.

109 *FCT v Blake* (HCA) at 4,664.

110 See *Reid v CIR* (CA) per Richardson J at 138.

111 *Scott v FCT* (HCA) at 293.

112 *Hayes v FCT* (HCA) at 73. See also *FCT v Blake* at 4,664.

201. The case examples above and others confirm that the following factors support a conclusion that a gift will be "income under ordinary concepts":
    - The gift is something that comes in (ie, does not include a savings in expenditure).[113]
    - The gift is ascertained and judged in relation to the recipient (as opposed to the payer).[114] However:
        - consideration of the relationship between the payer and recipient is still needed;[115]
        - the motive of the payer and whether a receipt is paid voluntarily or not is relevant, but not determinative;[116] and
        - the motive of the payer is only significant to the extent that it bears on the character of the payment in the recipient's hands.[117]
    - Receipts are periodic, regular or they recur.[118] Where payments are periodic, regular or they recur they can become part of the funds the recipient may expect to depend on for meeting living expenses just as with a salary or wages, annuities or beneficiary income.[119] However, a lump-sum payment may be income under ordinary concepts if the circumstances show that at the time of the payment it was the first of a series of periodic and regular payments the recipient could expect to receive.[120] If a taxpayer anticipates that, as a result of their activity, they would receive voluntary payments that would provide for the maintenance of the taxpayer and their family, this may indicate the payments will be income.[121] In the Commissioner's view, a taxpayer is more likely to anticipate their activity will result in gifts that they can rely on as "an income" where the likelihood that the gifts will recur is greater. For example, gifts are more likely to recur where:
        - multiple payers are involved; or
        - the recipient (or someone on their behalf) is actively soliciting the gifts, from multiple prospective payers.
    - The taxpayer derives the receipts beneficially.[122]
    - The gift is a gain from the taxpayer carrying on an organised activity.[123] A mere connection with an organised activity is not enough. The relationship between the gain and the taxpayer's activities must be such that the gain is in a relevant sense a product of those activities.[124]

202. It follows that the absence of these factors will support a conclusion that the gift is not income under ordinary concepts.

203. The following factors are also relevant:
    - Whether the receipts are expected periodic payments. That is, is it reasonable in the circumstances to presume the recipient expected to rely on them for their living expenses?[125]
    - Whether the payments are made for the purpose of supporting the recipient's living costs.[126]

113 See *Tennant v Smith* [1892] AC 150 (HL) per Lord Macnaghten at 164.

114 *Scott v FCT* (HCA) at 293 and *Hayes v FCT* (HCA) at 73. See also *Reid v CIR* (CA) per Richardson J at 138, *G v CIR* (SC) at 999, *Temperley (Inspector of Taxes) v Smith* [1956] 3 All ER 92 (EWHC) at 96, *Moorhouse v Dooland* (EWCA) per Evershed MR at 99 and *Herbert v McQuade* (EWCA) per Collins MR at 649.

115 See *Reid v CIR* (CA) per Richardson J at 136.

116 *Scott v FCT* (HCA) at 293 and *Hayes v FCT* (HCA) at 72.

117 See *Murray v Goodhews* (EWCA) per Buckley LJ at 46.

118 See *FCT v Myer Emporium Ltd* 87 ATC 4363 (HCA) at 4,370, *Reid v CIR* (CA) per Richardson J at 136 and *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) per Richardson P at 13,355.

119 See *Reid v CIR* (CA) per Richardson J at 136.

120 *FCT v Harris* (FCA) per Fisher J at 4,248–4,249.

121 See *G v CIR* (SC) at 999.

122 See *A Taxpayer v CIR* per Richardson P at 13,359.

123 See *A Taxpayer v CIR* (CA) per Richardson P at 13,359, *CIR v Buis* (2005) 22 NZTC 19,278 (HC) at 19,285–19,286 and *Wattie v CIR* (1997) 18 NZTC 13,297 (CA) per majority at 13,306.

124 *Scott v FCT* (HCA) at 293.

125 See *Dixon's case.*

126 *FCT v Blake* (QSC) at 4664. See also *Dixon's case.*

204. In the Commissioner's view, a series of gifts may be income under ordinary concepts under s CA 1(2) where:
    - The series of gifts fulfils the notion of "an income". That is, the payments have the necessary periodicity, and the payer makes them for the recipient to rely on, or intends the recipient to rely on them, for regular living expenses and the recipient does rely on them in this way.
    - The necessary periodicity of the payments refers to the requisite dimensions of regularity, recurrence, amount and frequency so that they amount to "an income".
    - The payments are periodic and made with the intention of providing an income when they began (or this has been established over the passage of time) to the extent that the recipient could reasonably have expected to rely on the payments for their living costs.
    - The recipient relies on the payments for their financial support.
    - The circumstances show the payments are connected with some activity or personal exertion of the recipient, even though that exertion or activity does not necessarily arise in the context of an employment relationship (past, present or future) and does not amount to a business or a profit-making activity.

205. In the Commissioner's view, it may be possible for a gift to be income under ordinary concepts because of some activity carried on by the recipient that does not involve an employment relationship or a business or a profit-making activity (meaning certain other provisions of Part C do not apply). However, in these circumstances the activity is most likely a voluntary activity with the gift being income under s CO 1. In other words, there may be few circumstances that a gift is income under ordinary concepts under s CA 1(2) and another provision of Part C does not apply.

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QUESTIONS WE'VE BEEN ASKED

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

QB 23/08: Income tax – deductibility of expenditure – renting to flatmates

Issued | Tukuna: 6 December 2023

This Question We've Been Asked explains when a person can claim deductions for expenditure incurred in deriving rental income, where the person rents a room in their home to a flatmate. It considers the possible application of the interest limitation, residential ring-fencing and mixed-use asset rules.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss DA 1, DA 2, CC 1, DG 3, DH 5, EE 50, EL 4, EL 9, s YA 1 ("main home"), Schedule 15

Question | Pātai

If a home owner lives in their home and rents out a room to a flatmate, can they claim deductions for costs incurred in deriving the rental income?

Answer | Whakautu

Yes. A home owner can claim deductions for costs incurred to the extent the expenditure is incurred in earning the rental income from the flatmate(s). The rental income from the flatmate is taxable.

Any expenditure incurred in earning the income from the flatmate needs to be apportioned between private use (living in the house) and income-earning use (rental income from a flatmate). Apportionment based on the use of physical space is a reasonable basis on which to determine the income-earning component of expenditure and to calculate the deduction amount.

There are some specific rules that may impact the home owner's tax treatment but these generally do not apply in flatmate situations:

- The interest limitation rule will not apply if the land is used predominantly for the person's main home.
- The residential ring-fencing rule will not apply if more than 50% of the land is used for most of the income year by the person as their main home.
- The mixed-use asset rules will not apply because the home is unlikely to be left vacant for the period required under the rules. If the mixed-use asset criteria are satisfied, the exclusion for long-term rental property is likely to apply.

Generally, the fact a person rents out a room in their home to a flatmate while living in the home will not stop the home being the person's main home.

Explanation | Whakamāramatanga

Introduction

1. This Question We've Been Asked (QWBA) explains how a person (the owner) who rents out a room in their home to a flatmate calculates their deductions for costs incurred in deriving the rental income.
2. We have been asked to consider:
   - how to calculate the amount of expenditure incurred in deriving income from renting out a room to a flatmate;
   - whether a home is an owner's "main home" if the owner shares their home with one or more flatmates;
   - whether the interest limitation rules apply to deny deductions for interest expenditure;
   - whether the residential ring-fencing rules apply to a person renting out a room to a flatmate; and
   - whether the mixed-use asset rules apply.

3. This item assumes the:
   - rental activities do not constitute the carrying on of a business;
   - person renting out the room is the property owner;
   - land has an existing single dwelling constructed on it;
   - land is not new build land within the scope of the s DH 4 exemption to the interest limitation rules;
   - property is the person's only home; and
   - flatmate is a third party and not a guest or family member who pays below market rent.
4. Private boarders and home-stay students are different to flatmates. Boarders pay for accommodation and services (eg regular meals). To remove any doubt, our discussion on the deductibility of costs at [6] to [19] does not apply to people who apply DET 19/01: Standard-cost household service for private boarding service providers (Determination, Wellington, Inland Revenue, May 2019) or DET 19/02: Standard-cost household service for short-stay accommodation providers (Determination, Wellington, Inland Revenue, May 2019).
5. All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Deductibility of costs incurred in renting a room to a flatmate

6. When renting a room to a flatmate, an owner will incur costs that relate to earning the rental income. Common types of costs include:
   - insurance;
   - local authority rates (including water rates);
   - electricity, gas, internet and other utilities;
   - repairs and maintenance; and
   - interest.
7. The owner is allowed to claim a deduction for expenditure to the extent it is incurred in deriving assessable income from renting a room to a flatmate. A deduction will be available only for periods where the owner has rented a room to a flatmate and not if the room is merely available for use. If the room is not rented out it will be for the owner's private use.
8. Rent that the owner receives from their flatmate is assessable income (s CC 1).
9. It is a question of fact whether a sufficient relationship exists between the expenditure and the derivation of income. It requires ascertaining the true character of the expenditure and considering the relationship between the advantage sought or obtained from the expenditure and the owner's income.
10. Generally, where an owner rents a room to a flatmate, a sufficient relationship between the rental income and above types of expenditure will exist and the issue is one of apportionment.

Basis of apportionment

11. A deduction is allowed to the extent to which expenditure is incurred in deriving assessable income.[1] However, a deduction is denied to the extent the expenditure is of a private or domestic nature (this is known as the private limitation).
12. The owner needs to apportion any mixed-use expenditure between their private use of the property and the rental use of the property.
13. For the period the owner is renting a room in their home to a flatmate, the use of the physical space is a reasonable basis for apportionment of mixed-use expenses. The owner's home will typically involve three types of space:
    - the owner's private or exclusive use area;
    - the flatmate's exclusive use area; and
    - common or shared areas.
14. An area will be for the flatmate's exclusive use only if it is specifically agreed by the parties that it is for the flatmate's exclusive use.

1 The deduction amount may be limited to the amount of income derived where a flatmate pays less than a market value rent (*Case E54* (1982) 5 NZTC 59,312 (TRA)). However, these situations are outside the scope of this QWBA.

15. In the apportionment calculation, expenses wholly relating to:
    - the flatmate's exclusive use area should be treated as 100% deductible.
    - the owner's private use area should be treated as 0% deductible.
16. In addition, the Commissioner is satisfied that common use areas may be treated as 50% deductible.[2] Example | Tauira 1 at [53] illustrates how to apportion expenditure based on physical space.
17. Mixed-use expenditure must be apportioned. But it may be possible to identify some items of expenditure (for example, specific repairs and maintenance expenses relating to a flatmate's room) as directly referable to the production of assessable income and not subject to apportionment under the private limitation. In these cases, the full amount may be deducted as expenditure incurred in deriving assessable income. On the other hand, there may be occasions where the expenditure is incurred solely for private use, so is non-deductible.

Depreciation loss

18. A depreciation loss is not available for residential buildings (that is, the home). However, the owner may be able to claim depreciation on chattels used or available for use in deriving assessable income.
19. If the owner has a depreciation loss in an income year, a deduction is allowed to the extent the loss is incurred by the owner in renting the room to the flatmate.
20. If the chattels are exclusively used by the flatmate, the owner can claim a deduction for the full depreciation loss. See the treatment of curtains in Example | Tauira 2. On the other hand, the owner cannot claim a depreciation loss if the chattels are for their exclusive use.
21. The owner may claim for only part of the depreciation on mixed-use chattels (that is, chattels in common areas that both the owner and flatmates can use).
22. The approach to work out how much depreciation the owner may claim each year for mixed-use chattels is similar to the approach to apportioning mixed expenses. The first step is to work out the depreciation loss for the year for each asset.
23. For low value items (up to $1,000), the depreciation loss is the asset's cost. If the asset is part of a group of items purchased at the same time from the same supplier, and the items would have the same depreciation rate, the $1,000 threshold applies to the group of items.
24. For other assets, the depreciation loss for the year is worked out using either the diminishing value (DV) method or the straight-line (SL) method. For information about the methods and the depreciation rates, see our website: Depreciation rate finder and calculator.
25. Once the depreciation losses for the year are calculated for the mixed-use chattels (including for low value items[3]) in the owner's home, the next step is to work out what proportion of those losses may be deducted.
26. Generally, the amount of the depreciation loss on chattels in common areas should be apportioned so that 50% is treated as relating to private use and non-deductible. However, where the actual use of the asset can be clearly demonstrated, an alternative basis may be adopted if it reflects a reasonable basis for apportionment.

Interest limitation rules

27. The interest limitation rules operate to deny interest deductions claimed by residential property owners. The interest limitation rules contain, among other exclusions and exceptions, a form of main home exclusion and an exception for new builds.[4]
28. The interest limitation rules deny the owner a deduction for interest incurred in relation to their land unless the land is "excepted residential land" as described in Schedule 15. Schedule 15 contains a main home exclusion.
29. The interest limitation rule does not apply to land used predominantly for a place configured as a residence or abode if that place is the person's main home.

2 The Commissioner has generally accepted 50% as a reasonable apportionment for common use areas (see QB 19/05: *What are my income tax obligations if I rent out my home or a separate dwelling on my property as short-stay accommodation* (Question We've Been Asked, Wellington, Inland Revenue, May 2019) and *Interpretation statement IS 17/02: Deductibility of Farmhouse Expenses* (Wellington, Inland Revenue March 2017)).

3 When determining whether an asset is a low value item, the asset's cost must be equal to or less than $1,000 prior to any apportionment for private use.

4 For the purpose of this item, we have assumed the land is not new build land within the scope of the s DH 4 exemption.

30. Whether an owner who rents out a room in their home to a flatmate is denied deductions for interest due to the interest limitation rules depends on the facts of each situation, namely:
    - whether the land is used predominantly for a place configured as a residence; and
    - whether the place is the owner's main home.

"Used predominantly for a place configured as a residence"

31. Whether a place is "configured as a residence" depends on whether the place has been formed or shaped to function as a place of residence, irrespective of whether it is currently used as a place of residence. A "residence" means a place where a person has a fixed presence and a degree of permanence. Therefore, a place will be configured as a residence if it is capable of being used as a residence with a degree of permanence.
32. Land will have been used predominantly for a place configured as a residence where the physical area of the land used for the place is more than 50% of the total land area.
33. If the land is used for one place configured as a residence, the "used predominantly" threshold will be satisfied. If other dwellings are situated on the land or the land is used for other purposes, the physical space of the respective structures or uses needs to be determined.[5] This QWBA deals only with land that has a single existing dwelling situated on it.

Main home

34. The next step is to consider whether the place is the owner's main home. "Main home" is defined in s YA 1 as:

> **main home** means, for a person, the 1 dwelling—
>
> (a) that is used as a residence by the person (a **home**); and
>
> (b) with which the person has the greatest connection, if they have more than 1 home

35. The definition provides that for a person the main home is the one dwelling they use as a residence. The focus of the main home definition is on the nature of the place and the relationship between the person and that place.
36. A "residence" is the place where a person has settled, where they ordinarily eat, live and sleep, and the place the person uses as a base for their daily activities and is the seat of that person's domestic life and interests. "Used" means actual physical use of the dwelling and not intended use. Therefore, a dwelling is used as a residence when it is customarily or repeatedly used for this purpose.
37. The definition of main home does not contain any restrictions that precludes a dwelling being the owner's main home due to the presence of a flatmate.
38. Generally, if the owner lives in the home and rents out a room to a flatmate(s), the owner still uses the dwelling as their residence.
39. Where considerable areas of the dwelling are for the flatmate's or flatmates' exclusive use, it might be argued that the owner does not reside in the entire dwelling. However, the definition does not require that the owner has full use and enjoyment of the dwelling nor does it use any language of apportionment. For that reason, if the dwelling is used as the owner's residence it will be within the scope of the main home exclusion and not subject to the interest limitation rules.

Residential ring-fencing rules

40. The residential ring-fencing rules prevent the owner from offsetting deductions incurred for residential properties against other sources of income (for example, salary or wages). This means if the rental activity is loss-making (the deductible expenses exceed the income), the excess deductions cannot be claimed that year. Any excess deductions are not permanently forfeited but are carried forward and may be offset against any future income derived from the residential property.
41. The residential ring-fencing rules apply to residential land where the person who owns the land is allowed a deduction for expenditure relating to its use or disposal. "Residential land" includes land that has a dwelling on it unless the land is farmland or used predominantly as business premises.
42. There are a few exclusions to the residential ring-fencing rules, including a main home exclusion.

5 See Example 9: Multiple residences on a single legal title in *Special report on interest limitation and additional bright-line rules* (Wellington, Inland Revenue, March 2022). .

Main home exclusion

43. The main home exclusion from the residential ring-fencing rules differs from the main home exclusion from the interest limitation rules. The owner can apply the main home exclusion if more than 50% of the land is used as the owner's main home for most of the income year. Therefore, the main home exclusion will apply if:
    - more than 50% of the land is used as the owner's main home (the space threshold); and
    - the land is used as the owner's main home for more than 50% of the income year (the time threshold).
44. The definition of a main home was discussed at [34].
45. As referred to above, where an owner rents out a room in their home to a flatmate, the three typical types of space are:
    - the owner's private or exclusive use area;
    - the flatmate's exclusive use area; and
    - common or shared areas.
46. The common use area is used by the owner as part of their residence. The fact the flatmate has access to the common use areas does not limit the owner's ability to use the area as their residence. Therefore, the owner's main home space consists of the owner's private use area and the common use areas (without apportionment for the flatmate's use). The area that is for the flatmate's exclusive use is excluded from the space threshold calculation.
47. It is likely an owner will be able to satisfy the space threshold if the land contains a single dwelling.
48. The time threshold will be satisfied if the land is the person's main home for more than 183 days in an income year. Whether the time threshold has been satisfied depends on the specific facts of each situation.
49. As sharing a home with flatmates does not prevent the home being the owner's main home, if both the space threshold and time threshold are satisfied, the main home exclusion to the residential ring-fencing rules will apply.

Mixed-use asset rules

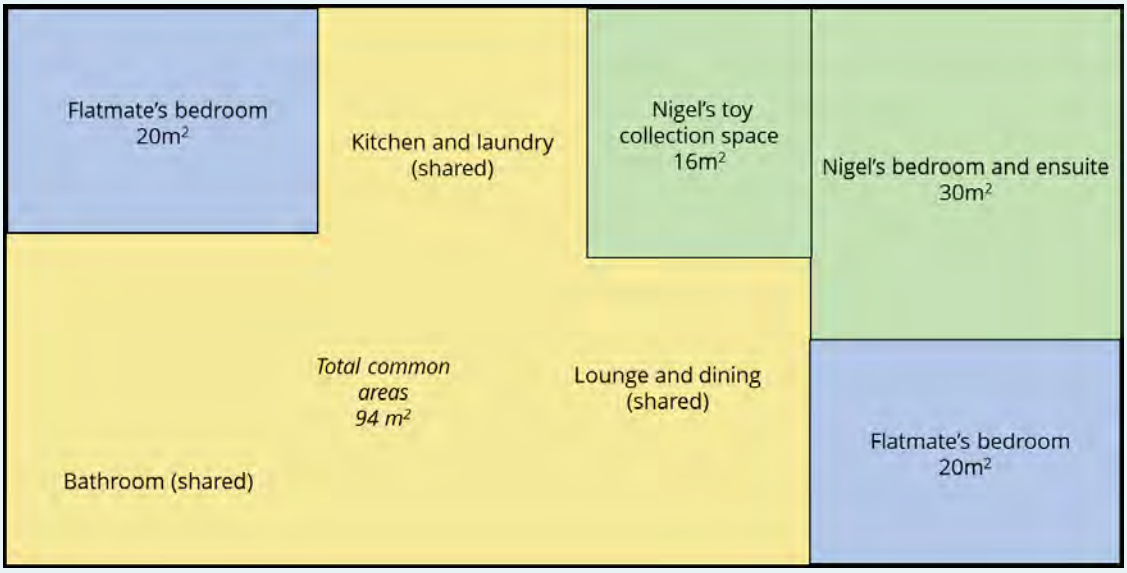
50. The mixed-use asset rules apply where assets are sometimes used privately, sometimes used to earn income, and are unused for a significant period during the year. The rules ensure an appropriate proportion of the expenses that relate to the "unused" period is deductible. The proportion that is deductible is based on the amount of income-earning use relative to the total use of the asset.
51. The mixed-use asset rules are unlikely to be relevant to an owner who rents out a room to a flatmate as the home is not unoccupied for at least 62 days during the income year.
52. If the mixed-use asset criteria are satisfied, it is likely that the specific exclusion for long-term rental property (s DG 3(4)(b)) will apply. Regardless of the mixed-use asset rules, a home owner will be unable to claim a deduction for expenditure incurred for any periods where the home is vacant.

Examples | Tauira

53. The following two examples illustrate how the law applies.

Example | Tauira 1 – Person rents out unfurnished rooms to two flatmates

Nigel lives in his three bedroom home with two flatmates. He purchased the home on 5 March 2022 and started renting out the two spare bedrooms to flatmates on 1 April 2022. The home has a 180m² floor plan as shown in the diagram below.



Nigel charges each flatmate $220 per week (a total of $22,880 in the 2023 income year). Nigel also receives a salary of $62,400.

In the income year, Nigel incurred the following expenses (total $44,900) relating to the property:

- interest – $37,000
- local authority rates – $2,500
- house insurance – $2,600
- utilities (power, gas, internet) – $2,800.

Nigel has elected not to depreciate any chattels. He should apportion his mixed expenses on the following basis:

- 40m² used exclusively by flatmates – 100% deductible
- 94m² common or shared areas – 50% deductible
- 46m² private area – 0% deductible.

Nigel must calculate what proportion of his mixed-use expenses he may deduct for the areas of the house used exclusively by the flatmates and what proportion he may deduct for common areas. The results of those calculations are then added together.

40/180 x 100 = 22.22%

94/180 x 50 = 26.11%

By adding the two figures (22.22% and 26.11%), Nigel calculates that, subject to any specific limitations, he may deduct 48.33% of his mixed expenses for the year ($21,700.17).

Nigel's land has been used predominantly for a place configured as a residence and that place is Nigel's main home. Therefore, Nigel's ability to claim a deduction for his interest costs is not subject to the interest limitation rules.

For 2023 income year, Nigel calculates his taxable income as:

Salary	$62,400
Rental income	$22,880
less deductible expenses	($21,700.17)
	$63,579.83

If Nigel had incurred a loss from the rental activity, the deductions over and above the amount of income would not be subject to the residential ring-fencing rules. This is because more than 50% of the land was used for most of the income year by Nigel as his main home.

The home has not been unoccupied during the income year, so the mixed-use asset rules have no application.

Example | Tauira 2 – Calculating a deduction for depreciation of chattels

This example uses the same facts as in Example | Tauira 1 except Nigel decides on 1 April 2022 to buy the following new items for his home and wishes to claim a depreciation loss:

- washing machine $1,800
- dryer $1,600
- air fryer $300
- shelving unit $2,000

The shelving unit is to be in Nigel's toy collection space and will not be accessible to his flatmates. Nigel cannot claim a depreciation loss for the shelving unit due to its exclusive private use.

Nigel can claim a depreciation loss on the other items to the extent the loss is incurred by Nigel in deriving assessable income. The washing machine, dryer and air fryer are all available for common use. Therefore, Nigel can deduct 50% of his depreciation losses in respect of the washing machine and dryer as follows:

- Washing machine (30% DV) $540 depreciation loss subject to 50% apportionment = $270 deduction.
- Dryer (30% DV) $480 depreciation loss subject to 50% apportionment = $240 deduction.

A summary of Nigel's fixed asset register shows:

Asset	Cost	Annual Depreciation Charge	Adjusted Tax Value	Deductible Depreciation Loss
Washing machine	$1,800	$540	$1,260	$270
Dryer	$1,600	$480	$1,120	$240

As the cost of the air fryer is less than the $1,000 low value asset threshold, Nigel can claim a deduction for $150 (50% of $300) in relation to the air fryer.

Later, Nigel decides to replace the old curtains with a more energy efficient option in each bedroom. On 1 April 2023, Nigel purchases new curtains at a cost of $1,000 per bedroom. Nigel cannot claim a depreciation loss for the cost to replace the curtains in his bedroom. However, Nigel can deduct the full depreciation loss he calculates for the curtains in the flatmates' bedrooms as these rooms are exclusively used by his flatmates.

Curtains (25% DV) $500 depreciation deduction for 2024 tax year.

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 2007 – ss CC 1, DA 1, DA 2, DA DG 3, DH 4, YA 1, subpart DG, subpart DH, subpart EL ("main home"), Schedule 15

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QB 23/09: Income tax – Forfeited deposits from cancelled land sale agreements

Issued | Tukuna: 13 December 2023

This question we've been asked (QWBA) clarifies the circumstances in which a forfeited deposit from a cancelled land sale agreement is income to the seller.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss CA 1, CB 1, CB 3, CB 6A – CB 23B, CZ 39, CZ40

Question | Pātai

Is a forfeited deposit from a cancelled land sale agreement income to the seller?

Answer | Whakautu

Yes, if one or more of these situations apply:

- A forfeited deposit is business income if the sale of the land that is the subject of the cancelled land sale agreement was **part of the current operations of the business or an ordinary incident of the business** (s CB 1).
- A forfeited deposit is income from a profit-making scheme **if the seller is carrying on a profit-making scheme** that involves the sale of the land (s CB 3).
- A forfeited deposit is income under ordinary concepts **if it has the character of income** (s CA 1(2)). It will have the character of income if the proceeds of the sale under the cancelled land sale agreement would have been taxable (eg, under the land sales rules) had the sale gone ahead.

A forfeited deposit is not income to the seller under the land sale rules because there is no 'disposal' of land where an agreement is cancelled and settlement and registration do not take place. However, despite there being no 'disposal' of the land, a forfeited deposit may still be income under one of the situations listed above.

Key terms

Land sale rules – the land sale rules are in ss CB 6A to CB 23B, CZ 39 and CZ 40.

Settlement – the date the parties fulfil their contractual obligations for the sale of land (eg, the buyer pays the purchase price and the seller provides the buyer with the means of acquiring the title to the land).[1]

Explanation | Whakamāramatanga

Background

1. This QWBA explains the circumstances in which a forfeited deposit from a cancelled land sale agreement is income to the seller.
2. When parties enter into a land sale agreement, the buyer usually agrees to pay a deposit. In New Zealand, a deposit is typically 10% of the purchase price but sometimes can be more. Only reasonable deposits are subject to forfeiture. This QWBA is concerned with deposits that have been forfeited, so therefore only considers the tax treatment of deposits that are reasonable.
3. The main function of a deposit is to guarantee performance.[2] A deposit is particularly important in land sale agreements as often there is a delay between the date when the parties sign the agreement and the settlement date.

1 DW McMorland, *Sale of Land* (4th ed, Cathcart Trust, Auckland, 2022) at [11.01].

2 *Howe v Smith* (1884) 27 ChD 89 (UKCA); *Soper v Arnold* (1889) 14 App Cas 429 (HL); *Garratt v Ikeda* [2002] 1 NZLR 577 (CA).

4. If the sale goes ahead, the deposit is credited to the buyer on settlement as part payment of the purchase price. If the sale falls through due to the buyer's default the deposit is liable to be forfeited. This means the seller can retain the deposit for their own use. If the seller also claims damages, they need to give credit for the amount of the forfeited deposit.[3]
5. In the situation where the sale falls through and the deposit is forfeited, the seller needs to consider whether the forfeited deposit is taxable income. A forfeited deposit will be taxable income if it is:
    - business income;
    - income from a profit-making scheme; or
    - income under ordinary concepts.
6. This QWBA also explains why a forfeited deposit is not income under the land sale rules. However, it is important to note that while a forfeited deposit is not income under the land sale rules, it may still be income if it is business income, income from a profit-making scheme or income under ordinary concepts.

Business income

7. Business income is taxable income under s CB 1. A forfeited deposit will be business income if the seller:
    - is in business; and
    - derives the forfeited deposit from the business.

Is the seller in business?

8. *Grieve v CIR* (1984) 6 NZTC 61,682 sets out the test for whether a business exists. Applying this test involves considering the nature of the taxpayer's activities and whether the taxpayer has an intention to make a 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.
9. *Grieve* also states it may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those that are characteristic of ordinary trade in the line of business in which the activity is conducted. However, in the end, it is the character and circumstances of the particular activity that are crucial.
10. *Grieve* notes that, while the taxpayer's statements about their intentions are relevant, actions will often speak louder than words.
11. Further guidance on *Grieve* and the test for whether a business exists can be found in IS 21/04 Income tax and GST – deductions for businesses disrupted by the COVID-19 pandemic[4].
12. If the seller is in business, the next question is whether they derive the forfeited deposit from their business.

Does the seller derive the forfeited deposit from their business?

13. A seller will derive a forfeited deposit from their business if the forfeited deposit:
    - has a nexus (connection) with the business activity; and
    - is revenue in nature.
14. The forfeited deposit must be connected to the seller's business activity. Business income does not include amounts that are private in nature. For example, if a sole trader receives a forfeited deposit in the context of a private land sale rather than a business land sale, the forfeited deposit will not be business income.

3 *Ng v Ashley King (Developments) Ltd* [2010] EWHC 456 (Ch), [2010] 4 All ER 914; *Shuttleworth v Clews* [1910] 1 Ch 176.

4 *Tax Information Bulletin*, Vol 33, No 9 (October 2021): 8.

15. The key question is whether the forfeited deposit is revenue (income) in nature. An amount will be revenue in nature if the person derives it from the current operations of the business or in the ordinary course of business.[5] This includes an amount that they derive from a transaction that is an ordinary incident of the business although not its main activity.[6] An amount that is capital in nature is not income from a business.[7]
16. To determine whether an amount is income from a business, it is necessary to consider the nature of the business and how the transactions producing the amount are related to the conduct of the business.[8]
17. For example, if a person is a property dealer or developer, then the sale of land that they have acquired for the purpose of that business is part of the ordinary business of that taxpayer. It is the way the business earns its income. Land acquired for the purpose of the business is held on revenue account and when it is sold the proceeds from the sale are business income (and therefore taxable under either the general rule in s CB 1 or under s CB 7 of the land sale rules).
18. If the sale of the land falls through due to the buyer's breach and the seller retains the deposit, then in the Commissioner's view the deposit is also part of the ordinary business of the seller and is revenue in nature. The transaction (the sale of the land) is part of the current operations of the business and the forfeited deposit is an amount arising from that transaction. The deposit is something that the parties have agreed to as part of their negotiations and the possibility that it may be forfeited if the buyer defaults is a contemplated outcome of the transaction. The chance that the sale may fall through is a risk that is part of the ordinary course of doing business that involves transacting in land. Example 1 illustrates this situation.
19. The same analysis applies if selling land is an ordinary incident of the business although not its main activity. A forfeited deposit arising from the (attempted) sale of that land would similarly be revenue in nature and income to the seller under s CB 1.
20. If a person in business holds land on capital account, then proceeds from the sale of that land are not income from a business. (An example of land that is generally held on capital account is business premises.
21. If a person in business sells land that is held on capital account, the sale falls through due to the buyer's breach and the seller retains the deposit, then in the Commissioner's view the forfeited deposit will also be of a capital nature. Just as the sale of the land is not part of the current operations (or an ordinary incident) of the business, a forfeited deposit arising from an agreement to sell that land is not part of the current operations (or an ordinary incident) of the business. Example 2 illustrates this situation.
22. It should be noted that on occasion disposals of land held on capital account by a business can still sometimes be taxable, eg under the bright-line test. In those situations the forfeited deposit will also be taxable (see the discussion on income under ordinary concepts from [30] below). To clarify, it is the tax treatment of the cancelled transaction that is at issue, and whether the underlying land is held on capital or revenue account will not always be decisive.

Example | Tauira 1 – business income as part of ordinary business

Instant Homes Ltd is a property developer. It regularly purchases land, builds houses or renovates existing properties for sale with the intention of making a profit. Recently the company purchased a property, built a home on it and sold it to Mr Brown. Mr Brown paid a 10% deposit but was unable to pay the balance of the purchase price on settlement date. Instant Homes Ltd cancelled the agreement and retained the deposit.

The forfeited deposit is business income to Instant Homes Ltd under s CB 1. Instant Homes Ltd is in business and it derives the forfeited deposit from the business. The sale of the land is part of the ordinary business of Instant Homes Ltd and the receipt of the forfeited deposit is an amount which arises from that transaction. The possibility that the sale may fall through and the deposit may be forfeited if Mr Brown defaults is part of doing business as a property developer and a contemplated outcome of the transaction.

5 *CIR v City Motor Service Ltd; CIR v Napier Motors Ltd* [1969] NZLR 1,010 (CA); *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383 (CA).

6 *AA Finance Ltd v CIR; CIR v Rangatira Ltd* (1995) 17 NZTC 12,182 (CA).

7 Section CB 1(2).

8 *AA Finance Ltd v CIR.*

Example | Tauira 2 – not business income as land held on capital account

Gorgeous George Ltd operates a hair salon. The company owns the land and building where the salon is located. Gorgeous George Ltd is doing well and decides to move to bigger premises so it can accommodate more stylists. Gorgeous George Ltd sells its existing property to Ju's Music Ltd. Ju's Music Ltd pays a 10% deposit but is unable to pay the balance on settlement date. Gorgeous George Ltd cancels the agreement and retains the deposit. If the sale had been completed, the proceeds would not have been taxable under the land sale rules.

The forfeited deposit is not business income to Gorgeous George Ltd under s CB 1. The sale of its business premises is the sale of land that is held on capital account. The sale of the land does not form part of the ordinary business of the company and is not an ordinary incident of the income-producing process. Just as the sale of the land is not part of the current operations of the business, a forfeited deposit arising from the agreement to sell the land is not part of the current operations of the business.

Income from a profit-making scheme

23. An amount arising from the carrying out of a profit-making undertaking or scheme is taxable income under s CB 3.[9] A forfeited deposit will be income from a profit-making scheme if the seller:
    - is carrying on or carrying out a profit-making undertaking or scheme; and
    - derives the forfeited deposit from the profit-making undertaking or scheme.[10]

Is the seller carrying on a profit-making scheme?

24. For a forfeited deposit to be income from a profit-making scheme, the seller of the land must be carrying on a profit-making scheme that involves the sale of that land.
25. Essentially an undertaking or scheme is a series of steps directed to an end result. It needs to have a plan or purpose that is coherent and has some unity of conception. The dominant purpose of entering into or creating an undertaking or scheme must be to make a profit.[11]
26. If the seller has entered into a scheme involving the sale of land for the purpose of making a profit (ie, the land is held on revenue account) and the seller receives a forfeited deposit, the scheme is clearly underway and in the process of being carried on or carried out. The next question is whether the seller derives the forfeited deposit from the scheme.

Is the forfeited deposit derived from the profit-making scheme?

27. For a forfeited deposit to be derived from a profit-making scheme, the scheme must have a nexus (connection) with the forfeited deposit. This connection confirms that the forfeited deposit is in fact derived from the carrying on of the scheme rather than from something else (eg, chance).[12]
28. In the Commissioner's view, a forfeited deposit will have the necessary connection to a profit-making scheme involving the sale of land for the following reasons:
    - The possibility that the seller could retain the deposit is a contemplated outcome of the scheme. It is not unintended or derived in an unexpected way. Although the sale of the land is the preferred outcome and this alternative outcome may have a low probability of occurring, a forfeited deposit is nevertheless an outcome that is contemplated under the scheme and the land sale agreement provides for it.
    - Cancellation of the contract does not mean the scheme has come to an end or been abandoned. The seller still owns the land and can continue with the scheme and sell the land to someone else.
    - Even if the seller decides to abandon the scheme following the cancellation of the sale, this does not detract from the fact that the seller received the forfeited deposit under a contract for the sale of land that the parties entered into as part of the scheme (ie, when the scheme was being carried on or out).

9 Only profits and gains arising from the undertaking or scheme itself are taxable. A deduction is allowed under s DB 26 to establish the value of the scheme property immediately before the scheme commences.

10 For simplicity, where this item refers to "carrying on" it includes both "carrying on" and "carrying out" and where it refers to a profit-making "scheme", it includes an "undertaking".

11 *Investment & Merchant Finance v FCT* (1970) CLR 177 (HCA); *Vuleta v CIR* [1962] NZLR 325 (SC); *Duff v CIR* (1982) 5 NZTC 61,131 (CA); and *Case S86* (1996) 17 NZTC 7,538 (TRA).

12 *Duff v CIR*; J Prebble, *The Taxation of Property Transactions* (Butterworths, Wellington, 1986) at 47.

29. In summary, where a person is carrying on a profit-making scheme involving the sale of land, it is the Commissioner's view that a forfeited deposit received under a contract for the sale of that land will also be derived from the scheme and will be income under s CB 3. As income under s CB 3 the forfeited deposit will contribute to any taxable profit arising from that scheme. Example 3 illustrates this situation.

Example | Tauira 3 – income from a profit-making scheme

Conor is an accountant who lives in Auckland. In 2017 he purchased some bare land near Wanaka with the intention of building a home on it and moving there permanently.

However, circumstances changed and Conor decided to stay in Auckland. He decided to subdivide the Wanaka land into four lots, provide services to each property and do some work to make the sections attractive to potential purchasers who might like to build a home there. This included clearing the land, significant earthworks to construct building platforms, putting in driveways, fencing and letterboxes and grassing the land. Connor hired a project manager to arrange for the work to be done.

The development was finished in early 2023 and Connor put the sections on the market. He received an unconditional offer from Ambrosia for one section and she paid a 10% deposit. However, Ambrosia changed her mind about building a home and did not pay the balance of the purchase price on settlement date. Conor cancelled the agreement and retained the deposit.

The forfeited deposit is income to Connor from a profit-making scheme he is carrying on. He has a coherent plan to develop the land and sell it for a profit. The forfeited deposit is connected to the profit-making scheme – the fact that a sale might not be completed is a contemplated outcome of the scheme and the contract of sale provides for it. As income under s CB 3 the forfeited deposit will contribute to any taxable profit arising from that scheme.

Income under ordinary concepts

30. If a forfeited deposit from a land sale agreement is not income from a business or a profit-making scheme, then it may be income under ordinary concepts. Income under ordinary concepts is taxable under s CA 1(2).
31. Whether a forfeited deposit from a land sale agreement is income under "ordinary concepts" depends on whether it has the character of income. Richardson J in *Reid v CIR* noted that "the answer is not to be found through the application of any single rigid test. It must be derived from a consideration of all the circumstances, some of which may point in one direction, some in another."
32. Income is something that comes in.[13] A forfeited deposit is an amount that "comes in" to the seller. It is generally a payment of money that the seller is entitled to retain on cancellation of the contract due to the buyer's breach (assuming the buyer cannot obtain relief from forfeiture).
33. A major determinant in many cases when deciding if a payment is income in character is whether the payment is recurrent or regular. A forfeited deposit is generally a one-off payment. Although a one-off payment is not typically indicative of income, it does not prevent it from having the character of income.[14]
34. Another key determinant when considering the nature of a payment is its character in the hands of the recipient, in this case the seller. For a forfeited deposit, resolving this question involves considering the relationship between the buyer and the seller and the purpose of a forfeited deposit (ie, what the seller receives the payment for). There is no necessary connection between the character which a payment has in relation to the payer and its character as a receipt by the payee.[15]
35. An amount that is capital in nature is not income under ordinary concepts.[16]

13 *Tennant v Smith* (1892) 3 TC 158 (HL).

14 *FCT v Cooling* 90 ATC 4472 (FCAFC); *FCT v Hyteco Hiring Pty Ltd* 92 ATC 4694 (FCAFC); *FCT v Dixon* (1952) 10 ATD 82 (HCA); *FCT v Myer Emporium* 87 ATC 4363 (HCA).

15 *Reid v CIR* (1985) 7 NZTC 5,176 (CA).

16 This is considered implicit in both s CA 1(2) and in *Reid v CIR* and is confirmed in *Case S86* (1996) 17 NZTC 7,538.

The nature of a forfeited deposit

36. The main function of a deposit in a land sale agreement is to act as a guarantee for the seller that the buyer will perform the contract. In other words, it is a guarantee for the seller that the buyer will complete their part of the contract and pay the balance of the purchase price to the seller on the agreed date.

37. If the sale goes ahead the deposit is treated as part payment of the purchase price. If the buyer defaults and the deposit is forfeited, the Commissioner's view is that in the hands of the seller the forfeited deposit is compensation for the failure of the buyer to pay the balance of the purchase price on settlement as promised. *Coumat Ltd v Whitford Properties Ltd* [2018] NZCA 15 supports this view. In that case, the Court of Appeal stated that a forfeited deposit of $1.25 million was compensation for the failure of the buyer to settle:[17]

> [44] The receipt of the $1.25 million can be seen as a legitimate benefit enjoyed by Whitford and not as a gratuitous windfall. The deposit had been a pledge for the performance of the Initial Tender Agreement, and can also be seen as an aspect of the price of the option to obtain the sale. Mr Allen had expressly agreed to the forfeiture upon failure to settle when he signed the Initial Tender Agreement. Whitford had, after all, lost the benefit of the sale, and Mr Allen had not honoured his pledge. The forfeiture was compensation for this failure, provided for in the contract.

38. A forfeited deposit does not replace a claim for breach of contract. The seller can retain a deposit and also make a claim for damages. However, the seller must give credit for the amount of the deposit and can only claim damages in excess of this amount. In the Commissioner's view, the fact that the seller gives credit for the amount of the deposit in a claim for damages supports the view that a deposit is compensatory in nature.

39. The Commissioner is aware of the argument that a forfeited deposit is more in the nature of a penalty (rather than compensation).[18] This argument arises because of uncertainty over the interaction between the law on deposits and the penalty rule, which have historically developed separately. The law on deposits is that a deposit is inherently liable to forfeiture (as long as it is reasonable) even if the seller suffers no loss. On the other hand, the traditional penalty rule is the rule that an amount payable on breach of a contract is unlawful as a penalty unless it can be justified as liquidated damages.

40. Reconciling these two principles is challenging. However, in the Commissioner's view a reasonable deposit is not a penalty and does not fall within the penalty rule.[19] The Privy Council in *Linggi Plantations Ltd v Jagatheesan* [1972] 1 MLJ 89 held that the forfeiture of "a reasonable deposit … has never been regarded as a penalty in English law or common English usage".[20] Later, in *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370, the Privy Council explained that the forfeiture of a reasonable deposit does not fall within the general penalty rule even though it bears no reference to the anticipated loss of the seller.[21] These two decisions were cited with approval by the Court of Appeal in *Garratt v Ikeda* [2002] 1 NZLR 577.

41. Therefore, the Commissioner's view is that a reasonable deposit is not in the nature of a penalty, but, in line with the Court of Appeal's decision in *Coumat*, is better viewed as compensation for the buyer's failure to settle. This view is consistent with Richardson J's guidance in *Reid v CIR*, to consider the nature of the receipt in the hands of the seller. The Commissioner also considers the fact credit is given for a forfeited deposit when claiming damages further supports the view that a forfeited deposit is compensatory in nature. In summary, the Commissioner's view is that a forfeited deposit is compensation for the failure of the buyer to settle. It is not a penalty.

17 The Court of Appeal's decision in *Garratt v Ikeda* provides implicit support for this view. Further support that a deposit is compensation in nature comes from *Polyset v Panhandat Ltd* [2002] 3 HKLRD 319 (HKCFA) and *Société Thermale d'Eugénie-les-Bains v Ministère de l'Économie, des Finances et de l'Industrie* [2007] 3 CMLR 38 (ECJ)

18 DW McMorland, *Sale of Land* (4th ed, Cathcart Trust, Auckland, 2022) at [12.60].

19 Support for this view comes from *Linggi Plantations Ltd v Jagatheesan* [1972] 1 MLJ 89 (PC); *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370 (PC); *Simanke v Liu* (1994) 2 NZ ConvC 191,888 (HC); *Polyset v Panhandat*; *Garratt v Ikeda*; *Cavendish Square Holding BV v EL Makdessi*; *ParkingEye Ltd v Beavis* [2016] 2 All ER 519 (UKSC). *Cavendish* has been adopted in NZ in *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2020] 1 NZLR 179 (NZSC).

20 Lord Hailsham LC at 94.

21 Lord Browne-Wilkinson at 373.

Does a forfeited deposit have the character of income in the hands of the seller?

42. Compensation payments take the character of what they replace.[22] Applying the general principles from *London and Thames Haven Oil Wharves Ltd v Attwooll*, the relevant questions are:
    - What is the compensation paid for?
    - If the compensation is paid for the failure to receive an amount of money, then would that amount of money have been income to the recipient?
43. The compensation is treated for income tax purposes in the same way as the amount the seller would have received if the sale had been completed.
44. In answer to the first question, in the situation where the buyer defaults and the seller retains the deposit, the compensation is paid for the buyer's failure to complete the contract. While the seller still owns the property and can resell it in a different transaction, the parties agreed that the seller has the right to retain a fixed amount of money (the deposit) if the buyer defaults. The seller receives the forfeited deposit because the buyer did not complete the purchase and the seller did not receive the balance of the purchase price promised under the contract.
45. The answer to the second question depends on the circumstances of the seller. If, for example, the sale had been completed and the proceeds from the sale of the land under that land sale agreement would have been taxable under the land sale rules, then the forfeited deposit is compensating for a loss of a revenue nature and will have the character of income. As the amount has the character of income, it will be income under ordinary concepts and taxable under s CA 1 (see Example 4 and Example 5).
46. If the sale had been completed and the proceeds from the sale of the property under that land sale agreement would not have been taxable income to the seller, then the forfeited deposit is compensating for a loss of a capital nature. In this case the forfeited deposit will not have the character of income and will not be income under ordinary concepts. An example of this situation is where the sale would not have been taxable under the bright-line test because the main home exclusion in the land sale rules applies (see Example 6).
47. If the sale had been completed but only part of the proceeds from the sale of the property under that land sale agreement would have been taxable, it follows that an equivalent proportion of the forfeited deposit will have the character of income. An example of this situation is where the main home exclusion in s CB 16A of the land sale rules applied for some of the bright-line period.

Example | Tauira 4 – income under ordinary concepts – bright-line test

Lucia bought a residential rental property on 1 August 2020. On 1 October 2022 she entered into an unconditional contract to sell the property to Gino. Gino paid a deposit of 10% and the balance was due on 1 December 2022.

Gino changed his mind about buying the property and did not pay the balance of the purchase price on the due date. Lucia cancelled the agreement and retained the deposit.

The forfeited deposit is income under ordinary concepts and therefore taxable under s CA 1(2). It has the character of income because all the proceeds of the sale would have been taxable under the bright-line test in s CB 6A if the sale had been completed. Lucia has lost the benefit of the sale and the buyer has failed to pay the purchase price on the settlement date. The forfeited deposit is compensation for Lucia not receiving an amount of a revenue nature. Lucia can claim a deduction for her expenses relating to the cancelled agreement such as agent's commission, legal and marketing fees under s DA 1.

22 *London and Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124; *Burmah Steamship Co Ltd v CIR* (1930) 16 TC 67.

Example | Tauira 5 – income under ordinary concepts – intention of resale

Phil heard from his friend Kelly that there was a new beachside subdivision being done where in Kelly's opinion the sections were going to be in hot demand. Phil bought one of the sections with the intention to on-sell it for a profit. He did not make any improvements to the section and listed it for sale.

Phil entered into a contract to sell the land to Jess. Jess paid a deposit but then changed her mind about buying the property and did not pay the balance of the purchase price on the due date. Phil cancelled the agreement and retained the deposit.

The forfeited deposit is income under ordinary concepts and therefore taxable under s CA 1(2). It has the character of income because the proceeds of the sale would have been taxable under s CB 6 if the sale had gone ahead because Phil acquired the land with the intention of selling it. Phil has lost the benefit of the sale and the buyer has failed to pay the purchase price on the settlement date. The forfeited deposit is compensation for Phil not receiving an amount of a revenue nature. Phil can claim a deduction for his expenses relating to the cancelled agreement such as agent's commission, legal and marketing fees under s DA 1.

Example | Tauira 6 – not income under ordinary concepts – main home exclusion

Maia and Nikau recently bought their first home. Then Maia got a job offer in a different city and they decided to sell their house and move. They entered into an unconditional contract to sell their home to Joon, who paid a 10% deposit.

Joon got into financial difficulty and failed to pay the balance on settlement date. Maia and Nikau cancelled the agreement and retained the deposit.

The forfeited deposit is not income to Maia and Nikau. If the sale had gone ahead, the proceeds from the sale would not have been taxable. Although the sale is within the relevant bright-line period, proceeds from the sale of the home would not have been taxable because of the main home exclusion from the bright-line test in the land sale rules. The forfeited deposit is compensation for the failure of the buyer to pay the purchase price on settlement date. The forfeited deposit does not have the character of income because it is compensation for Maia and Nikau not receiving an amount of a capital nature.

Income under the land sale rules

48. The land sale rules treat amounts derived from the disposal of land as income in various situations.[23] These rules include the bright-line test. Each of these rules has different requirements that need to be met for an amount to be income but they all require a disposal of land. If there is no disposal of land, an amount cannot be income under these rules.
49. In the context of a forfeited deposit, the question is whether there is a disposal of land if a land sale agreement is cancelled and title does not pass. Answering this question involves considering the meaning of "land" for tax purposes and what "disposal" means in a tax context.
50. For tax purposes, the definition of "land" covers both a legal interest in land and an equitable interest, including where that interest is contingent.[24]
51. Inland Revenue's position on the meaning of "disposal" in the land sale rules is that it requires complete alienation of the land by the disposer. The land must be 'got rid of' by the person.[25]
52. Therefore, in the context of a forfeited deposit, the question is whether the seller has disposed of a legal or an equitable interest in land during the period beginning with the making of the contract and ending on the cancellation of the contract.

23 Sections CB 6A to CB 15.

24 See the definitions of "land" and "estate or interest in land" in s YA 1.

25 *IS 22/03:* Income tax – Application of the land sale rules to co-ownership changes and changes of trustees, *Tax Information Bulletin* Vol 34, No 7 (August 2022): 17.

Has the seller disposed of a legal interest in land?

53. Legal ownership in land is transferred when the document that evidences the buyer's right to legal ownership is registered.[26] Typically the transfer is registered electronically at the time of settlement.

54. If a land sale agreement is cancelled due to the buyer's default, then settlement and registration do not take place. Without registration, there is no transfer of legal ownership. It is clear in this situation that the seller has not disposed of a legal interest in land. No alienation of the legal title by the seller has occurred. The seller holds the legal title throughout the period of the agreement.

Has the seller disposed of an equitable interest in land?

55. An equitable estate or interest in land is an interest in land that is recognised and enforceable under the rules of equity.

56. To understand whether the seller has disposed of an equitable interest in land, it is helpful to consider the interests of both the buyer and the seller during the sale process and how those interests relate to each other.

57. In most land sale agreements, the buyer has an equitable interest in land from the time a binding contract exists.[27] This means that equity recognises the buyer has acquired rights that should be protected in an appropriate manner.[28] The buyer's equitable interest is conditional on them making the full payment of the purchase price.[29]

58. In *Whiteleigh Holdings (New Zealand) Ltd v Whiteleigh Pacific Resources Ltd* (1987) 8 NZCPR 598, McGechan J identified that an unpaid seller retains a contingent interest in the equitable estate that passes to the buyer.[30]

> The equitable estate passing to the purchaser passes only upon a conditional basis. It passes and is received upon condition that the purchaser subsequently complete the agreement by paying the full purchase price. Pending completion therefore the vendor holds a contingent interest in the equitable estate which is passed to the purchaser. In the contingency that the contract is not completed, or becomes inequitable of specific performance, he will again become owner of that equitable estate. The existence of such a contingent interest in the equitable estate follows as an inevitable consequence of the established rules as to that which occurs in the event of the contingency. [Emphasis added]

59. On the basis that the seller holds a contingent interest in the buyer's equitable estate until the buyer pays the purchase price in full, the Commissioner's view is that the seller has not completely alienated the equitable interest in the land. The seller has not 'got rid of' the equitable interest completely because they still have an interest in the buyer's equitable estate.

60. While the definition of "land" includes a contingent equitable interest in the land, the Commissioner's view is that an equitable interest has not been disposed of (ie, completely alienated) where the seller retains a contingent interest in the purchaser's equitable interest.

Conclusion on the land sale rules

61. The Commissioner's view is that in the situation where a land sale agreement is cancelled due to the buyer's default, and settlement and registration do not take place, then there is no disposal of land for the purpose of the land sale rules. As there is no disposal of land, a forfeited deposit cannot be income under the land sale rules.

62. However, this does not mean that a forfeited deposit is not taxable income. In the situation where if the sale had gone ahead and the proceeds from the sale of land under that land sale agreement would have been income under the land sale rules then the seller should consider whether the forfeited deposit is business income (see [7] to [21] above), income from a profit-making scheme (see [23] to [29] above) or income under ordinary concepts (see [30] to [46] above).

26 Section 24 of the Land Transfer Act 2017.

27 *Bevin v Smith* [1994] 3 NZLR 648 (CA).

28 *Bevin v Smith*.

29 *Shaw v Foster* (1871–72) LR 5 HL 321; *Bevin v Smith*.

30 In *Bevin v Smith* the Court of Appeal said that the identification of a contingent equitable interest of an unpaid vendor in *Whiteleigh Holdings* was consistent with its view.

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QB 23/10: Foreign investment fund (FIF) calculation methods in cases of non-compliance

Issued: 14 December 2023

This QWBA explains that a person has a choice of methods to calculate FIF income even if they fail to declare the income in a tax return and later file a voluntary disclosure, or fail to file a tax return by the due date and later provide one including the income.

It also explains what happens if a person does not file a return and the Commissioner issues a default assessment.

This item is particularly relevant for natural persons and eligible trustees.

Key provisions

Income Tax Act 2007 (ITA) – ss EX 44, EX 48

Tax Administration Act 1994 (TAA) – ss 33, 37, 113, Part 9

All section references are to the ITA unless otherwise stated.

Question

Does a person have a choice of methods for calculating FIF income when they make a voluntary disclosure or file a late return?

Answer

Yes. Normally, a person has a choice of up to five methods for calculating FIF income subject to certain restrictions. This choice is available even if the person:

- **fails to declare FIF income in a tax return and later makes a voluntary disclosure; or**
- **fails to file a tax return by the due date and later provides one with FIF income.**

If the Commissioner issues a default assessment due to a person not filing a return, it will usually be based on the default calculation method. A person will need to file a return to challenge the assessment but can choose from the available methods in calculating the amount of FIF income to include.

Penalties and use of money interest may be applicable in cases of non-compliance.

Explanation

Introduction

1. This QWBA primarily explains what happens under the FIF rules if a natural person or eligible trustee:
   - fails to declare FIF income in a tax return and later makes a voluntary disclosure; or
   - fails to file a tax return by the due date and later provides one with FIF income.
2. It also explains what happens if a person does not file a return and the Commissioner issues a default assessment.
3. Some people are unsure whether they have a choice of methods to calculate FIF income when they correct their tax affairs. This QWBA clarifies that they do have a choice subject to the usual restrictions. This is particularly relevant for natural persons and eligible trustees but where other taxpayers have a choice of methods the same principles apply when they correct their tax affairs.
4. The law and reasoning supporting the answer is summarised in the body of this item with more detailed analysis set out in the appendix.

Overview of the FIF rules

5. The FIF rules apply to a person if they are a New Zealand tax resident who is not a transitional resident and they have certain kinds of investments overseas.

6. These investments are:
   - a direct income interest in a foreign company, including a foreign unit trust;
   - rights in a FIF superannuation scheme as a member or beneficiary; and
   - rights to benefit from a life insurance policy if it is not offered or entered into in New Zealand.
7. A person may have FIF income if they hold rights in these investments and they are not exempt. The rights are called attributing interests. If an exemption applies, other rules may tax any income from the investment.
8. If a person has an attributing interest in a FIF, they must calculate FIF income by choosing one of the following five methods:
   - the fair dividend rate (FDR) method;
   - the comparative value (CV) method;
   - the cost method;
   - the deemed rate of return method; and
   - the attributable FIF income method.
9. Restrictions apply as to which methods can be chosen depending on several factors such as the nature of the person and their investment.
10. A general rule is that once a person uses a particular method, they must use it in the following years. However, natural persons and eligible trustees can choose between the FDR and CV methods from one year to the next. Eligible trustees are trustees where:
    - the settlor is a natural person or deceased, and
    - the trust is a complying trust for a distribution, and
    - the trust is mainly for the benefit of natural persons for whom the settlor has or had natural affection or for the benefit of a charity.
11. A wide range of investments can be an attributing interest in a FIF and several methods for calculating FIF income are possible. For these reasons, this item focuses on a common attributing interest in a FIF where:
    - the taxpayer is a natural person or eligible trustee;
    - they own ordinary shares in a foreign company;
    - a market value is available for the shares;
    - the company is not in Australia[1];
    - the shareholding is under 10%;
    - the total cost of all FIF investments is over NZ$50,000; and
    - the choice of method is between FDR and CV.

The FDR method

12. FIF income under the FDR method is 5% of the opening market value of the shares plus any quick sale adjustment. A person needs to calculate a quick sale adjustment if they sell shares they have bought in the same year. Where a person acquires the shares during the year, the opening balance is zero and there is no FIF income under the FDR method provided no quick sales have occurred. Any dividends under this method are treated as excluded income and not taxed.

The CV method

13. By contrast, the CV method essentially calculates FIF income by comparing the closing market value of the shares with their opening value, adjusted for purchases and dividends. The result reflects the performance of the investment and foreign currency fluctuations. A positive result is FIF income. A special limitation rule may restrict losses to the amount of FIF income. Any dividends are part of the calculation and not taxed separately.

1 ASX-listed Australian companies are exempt from the FIF rules if the requirements of s EX 31 are met.

Choosing a method

14. A natural person or eligible trustee can choose the lower of the amount of FIF income calculated under the FDR or CV methods. A person makes their choice by reporting any resulting FIF income in their tax return.
15. The due date for a return is usually 7 July for a natural person with no agent. It will be a later date where a person or their agent has an extension of time arrangement. If the return is late, the person may have to pay a late filing penalty but can still choose between the FDR or CV methods.
16. Similarly, if the person omits FIF income from a return and later makes a voluntary disclosure, they can choose between the FDR or CV methods. Shortfall penalties may apply but these can be reduced by up to 100% for a voluntary disclosure. Use of money interest will be payable on any shortfall.

The default calculation method

17. If a person does not file a return, the Commissioner may issue a default assessment. In the common situation described at [11], the legislation treats the person as if they had chosen the FDR method if it is practical to use it. If it is not practical, the person is treated as if they had chosen the cost method. The CV method is not available. This may result in FIF income in the default assessment being higher than if the person had chosen the CV method.
18. In order to object to the assessment by way of a notice of proposed adjustment (NOPA), the person must file the return in question. This process is described in SPS 23/01 **Disputes Process** starting at paragraph 53. The person can choose between the FDR and CV methods when calculating FIF income to include in the return.
19. Alternatively, as set out in paragraph 87 of SPS 20/03 **Requests to amend assessments**, if the person simply files the return in question without issuing a NOPA, the Commissioner will treat the tax return as a request to amend the default assessment. The assessment will generally be amended after confirming that the tax return contains the correct tax position. However, if the person is within the relevant disputes resolution response period, they should consider issuing a NOPA with the tax return to preserve their dispute rights where the Commissioner declines to amend the default assessment.
20. The person may be subject to penalties and use of money interest.

Further information

21. For more information about the FIF rules, refer to **Guide to foreign investment funds - IR461**.
22. For more information about making voluntary disclosures, refer to **SPS 19/02 Voluntary disclosures**.
23. For more information about amending assessments, refer to **SPS 20/03 Requests to amend assessments**.
24. For more information about the disputes process, refer to **SPS 23/01 Disputes Process**.
25. These can be found on our website at ird.govt.nz. You may also decide to seek advice from a tax advisor.

Examples

26. The following examples demonstrate how the FIF rules apply in different scenarios.

Example 1 – Return includes FIF income correctly

James is a New Zealand resident. He is not a transitional resident.

He has owned ordinary shares in a company listed on the London Stock Exchange for several years. The market value of these shares at the start of the current income year is NZ$100,000. He receives no dividends during the year and the shares are worth NZ$103,000 at the end of his income year on 31 March. He has no agent and must file a tax return by 7 July.

James has an attributing interest in a FIF and must choose a calculation method. The available methods are FDR and CV. The amount of FIF income using the FDR method is 5% of the opening balance of NZ$100,000, or NZ$5,000. The amount using the CV method is NZ$103,000 less NZ$100,000, or NZ$3,000.

James is a natural person and can choose either method. He chooses the CV method and reports NZ$3,000 in his IR3 return. He files the return on time.

Example 2 – Return leaves out FIF income and more tax is payable

The facts are the same as in Example 1, but James forgets to include the FIF income in his return. He later remembers and makes a voluntary disclosure.

James chooses the CV method and reports NZ$3,000 in his voluntary disclosure. He is eligible for a reduction in shortfall penalties of up to 100% but must pay use of money interest on the shortfall.

Example 3 – Return leaves out FIF income but returns dividend income

The facts are the same as in Example 1 except that James receives dividend income of NZ$1,000 and reports that instead of FIF income in his return.

He later learns that the dividends are excluded income and he should have reported FIF income instead. He makes a voluntary disclosure of the shortfall.

James chooses the CV method and pays additional tax on the difference between the FIF income of NZ$3,000 and the dividend income of NZ$1,000. James is eligible for a reduction in shortfall penalties but must pay use of money interest on the shortfall.

Example 4 – Late return

The facts are the same as in Example 1 except that James files his return late by six months.

FIF income remains at NZ$3,000 but James may have to pay a late filing penalty.

Example 5 – Default assessment

Oscar is a New Zealand resident. He is not a transitional resident.

Oscar previously filed tax returns and reported FIF income but he has not done so for the last two years. Inland Revenue (IR) learns that Oscar has investments overseas through its annual automatic exchange of information programme with other tax authorities. IR sends a letter asking Oscar to confirm that his tax affairs are in order but he ignores the request. IR then issues default assessments for each of the two years using the default method of FDR:

- year 1 NZ$5,000
- year 2 NZ$5,200.

Oscar decides to correct his tax affairs and files the returns with NOPAs.

In year 1, the market value of ordinary shares Oscar held on the London Stock Exchange were NZ$100,000. They were valued at NZ$104,000 at the end of the year. No dividends were received and there were no quick sales.

Oscar can choose between the FDR and CV methods:

- FDR 100,000 x 5% + 0 (quick sale adjustment) = NZ$5,000.
- CV (104,000 + 0) – (100,000 + 0) = NZ$4,000.

Oscar chooses the CV method and reports FIF income of NZ$4,000 in his IR3 return.

At the end of year 2, Oscar's shares have increased in value to NZ$107,000. No dividends were received and there were no quick sales.

Oscar can choose between the FDR and CV methods:

- FDR 104,000 x 5% + 0 (quick sale adjustment) = NZ$5,200.
- CV (107,000 + 0) – (104,000 + 0) = NZ$3,000.

Oscar chooses the CV method and reports FIF income of NZ$3,000 in his IR3 return.

The returns and NOPAs are accepted. Oscar has to pay use of money interest on the shortfalls and may have to pay penalties.

References

Legislative references

Income Tax Act 2007 – ss BD 1, CQ 4-6, CX 57B, DN 5-9, EX 28-72 (the FIF rules), LJ 2(6), LJ 2(7)

Tax Administration Act 1994 – ss 33, 37, 113, 89D, Part 9

Other references

Guide to foreign investment funds – IR461 (guide, Inland Revenue, 2022)

https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir400---ir499/ir461/ir461-2022.pdf?modified=20220921025937&modified=20220921025937

IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit (Inland Revenue, 2022)

https://www.taxtechnical.ird.govt.nz/interpretation-statements/2021/is-21-09

SPS 19/02: Voluntary disclosures (Inland Revenue 2022)

https://www.taxtechnical.ird.govt.nz/standard-practice-statements/shortfall-penalties/sps-1902-voluntary-disclosures

SPS 20/03: Requests to amend assessments (Inland Revenue, 2020)

https://www.taxtechnical.ird.govt.nz/standard-practice-statements/investigations/sps-20-03

SPS 23/01: Disputes Process (Inland Revenue, 2023)

https://www.taxtechnical.ird.govt.nz/standard-practice-statements/disputes/sps-23-01

Appendix: Technical explanation of the answer in this QWBA

1. This appendix explains the answer to the question posed in this QWBA with the relevant legislative references to the Income Tax Act 2007 (ITA) and the Tax Administration Act 1994 (TAA). References are to the ITA unless otherwise stated. The focus is on natural persons and eligible trustees who own shares in a foreign company in the circumstances described at [11]. Where other taxpayers have a choice of methods, the same principles apply when they correct their tax affairs.

FIF income taxable

2. FIF income is income under s BD 1(1) because it is income under s CQ 4. It is assessable income under s BD 1(5). Section CQ 5 describes when FIF income arises. Essentially, this is when a person who is a New Zealand tax resident has an attributing interest in a FIF that is not exempt. The two main exclusions are for transitional residents and attributing FIF interests if the total cost does not exceed $50,000 at any time during the year. If the person does not need to apply the FIF rules, they may still have income under other sections in the ITA.
3. Under s CQ 6, FIF income is calculated using the relevant calculation method in ss EX 44 to EX 61.

Attributing interest in a FIF

4. FIF investments are listed in s EX 28, as follows:
   - a direct income interest in a foreign company, including a foreign unit trust
   - rights in a FIF superannuation scheme as a member or beneficiary
   - rights to benefit from a life insurance policy if it is not offered or entered into in New Zealand.
5. Section EX 29(1) provides that a person has an attributing interest in a FIF if:
   - the person holds rights in one of the listed categories, such as a direct income interest in a foreign company, and
   - none of the exemptions in ss EX 31 to EX 43 apply.
6. Section EX 30 describes how to determine a person's direct income interest in a foreign company. Basically, it is the percentage of the person's shareholding in the company. Whether or not the shareholding is 10% or more can be relevant to the application of the rules.
7. A FIF investment is not an attributing interest if an exemption from the FIF rules applies. A common exemption is for a shareholding in an ASX-listed Australian company under s EX 31. If the exemption applies, the person does not calculate FIF income but instead must return any dividend income on a cash basis. The person must also return any gains on sale if the shares are held on revenue account.

Calculation of FIF income

8. If the FIF investment is an attributing interest, s EX 44(1) provides five methods under which the amount of FIF income can be calculated:
   - the fair dividend rate (FDR) method
   - the comparative value (CV) method
   - the cost method
   - the deemed rate of return (DRR) method
   - the attributable FIF income method.
9. Section EX 44(2) explains the requirement to choose a calculation method and reads:

> *Choosing method*
>
> (2) The person must choose which calculation method applies by completing their return of income accordingly, but the choice is limited by sections EX 46, EX 47, EX 47B, EX 48, and EX 62.

10. The section requires a person to choose one of the calculation methods for each attributing interest. This choice is made by "completing a return of income accordingly" with the amount of FIF income resulting from the calculation. A "return of income" is defined in s YA 1 by reference to s 33 of the TAA. This section requires a person to file a return for each tax year. There is no explicit requirement that the choice has to be made by the due date for the return.
11. However, penalties can be imposed for filing a return late. For persons with a year ending on 31 March, the return must be filed by 7 July under s 37 of the TAA unless the person has an extension of time arrangement or uses an agent.

12. If a person uses the end-of-year automatic process and has more than $200 of income other than reportable income, they must provide this information to the Commissioner by the same date as someone who files an IR3 return (s 37(1B) of the TAA). FIF income is income other than reportable income.
13. Section EX 44(2) places restrictions on the choice a person can make. For example:
    - s EX 46(6) limits who can use the CV method for an attributing interest in shares in a foreign company.
    - s EX 47 limits the methods that can be used to calculate FIF income from an attributing interest in a non-ordinary share to the CV method, or failing that, the DRR method.
    - s EX 47B limits the method that a person can use for certain returning share transfers to the CV method.
    - s EX 62 limits the ability of persons to change methods from year to year.
14. If a person calculates FIF income using a method other than the attributable FIF income method, s EX 59(2) provides that other amounts derived from the attributing interest for a period are excluded income under s CX 57B. This means that, for example, a person does not need to return dividends from an investment in ordinary shares in a US company if they are required to calculate and return FIF income from the attributing interest and choose the FDR method. The dividends are excluded income under s CX 57B and not assessable income under s BD 1(5).
15. Section EX 57 contains rules about how to convert foreign amounts into New Zealand dollars. Credits for foreign tax paid are calculated on the segment of FIF income under ss LJ 2(6) and LJ 2(7) unless the attributable FIF income method has been used. See **IS 21/09: Income tax – foreign tax credits – how to calculate a foreign tax credit**, from page 83.

Default calculation method

16. Section EX 48 also limits the choice of calculation method. This section reads:

> **EX 48 Default calculation method**
>
> *When this section applies*
>
> (1) This section applies when—
>
> (a) a person does not choose a calculation method to calculate FIF income or loss from an attributing interest for a period; and
>
> (b) sections EX 46, EX 47, and EX 62 do not have the effect of requiring a particular calculation method to be used.
>
> *Default choice*
>
> (2) The person is treated as having chosen to use, for the period,—
>
> (a) the fair dividend rate method if it is practical to use it; and
>
> (b) the cost method if it is not practical to use the fair dividend rate method.

17. This section applies where a taxpayer does not file a return and the Commissioner issues a default assessment. If one of the restrictions in s EX 48(1)(b) do not apply, the person will be treated as though they chose the FDR method. If this is not possible, the person will be treated as if they chose the cost method. The CV method is not available. This could result in the person paying tax on a higher amount of FIF income. In order to challenge the assessment, the person needs to file a return. If the taxpayer is a natural person or eligible trustee, they can choose the CV method in that return if applicable.
18. In order to object to the assessment by way of a NOPA, s 89D(2) of the TAA requires the person to file the return in question. This process is described in **SPS 23/01 Disputes Process** starting at paragraph 53. The person can choose between the FDR and CV methods when calculating FIF income to include in the return.
19. Alternatively, as set out in paragraph 87 of **SPS 20/03 Requests to amend assessments**, if the person simply files the return in question without issuing a NOPA, the Commissioner will treat the tax return as a request under s 113 of the TAA to amend the default assessment. The assessment will generally be amended after confirming that the tax return contains the correct tax position. However, if the person is within the relevant disputes resolution response period, they should consider issuing a NOPA with the tax return to preserve their dispute rights where the Commissioner declines to amend the default assessment.
20. The person may be subject to penalties and use of money interest.

Dividends returned instead of FIF income

21. A person who includes a dividend in their return but no FIF income has not met the requirements of s EX 44(2). The FIF rules require a person to "calculate" FIF income. This means determining the amount of income mathematically. For example, the FDR method requires a person to calculate 5% of the opening market value of an attributing interest and add any income from quick sales taking into account the currency conversion rules.
22. To correct the situation, the person should make a voluntary disclosure. A voluntary disclosure can result in shortfall penalties being reduced by up to 100%. The person can choose between the FDR or CV methods in the voluntary disclosure, subject to the usual restrictions on choice.

Other cases

23. This item focuses on the choice a natural person or eligible trustee may have between the FDR and CV methods when correcting their tax affairs. However, the same principle applies to any taxpayer who has a choice of methods available to them when correcting their tax affairs. For example, a company may meet the criteria to use the attributable FIF income method and be able to choose between that and the FDR method in the year of acquisition when making a voluntary disclosure, filing a late return or filing a return in response to a default assessment.

FIF losses may be restricted

24. FIF losses can be deductible without satisfying the general permission because of section DN 5. Section DN 6 describes when a FIF loss arises. Its provisions are similar to what has already been described above for section CQ 5.
25. However, a deduction for a loss amount calculated using the CV method can be subject to a special limitation rule. This applies where the person is allowed to use either the FDR or CV methods. If the CV method is used and the overall result for all of those investments is a loss (ie the total of the negative results is more than the total of the positive results), the effect of s EX 51(8) is that the amount of each negative result is reduced to the extent necessary so that the overall result for all of the investments is zero.
26. The positive results are still taxable income under section CQ 4 in the normal way. However, this special loss limitation rule can mean that the total deduction for the loss amounts under section DN 5 cannot exceed the total FIF income.

TECHNICAL DECISION SUMMARIES

Technical decision summaries (TDS) are summaries of technical decisions made by the Tax Counsel Office. As this is a summary of the original technical decision, it may not contain all the facts or assumptions relevant to that decision. A TDS is made available for information only and is not advice, guidance or a "Commissioner's official opinion" (as defined in s 3(1) of the Tax Administration Act 1994). **You cannot rely on this document as setting out the Commissioner's position more generally or in relation to your own circumstances or tax affairs**. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest).

TDS 23/14: Omitted income, shortfall penalties

Decision date | Rā o te Whakatau: 26 May 2023

Issue date | Rā Tuku: 24 November 2023

Subjects | Kaupapa

Whether the Taxpayer returned all their assessable income for the income years in dispute. If not, whether the Taxpayer was liable for shortfall penalties.

Taxation laws | Ture tāke

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

Facts | Meka

1. The dispute concerned the tax treatment of various amounts paid to an individual Taxpayer over several income years. The Taxpayer proposed adjustments in relation to undisclosed dividend income, beneficiary income and other income that CCS had assessed as derived by the Taxpayer.
2. The Taxpayer was in full-time employment and also involved in their family's business operations. The family's business was in a group structure involving both company and trust entities.
3. One of the family companies owned and operated a business (the Company). The Company's leasehold interest in a property was acquired by the local Council for the construction of a road. The Company subsequently transferred amounts to entities associated with the Taxpayer. The Taxpayer also received amounts directly from the Council in relation to the leasehold acquisition.
4. One of the family trusts (the Trust) made regular payments into the Taxpayer's bank accounts.
5. In addition, there were unexplained cash deposits and payments made to the Taxpayer's bank accounts and to the Taxpayer's credit card (unexplained deposits).
6. CCS issued reassessments to the Taxpayer for the years in dispute.[1] As part of the reassessments CCS imposed an evasion shortfall penalty of 150% of the tax shortfall.[2] The penalty was reduced by 50% for previous behaviour.[3] As noted above at [1], the Taxpayer initiated the dispute by proposing adjustments to the reassessments issued by CCS.

Issues | Take

7. The preliminary issues were:
   - The onus and standard of proof.
   - Was the CSOP issued within the two-month response period?

1 Under s 89C(eb) of the Tax Administration Act 1994 (TAA).
2 Under s 141E of the TAA.
3 Under s 141FB of the TAA.

8. The main issues were:
   - Were the assessments issued by CCS (without first issuing a NOPA) valid?
   - Were amounts paid to the Taxpayer in relation to the Company undisclosed dividend income?
   - Were amounts paid to the Taxpayer by the Trust undisclosed beneficiary income?
   - Were the unexplained deposits assessable income to the Taxpayer?
   - Was CCS entitled to amend the Taxpayer's assessments to increase the amounts outside the four-year time bar period set out in s 108 of the TAA?
   - Was the Taxpayer liable for evasion shortfall penalties in relation to the tax shortfalls?

Decisions | Whakatau

9. The Tax Counsel Office decided:
   - The onus was on the Taxpayer to prove that the amounts received were not taxable income. The onus was on CCS to prove that the Taxpayer was liable under s 141E of the TAA for a shortfall penalty for evasion or a similar act. The standard of proof was the balance of probabilities.
   - The CSOP was validly issued within the 2-month response period.
   - The reassessments issued by CCS were made under s 89C(eb) of the TAA and were not invalid.
   - The amounts received from the Company and the Council were the Taxpayer's dividend income.
   - For the earlier income years in dispute, the deposits from the Trust were the Taxpayer's beneficiary income.
   - For the latter income years in dispute, the deposits from the Trust were not the Taxpayer's beneficiary income.
   - Most of the unexplained deposits were the Taxpayer's income under ordinary concepts.
   - The time bar in s 108(1) of the TAA did not prevent the Commissioner from making the reassessments because exceptions to the time bar (under s 108(2)) applied in the circumstances.
   - The Taxpayer was liable for evasion shortfall penalties on the tax shortfalls arising due to the Taxpayer not returning the unexplained deposits. The shortfall penalties were correctly reduced by 50% for previous behaviour.
   - However, the Taxpayer was not liable for evasion shortfall penalties on the tax shortfalls from the dividend income, the beneficiary income and most of the unexplained deposits.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue 1 | Take tōmua tuatahi: Onus and standard of proof

10. The onus of proof in civil proceedings[4] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[5] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[6]
11. The standard of proof in civil proceedings is the balance of probabilities.[7] This standard is met if it is proved that a matter is "more likely than not".[8] TCO applied a similar standard to considering the issues in this dispute, given the Taxpayer's ability to challenge any subsequent assessments that are made in civil proceedings.
12. Accordingly, in this dispute:
   - the onus was on the Taxpayer to prove that the amounts received were not taxable income.
   - the onus was on CCS to prove that the Taxpayer was liable under s 141E for a shortfall penalty for evasion or a similar act.
   - the standard of proof was the balance of probabilities.

4 Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

5 Section 149A(2) of the TAA.

6 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

7 Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

8 *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

Preliminary Issue 2 | Take tōmua tuarua: Issue of CSOP within the response period

13. The issue was whether the Commissioner's Statement of Position (CSOP) was issued within the 2-month response period.[9]
14. CCS argued that it sent the CSOP by email to the Taxpayer's Tax Agent within the response period. However, there was a problem with the Tax Agent's mailbox.
15. The Taxpayer argued that the CSOP was not issued within the response period because they did not become aware of the CSOP until the response period had expired.
16. TCO considered CCS must "issue" the CSOP within the response period under s 89M(6BA) of the TAA. There was no legislative requirement to notify the Taxpayer. TCO considered that the Taxpayer had not satisfied the burden of proof that the CSOP was not issued within the response period. Further, the Taxpayer's rights to fair and efficient resolution of the dispute had not been prejudiced.
17. TCO noted that it was ultimately for the Courts to conclude whether the CSOP was issued under s 89M(6BA) of the TAA within the 2month response period.

Issue 1 | Take tuatahi: Validity of assessments

18. Under Issue 1 in this summary all statutory references are to the TAA unless stated otherwise.
19. The Taxpayer raised a procedural issue regarding CCS's handling of the audit and dispute. The Taxpayer argued that the assessments made by CCS were not valid as a prior NOPA was not issued.
20. Section 89C(eb) allows CCS to issue an assessment without issuing a NOPA if it has reasonable grounds to believe that the taxpayer has been involved in fraudulent activity. In addition, under s 138E(1)(e)(iv), challenge rights are not conferred to matters left to the discretion, judgment, opinion, approval, consent, or determination of the Commissioner in s 89C. This would include the Commissioner's judgment or opinion that the taxpayer was involved in fraudulent activity (in s 89C(eb)). Therefore, the Taxpayer was unable to challenge CCS's exercise of its discretion under s 89C(eb).
21. TCO considered:
    - Whether CCS had reasonable grounds to believe that the Taxpayer had been involved in fraudulent activity was a matter which s 89C(eb) left to CCS's judgment or opinion. It was unnecessary to determine if the grounds relied on were reasonable. It was sufficient that CCS believed the grounds were reasonable.
    - CCS had formed a view that the Taxpayer was involved in fraudulent activity by not returning income from multiple sources in their income tax returns. CCS issued reassessments for income tax without first issuing a NOPA based on that belief.
22. Accordingly, TCO concluded that:
    - The reassessments made by CCS under s 89C(eb) were not invalid.
    - Section 138E applied in the current instance, so that the Taxpayer did not have challenge rights in relation to CCS's decision to invoke s 89C(eb).
    - Therefore, the decision was not a matter which may be put in issue in challenge proceedings and, as such, CCS was not required to establish that they had reasonable grounds to believe that the Taxpayer had been involved in fraudulent activity.

Issue 2 | Take tuarua: Undisclosed dividend income

23. The issue was whether the Taxpayer derived dividend income from the Company in the relevant income year.
24. CCS considered that the amounts paid by the Company and the Council were dividends paid to the Taxpayer. CCS considered that the payments were caused by a shareholding relationship because the amounts would not have been paid to the Taxpayer in the absence of the Taxpayer's association with the shareholders of the Company. TCO noted that the Taxpayer did not dispute this conclusion.
25. The Taxpayer argued that the compulsory acquisition of the Company's leasehold interest caused the closure of its business and the Company's shareholders resolved to commence the strike-off process and allow a liquidator to be appointed. The Taxpayer argued that the transfers were not dividends but distributions of capital reserves in the course of liquidation. Further, the Taxpayer argued that transfers made prior to the shareholder's resolution were interest free loans.

9 Section 89AB of the TAA.

26. CCS argued that the dividend exclusion for amounts paid on liquidation did not apply as the Taxpayer was not a shareholder of the Company . Further, CCS disputed the veracity of the special resolution of shareholders.
27. Section CD 26 confirms that an amount paid on the liquidation of a company may not be treated as a dividend if the amount:
    - is paid to a shareholder;
    - is paid in relation to a share on the liquidation of the Company; and
    - does not exceed the available subscribed capital per share calculated under the ordering rule and the available capital distribution amount calculated under s CD 44.
28. After considering the facts and evidence provided by the parties, TCO considered the Taxpayer had not satisfied the onus of proving on the balance of probabilities that the amounts transferred by the Company were not dividend income. There was no contemporaneous documentation to support the Taxpayer's submissions that transfers made prior to the shareholders resolution were interest free loans or to support the veracity of the special resolution authorising liquidation. In any event, since the Taxpayer was not a shareholder of the Company, TCO considered the s CD 26 exclusion for capital distributions on liquidation did not apply.[10]
29. Accordingly, TCO agreed with the reassessments made by CCS in relation to dividend income in the relevant income year and concluded the Taxpayer's proposed adjustments should not be made.

Issue 3 | Take tuatoru: Undisclosed beneficiary income

30. The issue was whether amounts paid to the Taxpayer by the Trust were undisclosed beneficiary income.
31. The Taxpayer received regular distributions from the Trust. The distributions were not returned in the Taxpayer's income tax returns. CCS argued the distributions were beneficiary income paid to the Taxpayer. The Taxpayer argued the distributions related to after-tax profits sourced from dividends received by the Trust from two of the family companies.
32. In addition, the Taxpayer argued that certain monthly amounts were distributions to the Taxpayer's parents and were paid directly to the Taxpayer in their capacity as trustee of the Parents Family Trust.[11]
33. CCS argued that the Trust had insufficient prior-year after-tax profits to account for the payments made to the Taxpayer. In the absence of supporting documentation, CCS argued the amounts deposited into the Taxpayer's personal bank accounts were beneficiary income derived for all the income years in dispute.
34. An amount of income derived in an income year by a trustee of a trust is either beneficiary income or trustee income.[12] "Beneficiary income" is defined in s HC 6 as income derived by a trustee which has either been vested absolutely in interest in a beneficiary in the income year or has been paid to the beneficiary within the income year or the extended period set out in s HC 6(1B).
35. For the purposes of the dispute, TCO divided the income years in dispute in two, and concluded as follows:
    - For the earlier income years in dispute, TCO considered the Taxpayer had not satisfied the onus of proving on the balance of probabilities that the amounts paid to the Taxpayer were not beneficiary income. In particular, TCO considered there was insufficient evidence to support the Taxpayer's position that the amounts received from the Trust were either sourced from after tax distributions or distributions of beneficiary income made to the Taxpayer's parents. As such, TCO considered the amounts received by the Taxpayer in the earlier income years were beneficiary income.
    - For the latter income years in dispute, TCO considered the amounts paid to the Taxpayer were not beneficiary income as the statutory definition contained in s HC 6 was not met. The Trust did not return any income during the latter income years. It followed that the amounts paid to the Taxpayer during the latter income years were not "beneficiary income" as defined in s HC 6. Accordingly, TCO disagreed with the reassessments made by CCS and concluded the Taxpayer's proposed adjustments for the latter income years should be made.

10 However, as noted above at [24], the Taxpayer was associated with the shareholders of the Company under s CD 6(1)(a)(ii).

11 The Taxpayer's parents resided in a home owned by the Parents Family Trust and paid the household expenses using distributions from the Trust. The Taxpayer claimed that their parents included the distributions as beneficiary income in their respective individual income tax returns.

12 Section HC 5.

Issue 4 | Take tuawhā: Unexplained deposits

36. The issue was whether the unexplained deposits (deposits made to bank accounts owned by the Taxpayer or paid against the Taxpayer's credit card) were the Taxpayer's income under ordinary concepts (s CA 1).
37. CCS argued the cash deposits showed the Taxpayer derived income from unexplained sources. Further, CCS argued the deposits were income under ordinary concepts because they were received on a periodic, recurrent and regular basis.
38. The Taxpayer argued that the unexplained deposits were not income under ordinary concepts but non-income amounts received from a number of sources:
    - cash allowances received from their employer;
    - loan repayments relating to monies the Taxpayer lent to friends;
    - loans from the Taxpayer's parents;
    - casino winnings and the redeposit of unspent cash withdrawals;
    - transfers between bank accounts of associated entities; and
    - bank errors.
39. TCO summarised the relevant case law for unexplained amounts as follows:
    - The taxpayer has the onus of proving that the amounts are not income.[13] The standard of proof is the balance of probabilities.[14]
    - The taxpayer can meet the onus of proof if the taxpayer provides specific details of other sources of funds that are capital or non-taxable in nature.[15]
    - The taxpayer is required to do more than simply provide a credible possible alternative explanation for the amounts. The taxpayer must establish that the Commissioner's assessment is incorrect and by how much it is incorrect.[16]
40. TCO considered the Taxpayer had not satisfied the onus of proving on the balance of probabilities that the unexplained deposits (except as specified below totalling a relatively small amount) were not income received in the income years in dispute. TCO acknowledged that the Taxpayer had provided some explanations that might be credible for some of the transfers or deposits, but the Taxpayer had not provided sufficient evidence to prove on the balance of probabilities that the deposits were not income of the Taxpayer, particularly in light of evidence provided by CCS.
41. However, TCO considered the Taxpayer had satisfied the onus of proving on the balance of probabilities that the following amounts were not income under ordinary concepts:
    - deposits that consisted of transfers between the Taxpayer's bank accounts;
    - a deposit that consisted of a reimbursement of a business cost; and
    - a deposit that was a bank error.
42. Accordingly, TCO concluded:
    - The adjustments proposed by the Taxpayer for the deposits specified above at [41] should be made.
    - The remaining adjustments proposed by the Taxpayer with respect to the unexplained deposits should not be made.

Issue 5 | Take tuarima: Time bar

43. Under Issue 5 in this summary all statutory references are to the TAA unless stated otherwise.
44. The issue was whether CCS could amend the income tax assessments for the income years in dispute to increase the amounts under s 108(2) of the TAA. Subject to some exceptions, including those in s 108(2) and s 108B, s 108(1) prevents the Commissioner from amending an assessment, to increase the amount assessed or decrease the amount of a net loss, if:
    - the taxpayer has furnished an income tax return, and
    - an assessment has been made, and
    - four years have passed from the end of the tax year in which the taxpayer provides the tax return.

13 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 at 61,283.

14 *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Case Y3* (2007) 23 NZTC 13,028; *Case X16* (2005) 22 NZTC 12,216.

15 *Case L40* (1989) 11 NZTC 1,249.

16 *Case S30* (1995) 17 NZTC 7,207.

45. However, if an exception applies, the Commissioner may amend an otherwise time-barred assessment.
46. TCO summarised that s 108(2)(b) applies as follows:
    - Income of a particular nature is income that has a basic or inherent feature, quality or character. The source of the income is where it is from.
    - Income must be mentioned in or with the return of the taxpayer seeking the protection of the time bar. The disclosure of income at some other time, or in another taxpayer's return, will not suffice.
    - The omission of income does not need to be fraudulent or deliberate.
    - Once it is determined that the time bar exception applies, the Commissioner is not confined to the omitted sums but may amend the whole assessment.
47. TCO considered that:
    - The dividend income and the beneficiary income were distinct categories of income (ie, of a particular nature) that were required to be returned, and they were also types of income derived from particular sources (the Company and the Trust respectively).
    - The unexplained deposits were periodic amounts and relied on by the Taxpayer to meet regular expenses. As such, they were income of a particular nature. The unexplained deposits were also derived from a particular source or sources, even though the source or sources remained unknown.
48. Accordingly, TCO considered that CCS's opinion that the Taxpayer's income tax returns did not include income of a particular nature or from a particular source was reasonably open to it on the information available to it. Further, TCO considered the Taxpayer had failed to show that CCS did not honestly hold the opinion or misdirected itself as to the legal basis on which the opinion was to be formed. Therefore, TCO concluded that s 108(2)(b) applied to allow the Commissioner to assess the Taxpayer for the income years in dispute.

Issue 6 | Take tuaono: Evasion shortfall penalty

49. Under Issue 6 in this summary all statutory references are to the TAA unless stated otherwise.
50. The issue is whether CCS has discharged its burden of proof that the Taxpayer was liable under s 141E for a shortfall penalty for evasion or a similar act.
51. Section 141E(a) imposes a shortfall penalty on a taxpayer if the following requirements are satisfied:
    - The taxpayer has taken a tax position.
    - Taking the tax position has resulted in a tax shortfall.
    - The taxpayer has evaded the assessment or payment of tax by the taxpayer or another person under a tax law.
52. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.
53. TCO summarised the elements of s 141E(1)(a) as follows:
    - The requirement for evasion will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.
    - Recklessness can amount to evasion. In the context of evasion recklessness involves the conscious taking of risk. Where recklessness is alleged, the Commissioner must prove that:
        - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
        - The taxpayer made a conscious decision to ignore the facts without making further inquiry.

Dividend income

54. The Taxpayer did not return dividend income from the Company in the relevant income year.
55. TCO noted that:
    - The receipt from the Council was an unusual or one-off transaction.
    - The Taxpayer had sought specialist advice on the tax treatment of the receipt, including that it could be distributed "tax free" on liquidation.

- It was not clear if the Taxpayer was aware of the necessary requirements to satisfy the s CD 26 exclusion for shareholder distributions "on liquidation", in particular that the distribution must be made to the Company's shareholder and not merely an associated party.
- While the steps were not executed correctly, CCS had not provided evidence that this was due to recklessness, as opposed to merely a mistake due to a lack of reasonable care or carelessness.

56. Accordingly, TCO concluded that:
    - CCS had not provided sufficient evidence that the Taxpayer knew he was breaching a tax obligation or made a conscious decision to ignore his tax obligations.
    - CCS had not satisfied the burden of proving evasion in relation to the dividend income.

Beneficiary income

57. The Taxpayer did not return beneficiary income from the Trust in the earlier income years.
58. The relevant facts were:
    - The Taxpayer was the sole director of the Trust's corporate trustee and had full access to the Trust's bank account (including signing authority).
    - In their capacity as director of the Trust's corporate trustee, the Taxpayer would have been aware of the contents of the Trust's income tax returns.
    - The Trust did not allocate beneficiary income to the Taxpayer in its income tax returns.
    - The Trust returned trustee income for these periods and the Taxpayer may have considered that the tax liability on the income had been met by the Trust and that there was no further tax obligation.
59. TCO considered that CCS had not provided sufficient evidence that the Taxpayer knew there was a breach of a tax obligation or made a conscious decision to ignore their tax obligations. Accordingly, TCO concluded that CCS had not satisfied the burden of proving evasion in relation to the tax shortfall of beneficiary income in the earlier income years.

Unexplained Deposits

60. The Taxpayer did not return the unexplained deposits as assessable income in the relevant income years.
61. TCO considered the knowledge requirement for evasion would be met if a taxpayer's knowledge must have put them on inquiry that their tax obligations would not be met, but they chose to proceed in spite of that risk.
62. The unexplained deposits were received by the Taxpayer in his bank accounts over a sustained period of time. The total amount of unexplained deposits received each year were not insubstantial and the Taxpayer relied on them to meet regular expenses.
63. TCO inferred from these circumstances that the Taxpayer knew that the unexplained deposits were income and filed their income tax returns without including them knowing that the returns were incorrect and misleading and in breach of their tax obligations. The Taxpayer had not shown that they had reasonable grounds for believing otherwise.
64. There is no evidence that the Taxpayer made inquiries to determine whether the unexplained deposits were income or not.
65. TCO considered CCS had satisfied its burden of proving that the Taxpayer evaded the assessment or payment of tax when they took tax positions in relation to the unexplained deposits.

Conclusion

66. TCO concluded that:
    - CCS had not satisfied the burden of proving that the Taxpayer evaded the assessment or payment of tax when they took the tax positions with respect to the dividend income and beneficiary income amounts.
    - However, CCS had satisfied the burden of proving evasion in relation to the omitted unexplained deposits.
67. Therefore, the Taxpayer was liable for shortfall penalties for evasion under s 141E only in relation to the unexplained deposits.
68. The resulting outcome was that CCS would need to calculate and reverse the evasion shortfall penalties relating to:
    - the dividend income;
    - the beneficiary income;
    - the amounts that TCO concluded were not income under ordinary concepts.
69. The shortfall penalties were reduced by 50% for previous behaviour.

TDS 23/15: Income Tax and GST – Omitted business income and liability for shortfall penalties

Decision date | Te Rā o te Whakatau: 26 May 2023

Issue date | Te Rā Tuku: 29 November 2023

Subjects | Kaupapa

INC/GST: Omitted business income; TAA: Shortfall penalties, onus and standard of proof

Facts | Meka

1. The Taxpayer was an incorporated company that carried on a retail business and was registered for GST. X was the Taxpayer's sole director and shareholder. The Taxpayer had paid wages with PAYE deducted to X and for one income year to Y. X's shareholder current account was also credited with a shareholder salary. X was married to Y.
2. X and Y were settlors, trustees, and beneficiaries of a Trust.
3. Customer Compliance Services, Inland Revenue (CCS) investigated the Taxpayer's income tax and GST affairs and concluded that the Taxpayer had omitted some business income from its income tax and GST assessments. CCS considered that the income had been:
   - deposited into X's and Y's personal bank accounts and the bank accounts of a Trust, used by X and Y and the Trust, and not returned by them for income tax purposes
   - used to pay X's and Y's personal expenses
   - used to fund property purchases made by X and Y and the Trust.
4. CCS also formed the view that the common ownership requirement for a subvention payment made by the Taxpayer to Company A was not met. The New Zealand Companies Register showed Y as Company A's sole director and holding 51% of its shares and X holding the remaining 49%. CCS considered the Taxpayer and Company A were 49% commonly owned, not the required 66%.
5. CCS issued a Notice of Proposed Adjustment (NOPA) to the Taxpayer proposing:
   - income tax and GST adjustments for the applicable years to include the omitted business income in the Taxpayer's income tax and GST returns and disallow the subvention payment
   - consequential adjustments assessing shareholder salary, dividends, or income under ordinary concepts to X, Y, and the Trust
   - a shortfall penalty for evasion for each income year and GST taxable period, reduced by 50% for previous behaviour. No shortfall penalty was proposed in respect of the adjustment relating to the subvention payment.
6. The 4-year time bar periods for amending the Taxpayer's income tax and GST assessments had expired in respect of some of the income years and GST taxable periods in dispute. However, CCS considered that exceptions applied to allow the assessments to be amended at any time.
7. The Taxpayer rejected the proposed adjustments, and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

8. The main issues in dispute were:
   - Whether the Taxpayer omitted business income from its income tax and GST assessments (s CB 1 of the ITA 2007 and s 8 of the GSTA).
   - Whether the omitted business income (if any) was assessable to X, Y, and the Trust as shareholder salary, dividends, or income under ordinary concepts (ss CE 1, CD 1, and CA 1(2) of the ITA 2007).
   - Whether the common ownership requirement for the subvention payment was met (ss IA 3 and IC 2-IC 6 of the ITA 2007).

- Whether the Commissioner could increase the Taxpayer's income tax and GST assessments (ss 108(2) and 108A(3) of the TAA).
- Whether the Taxpayer was liable for shortfall penalties for evasion, reduced by 50% for previous behaviour (ss 141E and 141FB of the TAA).

9. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

10. TCO decided that:
    - The Taxpayer omitted business income from its income tax and GST assessments.
    - The omitted business income was assessable income of X and Y and the Trust:
        - Employment income in the form of additional shareholder salary for X or, alternatively, dividend income or income under ordinary concepts.
        - Dividend income of Y or, alternatively employment income or income under ordinary concepts.
        - Dividend income of the Trust or, alternatively, income under ordinary concepts.
    - The common ownership requirement for the subvention payment was not met.
    - CCS's position that the time bar exceptions in ss 108(2) and 108A(3) of the TAA apply was accepted. The Commissioner could increase the Taxpayer's income tax and GST assessments.
    - The Taxpayer was liable for evasion shortfall penalties, reduced by 50% for previous behaviour.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

11. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
12. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer had discharged the onus of proof was considered in the relevant issues.
13. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgement he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[5]

Issue 1 | Take tuatahi: Whether the Taxpayer omitted business income from its assessments

14. It was not in dispute that the Taxpayer was carrying on a business and an amount that a person derives from a business is income of the person (s CB 1 ITA 2007). It was also not in dispute that the Taxpayer was carrying on a taxable activity and that GST was charged on its taxable supplies under s 8 of the GSTA.
15. Under s 22 of the TAA, a taxpayer carrying on a business dealing in goods is required to keep sufficient records to enable the Commissioner to ascertain their assessable income. Similarly, under s 75 of the GSTA a GST registered person must also keep sufficient records to enable the Commissioner to ascertain their liability to tax.

1 Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

2 Section 149A(2) of the TAA.

3 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

4 Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

5 *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

Application

16. TCO concluded that the Taxpayer had omitted business income from its income tax and GST assessments.
17. The proposed adjustments by CCS were not arbitrary. Evidence of CCS's investigation into, and analysis of, the Taxpayer's income tax and GST affairs shows that it:
    - undertook a comprehensive investigation and analysis of the Taxpayer's tax affairs
    - exhausted most, if not all, lines of inquiry
    - found a factual basis for the proposed adjustments
    - gave the Taxpayer adequate opportunities to provide explanations and supporting documentation
    - considered and accepted explanations and supporting documents the Taxpayer provided and made consequential adjustments to reduce the adjustments originally proposed, including some adjustments where supporting documentation was incomplete.
18. The Taxpayer had not shown the proposed adjustments were incorrect:
    - It had not provided any or sufficient evidence and records to show the amounts making up the proposed adjustments were anything other than business income it had omitted from its income tax and GST assessments
    - It had not shown CCS failed to exclude drawings, tax-paid salaries and wages, loans, proceeds from capital disposals, and business income returned by Company A for tax purposes from the proposed adjustments.

Issue 2 | Take tuarua: Whether the omitted business income is assessable to X, Y, and the Trust

Employment income

19. Section CE 1 provides that salary or wages derived by a person in connection with their employment or service is income of the person.
20. Under s RD 5, "Salary or wages" means a payment of salary, wages, or allowances made to a person in connection with their employment. It includes a bonus, commissioner, gratuity, or pay of any other kind.
21. An amount will be derived in connection with a person's employment or service if it was received because the person was an employee or because of the service they provided. The amount need not be paid under a contract of employment.[6]
22. Generally, salary and wages are "PAYE income payments" taxable under the PAYE (pay as you earn) rules. If certain requirements are met, a person who is a shareholder and an employee of a company can elect that salary and wages the company pays them is treated as income not subject to PAYE.

Dividends

23. Under s CD 1 a dividend derived by a person is income of the person. Under s CD 4, a dividend is a "transfer of value" from a company to a person if the cause of the transfer is a shareholding in the company.
24. Section CD 5 provides that a transfer of value occurs when a company provides money or money's worth to a person.
25. Under s CD 6 a transfer of value to a person is caused by a shareholding in the company:
    - if the person:
        - holds shares in the company, or
        - is associated with a shareholder, and
    - the company makes the transfer because of the shareholding of the relevant person.
26. Associated persons include:
    - A company and a person (not a company) with a 25% or more interest in the company.
    - Two persons connected by marriage.
    - A trust and a person who is a beneficiary in the trust.
    - A trust and its settlor.
    - Two persons associated to the same third person.

6 *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11,303 (CA), at 11,304 and 11,306.

27. Case law shows that company money taken and retained by a shareholder, whether deposited in their bank account or used for their personal expenditure, can be dividends under s CD 1.

Income under ordinary concepts

28. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.
29. The phrase "income under ordinary concepts" is not defined in the ITA 2007. However, income has been described as a flow of money or money's worth arising from the ownership of property or capital, from labour, or from a combination of those things.[7]
30. Regular recurrent payments on which the recipient depends to meet living expenses may be income under ordinary concepts.[8]

Application

31. TCO concluded that the omitted business income was assessable income of X, Y, and the Trust in the following ways:
    - Employment income in the form of additional shareholder salary of X or, alternatively, dividend income or income under ordinary concepts.
    - Dividend income of Y or, alternatively employment income or income under ordinary concepts.
    - Dividend income of the Trust or, alternatively, income under ordinary concepts.
32. The relevant amounts were employment income of X, and Y if the income was not assessable to Y as dividend income, because there was a connection between the income and their employment or service.
33. The relevant amounts were dividend income of Y and the Trust, and X if the dispute proceeded to challenge stage and it was found the business income was not X's employment income, because:
    - The Taxpayer made transfers of value when it deposited and otherwise made available money to X, Y, and the Trust.
    - The transfers of value were caused by X's shareholding in the Taxpayer:
        - X held shares in the Taxpayer.
        - Y and the Trust were associated with X.
        - There did not appear to be any reason for the Taxpayer to have made the transfers of value to X and Y and the Trust other than because of X's shareholding.
34. If not employment or dividend income, the relevant amounts were assessable to X and Y and the Trust as income under ordinary concepts. This was because:
    - Money was made available to X and Y and the Trust regularly and, or, recurrently over the income years in dispute.
    - X and Y and the Trust used the money for their own purposes, including regular expenses.
    - The Taxpayer had not explained the reason why the money was made available to X and Y and the Trust or otherwise disproved that it arose from the ownership of property or capital, from labour, or from a combination of those things.

Issue 3 | Take tuatoru: Whether the common ownership requirement for the subvention payment was met

35. A company may make a tax loss available to another company to subtract from their net income if certain requirements are met. One of the requirements is that the companies are at least 66% commonly owned. To be 66% commonly owned, a group a group of persons must hold common "voting interests" in both companies that add up to at least 66%.
36. If a "market value circumstance" exists, the group of persons must hold common "market value interests" adding up to at least 66%. In the dispute there was no suggestion that any market value circumstance existed. Accordingly, only common voting interests were relevant in determining whether the common ownership requirement was met.
37. If all relevant requirements are met, the other company can use the loss by making a subvention payment to the loss company.

7 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,355. See also *Tennant v Smith* [1892] AC 150 (HL) and *CIR v Parson* (No 2) [1968] NZLR 574 (CA).

8 *Reid v CIR* (1985) 7 NZTC 5,176 (CA) at 5,183.

38. Common voting interests are measured by determining the percentage of a person's "voting interests" in each company. A person's "voting interest" in a company equals the percentage of the total "shareholder decision-making rights" for the company carried by shares or options held by the person. "Shareholder decision-making rights" are rights to vote or participate in decision-making concerning company dividends or distributions, the company's constitution, variations in its capital, or the appointment of directors (ss IC 3, YA 1 and YC 2).
39. For income tax purposes, a person holds or does something as a nominee for another person if they act on the other person's behalf. Where a person holds or does something as a nominee for another person, the other person is treated as doing or holding the thing and the nominee is ignored (s YB 21).
40. How s YB 21 applies where a person holds shares as a nominee for another person is considered by the Commissioner in an Interpretation Statement.[9] In summary:
    - A person who holds shares as a nominee for another person:
        - is registered as the holder of the shares, but holds them for another person and has no beneficial interest in them
        - must deal with the shares and exercise voting and other rights attached to them as directed by the other person.
    - Evidence of a trust or another similar arrangement or agreement is required to prove a person holds shares on behalf of another.

Application

41. CCS argued that the common ownership requirement was not met. It argued that the Taxpayer and Company A were commonly owned as to 49%, not the required 66%. The Taxpayer argued that the common ownership requirement was met. It argued that X held 50% of their shares as nominee for Y, making the Taxpayer and Company A 99% commonly owned.
42. TCO concluded that the common ownership requirement for the subvention payment was not met. This was because from the evidence presented:
    - Y held 51% of Company A's shares and X held the remaining 49%.
    - X held 100% of the Taxpayer's shares in their own right. The Taxpayer had not shown that X held half of the Taxpayer's shares as nominee for Y.
43. Accordingly, the common voting interests in the Taxpayer and Company A were 49%, not the required 66%.

Issue 4 | Take tuawhā: Whether the Commissioner could increase the Taxpayer's income tax and GST assessments

44. Generally, under s 108 TAA the Commissioner may not amend an assessment to increase the amount assessed if:
    - the taxpayer has furnished an income tax return
    - an assessment has been made, and
    - four years have passed from the end of the tax year in which the taxpayer provides the tax return.
45. However, under s 108(2) TAA, the Commissioner may amend an assessment at any time if the Commissioner is of the opinion that a tax return provided by a taxpayer is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source.
46. An income tax return is misleading if:
    - it includes something which gives the Commissioner a wrong impression, or
    - it does not include something, the omission of which gives the Commissioner a wrong impression as to the taxpayer's true income tax position.
47. An income tax return will be "fraudulent or wilfully misleading" when the taxpayer:
    - filed it knowing that it did not reflect their true income tax position, or
    - was recklessly careless as to whether the return was wrong.

9 IS 12/01 Income tax: timing of share transfers for the purposes of the continuity provisions.

48. To be "fraudulent or wilfully misleading", the filing of the incorrect return must be deliberate and intentional. Inadvertently filing an incorrect return or filing a return which the taxpayer honestly believes to be correct will not constitute filing a "fraudulent or wilfully misleading" return.
49. Where the taxpayer is not a natural person, the issue will be whether the person signing the return wilfully filed a misleading return.
50. Generally, under s 108A TAA, the Commissioner may not amend a GST assessment to increase the amount assessed if four years have passed from the end of the GST return period in which the taxpayer provides their GST return.
51. However, under s 108A(3) TAA, the Commissioner may increase a GST assessment at any time if the Commissioner considers that a taxpayer has knowingly or fraudulently failed to disclose all material facts necessary for determining the amount of GST payable.
52. In regard to the application of s 108A(3):
    - For a person knowingly to fail to disclose all material facts the person must have knowledge or be aware of the failure.
    - For a person to fraudulently fail to disclose all material facts, the person must deliberately fail to disclose the facts knowing they are acting in breach of a legal obligation.
    - Knowledge can be established by inference, recklessness, and wilful blindness.
    - In the case of a company, the knowledge of a responsible officer or officers of the company may be attributed to the company.
    - Disclosure is not limited to what is contained in the GST return. Regard should be had to the whole of the information that the Commissioner may be expected to treat as made available, including information disclosed in other documents.
    - "All of the material facts" include all facts which a person knows or is capable of knowing that are material to determining the correct tax payable. The Commissioner must be given an adequate opportunity to consider whether a particular receipt was assessable income or a particular outgoing was an allowable deduction.

Application

53. CCS argued that ss 108(2) and 108A(3) of the TAA applied to allow the Commissioner to amend the Taxpayer's income tax and GST assessments. CCS argued that this was because:
    - It was of the opinion that the Taxpayer's income tax returns for the income years in dispute were fraudulent or wilfully misleading (s 108(2) of the TAA).
    - It considered the Taxpayer knowingly or fraudulently failed to disclose to the Commissioner all material facts necessary for determining the amount of GST payable for each GST period in dispute (s 108A(3) of the TAA).
54. TCO concluded that the Commissioner could increase the Taxpayer's income tax assessments. This was because CCS was of the opinion the Taxpayer's tax returns were fraudulent or wilfully misleading. There was evidence supporting CCS's opinion, including evidence showing the Taxpayer's income tax returns were filed deliberately and intentionally. X, as the Taxpayer's responsible officer, knew that they did not reflect the Taxpayer's true income tax position. There was nothing to suggest CCS did not hold the opinion or that the opinion was not honestly held.
55. TCO also concluded that the Commissioner could increase the Taxpayer's GST assessments. This was because CCS considered that the Taxpayer knowingly or fraudulently failed to disclose to the Commissioner all material facts necessary for determining the amount of GST payable for each GST period in dispute. There was evidence supporting CCS's opinion including:
    - the Taxpayer failed to disclose material facts in its GST returns, namely the true consideration it received for making taxable supplies, and
    - X, as the Taxpayer's responsible officer, knew the Taxpayer was acting in breach of a legal obligation.
56. Further, there was nothing to suggest CCS did not honestly hold the opinion or that CCS misdirected itself as to the legal basis on which the opinion was to be formed.

Issue 5 | Take tuarima – Whether the Taxpayer was liable for shortfall penalties for evasion

57. Section 141E(1)(a) imposes a shortfall penalty for evasion on a taxpayer if the following requirements are satisfied:[10]
    - The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[11]
    - Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[12]
    - The taxpayer has evaded the assessment or payment of tax. Evasion requires an intention to avoid the assessment or payment of tax known to be chargeable:
        - The element of intention will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.[13]
        - Recklessness can amount to evasion and involves the conscious taking of risk. Recklessness will be proven where: [14]
            - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
            - The taxpayer made a conscious decision to ignore the facts without making further inquiry.
58. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.
59. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E.[15] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[16]

Application

60. TCO concluded that the Taxpayer was liable for evasion shortfall penalties (reduced by 50% for previous behaviour) because:
    - They took tax positions that resulted in tax shortfalls.
    - In taking the tax positions, the Taxpayer evaded the assessment or payment of tax. There was evidence a responsible officer of the Taxpayer, X, knew that omitting to include business income in the Taxpayer's income tax and GST returns breached its tax obligations.
61. The imposition of shortfall penalties for evasion was appropriate given the seriousness of the Taxpayer's non-compliance. This occurred recurrently over the income years and taxable periods in dispute, involved substantial amounts and was not voluntarily disclosed.

10 The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: Shortfall Penalty—Evasion as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

11 Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

12 Definition of "tax shortfall" in s 3 of the TAA.

13 *Taylor v Attorney-General* [1963] NZLR 261 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388; *R v G* [2013] NZCA 146.

14 *Case H90* (1986) 8 NZTC 619; *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626; *R v G* [2013] NZCA 146.

15 Section 149A(2) of the TAA.

16 Section 149A(1) of the TAA.

TDS 23/16: Income Tax and GST – Omitted business income and liability for shortfall penalties

Decision date | Te Rā o te Whakatau: 26 May 2023

Issue date | Te Rā Tuku: 29 November 2023

Subjects | Kaupapa

INC/GST: Omitted business income; TAA: Shortfall penalties, onus and standard of proof

Facts | Meka

1. The Taxpayer was an incorporated company that carried on a retail business and was registered for GST. Y was the Taxpayer's sole director and held 51% of its shares and X held the remaining 49%. Y was married to X.
2. The Taxpayer's business was managed by E who was married to F. F and Y were the signatories on the Taxpayer's bank account.
3. Customer Compliance Services, Inland Revenue (CCS) investigated the Taxpayer's income tax and GST affairs and concluded that the Taxpayer had omitted some business income from its income tax and GST assessments. CCS considered that:
    - Some cash deposited in F's bank accounts was not transferred to the Taxpayer's bank account and had instead been:
        - transferred to F's bank accounts and retained by F
        - transferred to persons recorded as the Taxpayer's employees but not treated by the Taxpayer as wages
        - withdrawn in cash
        - spent by F and E personally
        - spent on goods and services of an unknown nature.
    - The business income was not included in the Taxpayer's income tax and GST assessments.
4. CCS also formed the view that the common ownership requirement for a subvention payment received by the Taxpayer from Company B was not met. The New Zealand Companies Register showed X as Company B's sole director and shareholder. CCS considered the Taxpayer and Company B were 49% commonly owned, not the required 66%.
5. CCS issued a Notice of Proposed Adjustment (NOPA) to the Taxpayer proposing:
    - income tax and GST adjustments for the applicable years to include the omitted business income in the Taxpayer's income tax and GST returns and disallow the subvention payment
    - a shortfall penalty for evasion for each income year and GST taxable period, reduced by 50% for previous behaviour. No shortfall penalty was proposed in respect of the adjustment relating to the subvention payment.
6. The 4-year time bar periods for amending the Taxpayer's income tax and GST assessments had expired in respect of some of the income years and GST taxable periods in dispute. However, CCS considered that exceptions applied to allow the assessments to be amended at any time.
7. The Taxpayer rejected the proposed adjustments, and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

8. The main issues in dispute were:
    - Whether the Taxpayer omitted business income from its income tax and GST assessments (s CB 1 of the ITA 2007 and s 8 of the GSTA).
    - Whether the common ownership requirement for the subvention payment was met (ss IA 3 and IC 2-IC 6 of the ITA 2007).

- Whether the Commissioner could increase the Taxpayer's income tax and GST assessments (ss 108(2) and 108A(3) of the TAA).
- Whether the Taxpayer was liable for shortfall penalties for evasion, reduced by 50% for previous behaviour (ss 141E and 141FB of the TAA).

9. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

10. TCO decided that:
    - The Taxpayer omitted business income from its income tax and GST assessments.
    - The common ownership requirement for the subvention payment was not met.
    - CCS's position that the time bar exceptions in ss 108(2) and 108A(3) of the TAA apply was accepted. The Commissioner could increase the Taxpayer's income tax and GST assessments.
    - The Taxpayer was liable for evasion shortfall penalties, reduced by 50% for previous behaviour.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

11. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
12. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer had discharged the onus of proof was considered in the relevant issues.
13. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgement he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[5]

Issue 1 | Take tuatahi: Whether the Taxpayer omitted business income from its assessments

14. It was not in dispute that the Taxpayer was carrying on a business and an amount that a person derives from a business is income of the person (s CB 1 ITA 2007). It was also not in dispute that the Taxpayer was carrying on a taxable activity and that GST was charged on its taxable supplies under s 8 of the GSTA.
15. Under s 22 of the TAA a taxpayer carrying on a business dealing in goods is required to keep sufficient records to enable the Commissioner to ascertain their assessable income. Similarly, under s 75 of the GSTA a GST registered person must also keep sufficient records to enable the Commissioner to ascertain their liability to tax.

Application

16. TCO concluded that the Taxpayer had omitted business income from its income tax and GST assessments.
17. The proposed adjustments by CCS were not arbitrary. Evidence of CCS's investigation into, and analysis of, the Taxpayer's income tax and GST affairs shows that it:
    - undertook a comprehensive investigation and analysis of the Taxpayer's tax affairs
    - exhausted most, if not all, lines of inquiry
    - found a factual basis for the proposed adjustments
    - gave the Taxpayer adequate opportunities to provide explanations and supporting documentation.

1 Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

2 Section 149A(2) of the TAA.

3 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

4 Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

5 *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

18. The Taxpayer had not shown the proposed adjustments were incorrect:
    - It had not provided any or sufficient evidence and records to show the amounts making up the proposed adjustments were anything other than business income it had omitted from its income tax and GST assessments
    - It had not shown CCS failed to exclude shareholder salaries, drawings, loans, proceeds from the sale of capital assets, and amounts it paid to F to reimburse the cost of business stock purchased personally from the proposed adjustments.

Issue 2 | Take tuarua: Whether the common ownership requirement for the subvention payment was met

19. A company may make a tax loss available to another company to subtract from their net income if certain requirements are met. One of the requirements is that the companies are at least 66% commonly owned. To be 66% commonly owned, a group a group of persons must hold common "voting interests" in both companies that add up to at least 66%.
20. If a "market value circumstance" exists, the group of persons must hold common "market value interests" adding up to at least 66%. In the dispute there was no suggestion that any market value circumstance existed. Accordingly, only common voting interests were relevant in determining whether the common ownership requirement was met.
21. If all relevant requirements are met, the other company can use the loss by making a subvention payment to the loss company.
22. Common voting interests are measured by determining the percentage of a person's "voting interests" in each company. A person's "voting interest" in a company equals the percentage of the total "shareholder decision-making rights" for the company carried by shares or options held by the person. "Shareholder decision-making rights" are rights to vote or participate in decision-making concerning company dividends or distributions, the company's constitution, variations in its capital, or the appointment of directors (ss IC 3, YA 1 and YC 2).
23. For income tax purposes, a person holds or does something as a nominee for another person if they act on the other person's behalf. Where a person holds or does something as a nominee for another person, the other person is treated as doing or holding the thing and the nominee is ignored (s YB 21).
24. How s YB 21 applies where a person holds shares as a nominee for another person is considered by the Commissioner in an Interpretation Statement.[6] In summary:
    - A person who holds shares as a nominee for another person:
        - is registered as the holder of the shares but holds them for another person and has no beneficial interest in them
        - must deal with the shares and exercise voting and other rights attached to them as directed by the other person.
    - Evidence of a trust or another similar arrangement or agreement is required to prove a person holds shares on behalf of another.

Application

25. CCS argued that the common ownership requirement was not met. It argued that the Taxpayer and Company B were commonly owned as to 49%, not the required 66%. The Taxpayer argued that the common ownership requirement was met. It argued that X held 50% of its shares as nominee for Y, making the Taxpayer and Company B 99% commonly owned.
26. TCO concluded that the common ownership requirement for the subvention payment was not met. This was because from the evidence presented:
    - Y held 51% of the Taxpayer's shares and X held the remaining 49%.
    - X held 100% of Company B's shares in their own right. The Taxpayer had not shown that X held half of Company B's shares as nominee for Y.
27. Accordingly, the common voting interests in the Taxpayer and Company B were 49%, not the required 66%.

6 IS 12/01 Income tax: timing of share transfers for the purposes of the continuity provisions.

Issue 3 | Take tuatoru: Whether the Commissioner could increase the Taxpayer's income tax and GST assessments

28. Generally, under s 108 TAA the Commissioner may not amend an assessment to increase the amount assessed if:
    - the taxpayer has furnished an income tax return;
    - an assessment has been made, and
    - four years have passed from the end of the tax year in which the taxpayer provides the tax return.
29. However, under s 108(2) TAA, the Commissioner may amend an assessment at any time if the Commissioner is of the opinion that a tax return provided by a taxpayer is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source.
30. An income tax return is misleading if:
    - it includes something which gives the Commissioner a wrong impression, or
    - it does not include something, the omission of which gives the Commissioner a wrong impression as to the taxpayer's true income tax position.
31. An income tax return will be "fraudulent or wilfully misleading" when the taxpayer:
    - filed it knowing that it did not reflect their true income tax position, or
    - was recklessly careless as to whether the return was wrong.
32. To be "fraudulent or wilfully misleading", the filing of the incorrect return must be deliberate and intentional. Inadvertently filing an incorrect return or filing a return which the taxpayer honestly believes to be correct will not constitute filing a "fraudulent or wilfully misleading" return.
33. Where the taxpayer is not a natural person, the issue will be whether the person signing the return wilfully filed a misleading return.
34. Generally, under s 108A TAA, the Commissioner may not amend a GST assessment to increase the amount assessed if four years have passed from the end of the GST return period in which the taxpayer provides their GST return.
35. However, under s 108A(3) TAA, the Commissioner may increase a GST assessment at any time if the Commissioner considers that a taxpayer has knowingly or fraudulently failed to disclose all material facts necessary for determining the amount of GST payable.
36. In regard to the application of s 108A(3):
    - For a person knowingly to fail to disclose all material facts the person must have knowledge or be aware of the failure.
    - For a person to fraudulently fail to disclose all material facts, the person must deliberately fail to disclose the facts knowing they are acting in breach of a legal obligation.
    - Knowledge can be established by inference, recklessness, and wilful blindness.
    - In the case of a company, the knowledge of a responsible officer or officers of the company may be attributed to the company.
    - Disclosure is not limited to what is contained in the GST return. Regard should be had to the whole of the information that the Commissioner may be expected to treat as made available, including information disclosed in other documents.
    - "All of the material facts" include all facts which a person knows or is capable of knowing that are material to determining the correct tax payable. The Commissioner must be given an adequate opportunity to consider whether a particular receipt was assessable income or a particular outgoing was an allowable deduction.

Application

37. CCS argued that ss 108(2) and 108A(3) of the TAA applied to allow the Commissioner to amend the assessments. CCS argued that this was because:
    - It was of the opinion that the Taxpayer's income tax returns for the income years in dispute were fraudulent or wilfully misleading (s 108(2) of the TAA).
    - It considered the Taxpayer knowingly or fraudulently failed to disclose to the Commissioner all material facts necessary for determining the amount of GST payable for each GST period in dispute (s 108A(3) of the TAA).

38. TCO concluded that the Commissioner could increase the Taxpayer's income tax assessments. This was because CCS was of the opinion the Taxpayer's tax returns were fraudulent or wilfully misleading. There was evidence supporting CCS's opinion, including evidence showing the Taxpayer's income tax returns were filed deliberately and intentionally X, and likely Y, knowing that they did not reflect the Taxpayer's true income tax position. There was nothing to suggest CCS did not hold the opinion or that the opinion was not honestly held.
39. TCO also concluded that the Commissioner could increase the Taxpayer's GST assessments. This was because CCS considered that the Taxpayer knowingly or fraudulently failed to disclose to the Commissioner all material facts necessary for determining the amount of GST payable for each GST period in dispute. There was evidence supporting CCS's opinion including:
    - the Taxpayer failed to disclose material facts in its GST returns, namely the true consideration it received for making taxable supplies, and
    - X, and likely Y as the Taxpayer's sole director, knew the Taxpayer was acting in breach of a legal obligation.
40. Further, there was nothing to suggest CCS did not honestly hold the opinion or that CCS misdirected itself as to the legal basis on which the opinion was to be formed.

Issue 4 | Take tuawhā – Whether the Taxpayer was liable for shortfall penalties for evasion

41. Section 141E(1)(a) imposes a shortfall penalty for evasion on a taxpayer if the following requirements are satisfied:[7]
    - The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[8]
    - Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[9]
    - The taxpayer has evaded the assessment or payment of tax. Evasion requires an intention to avoid the assessment or payment of tax known to be chargeable:
        - The element of intention will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.[10]
        - Recklessness can amount to evasion and involves the conscious taking of risk. Recklessness will be proven where:[11]
            - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
            - The taxpayer made a conscious decision to ignore the facts without making further inquiry.
42. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.
43. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E.[12] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[13]

7 The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: Shortfall Penalty—Evasion as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

8 Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

9 Definition of "tax shortfall" in s 3 of the TAA.

10 *Taylor v Attorney-General* [1963] NZLR 261 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388; *R v G* [2013] NZCA 146.

11 *Case H90* (1986) 8 NZTC 619; *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626; *R v G* [2013] NZCA 146.

12 Section 149A(2) of the TAA.

13 Section 149A(1) of the TAA.

Application

44. TCO concluded that the Taxpayer was liable for evasion shortfall penalties (reduced by 50% for previous behaviour) because:
    - It took tax positions that resulted in tax shortfalls.
    - In taking the tax positions, the Taxpayer evaded the assessment or payment of tax. There was evidence responsible officers of the Taxpayer, X and Y, knew that omitting to include business income in the Taxpayer's income tax and GST returns breached its tax obligations.
45. The imposition of shortfall penalties for evasion was appropriate given the seriousness of the Taxpayer's non-compliance. This occurred recurrently over the income years and taxable periods in dispute, involved substantial amounts and was not voluntarily disclosed.

TDS 23/17: Income Tax – Omitted income and liability for shortfall penalties

Decision date | Te Rā o te Whakatau: 26 May 2023

Issue date | Te Rā Tuku: 29 November 2023

Subjects | Kaupapa

INC: Omitted employment income; TAA: Shortfall penalties, onus and standard of proof

Facts | Meka

1. The Taxpayer was a trust with X and Y being settlors, trustees and beneficiaries. The Taxpayer was involved in property investment. Both X and Y were signatories of the Taxpayer's bank accounts. X was also the sole director and shareholder of Company B.
2. The Taxpayer returned only rental income for income tax purposes.
3. Customer Compliance Services, Inland Revenue (CCS) investigated the Taxpayer's income tax affairs and formed the view that:
    - Money from Company B had been deposited in the Taxpayer's bank accounts and retained by the Taxpayer and was used to fund the purchase of properties.
    - Money from Company B deposited and used in this way was not:
        - recorded as capital drawings or loans in the Taxpayer's financial statements, or
        - returned by the Taxpayer for income tax purposes.
4. CCS issued a Notice of Proposed Adjustment (NOPA) to the Taxpayer proposing:
    - Income tax adjustments for the applicable income years to include the money it considered the Taxpayer had received from Company B as unimputed dividends or, alternatively, income under ordinary concepts.
    - A shortfall penalty for evasion for each income year, reduced by 50% for previous behaviour.
5. The 4-year time bar periods for amending the Taxpayer's income tax assessments had expired in respect of some of the income years and in dispute. However, CCS considered that exceptions applied to allow the assessments to be amended at any time.
6. The Taxpayer rejected the proposed adjustments, and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

7. The main issues in dispute were:
    - Whether money the Taxpayer received from Company B was assessable as dividends or, alternatively, income under ordinary concepts (ss CD 1 and CA 1(2) of the ITA 2007).
    - Whether the Commissioner could increase the Taxpayer's income tax assessments (ss 108(2) of the TAA).
    - Whether the Taxpayer was liable for shortfall penalties for evasion, reduced by 50% for previous behaviour (ss 141E and 141FB of the TAA).
8. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

9. TCO decided that:
    - Money the Taxpayer received from Company B was assessable to the Taxpayer as dividend income. If the dispute proceeded to challenge stage and it was found the amount was not the Taxpayer's dividend income, the amount was assessable to the Taxpayer as income under ordinary concepts.

- CCS's position that the time bar exception in s 108(2) of the TAA applied was accepted. The Commissioner could increase the Taxpayer's income tax assessments.
- The Taxpayer was liable for evasion shortfall penalties, reduced by 50% for previous behaviour.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

10. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
11. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer had discharged the onus of proof was considered in the relevant issues.
12. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgement he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[5]

Issue 1 | Take tuatahi: Whether money received from Company B was assessable to the Taxpayer

Dividends

13. Under s CD 1 a dividend derived by a person is income of the person. Under s CD 4, a dividend is a "transfer of value" from a company to a person if the cause of the transfer is a shareholding in the company.
14. Section CD 5 provides that a transfer of value occurs when a company provides money or money's worth to a person.
15. Under s CD 6 a transfer of value to a person is caused by a shareholding in the company:
    - if the person:
        - holds shares in the company, or
        - is associated with a shareholder, and
    - the company makes the transfer because of the shareholding of the relevant person.
16. Associated persons include:
    - A company and a person (not a company) with a 25% or more interest in the company.
    - Two persons connected by marriage.
    - A trust and a person who is a beneficiary in the trust.
    - A trust and its settlor.
    - Two persons associated to the same third person.
17. Case law shows that company money taken and retained by a shareholder, whether deposited in their bank account or used for their personal expenditure, can be dividends under s CD 1.

Income under ordinary concepts

18. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.
19. The phrase "income under ordinary concepts" is not defined in the ITA 2007. However, income has been described as a flow of money or money's worth arising from the ownership of property or capital, from labour, or from a combination of those things.[6]

1 Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

2 Section 149A(2) of the TAA.

3 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

4 Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

5 *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

6 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,355. See also *Tennant v Smith* [1892] AC 150 (HL) and *CIR v Parson* (No 2) [1968] NZLR 574 (CA).

20. Regular recurrent payments on which the recipient depends to meet living expenses may be income under ordinary concepts.[7]

Application

21. TCO concluded that the money received from Company B was assessable to the Taxpayer as dividend income. This was because:
    - Company B made transfers of value when it deposited and otherwise made available money to the Taxpayer.
    - The transfers of value were caused by a shareholding in Company B:
        - X held shares in Company B.
        - The Taxpayer was associated with X as they were a settlor of the Taxpayer.
        - There did not appear to be any reason for Company B to have made the transfers of value other than because of X's shareholding.
22. If the dispute proceeded to challenge stage and it was found the amount received from Company B was not the Taxpayer's dividend income, the amount was assessable to the Taxpayer as income under ordinary concepts:
    - The money was made available to the Taxpayer recurrently over the income years in dispute, and regularly for a period of one income year.
    - The Taxpayer and X and Y used the money for their own purposes.
    - The Taxpayer did not explain the reason why it received the money or otherwise disproved that it arose from the ownership of property or capital, from labour, or from a combination of those things.

Issue 2 | Take tuarua: Whether the Commissioner could increase the Taxpayer's income tax assessments

23. Generally, under s 108 TAA the Commissioner may not amend an assessment to increase the amount assessed if:
    - the taxpayer has furnished an income tax return;
    - an assessment has been made, and
    - four years have passed from the end of the tax year in which the taxpayer provides the tax return.
24. However, under s 108(2) TAA, the Commissioner may amend an assessment at any time if the Commissioner is of the opinion that a tax return provided by a taxpayer is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source.
25. An income tax return is misleading if:
    - it includes something which gives the Commissioner a wrong impression, or
    - it does not include something, the omission of which gives the Commissioner a wrong impression as to the taxpayer's true income tax position.
26. An income tax return will be "fraudulent or wilfully misleading" when the taxpayer:
    - filed it knowing that it did not reflect their true income tax position, or
    - was recklessly careless as to whether the return was wrong.
27. To be "fraudulent or wilfully misleading", the filing of the incorrect return must be deliberate and intentional. Inadvertently filing an incorrect return or filing a return which the taxpayer honestly believes to be correct will not constitute filing a "fraudulent or wilfully misleading" return.

Application

28. CCS argued that s 108(2) of the TAA allowed the Commissioner to amend the Taxpayer's income tax assessments. CCS argued that it was of the opinion that the Taxpayer's income tax returns for the income years in dispute were fraudulent or wilfully misleading.

7 *Reid v CIR* (1985) 7 NZTC 5,176 (CA) at 5,183.

29. TCO concluded that the Commissioner could increase the Taxpayer's income tax assessments. This was because
    - CCS was of the opinion the Taxpayer's income tax returns did not mention dividend income which was of a particular nature or was derived from a particular source and in respect of which a tax return was required to be provided.
    - There was support for CCS's opinion:
        - The income was of a particular nature, namely dividend income. It was derived from a particular source, namely Company B.
        - The Taxpayer's income tax returns for the income years in dispute did not include any dividend income from Company B.
    - There was nothing to suggest CCS did not hold the opinion or that the opinion was not honestly held.

Issue 3 | Take tuatoru: Whether the Taxpayer was liable for shortfall penalties for evasion

30. Section 141E(1)(a) imposes a shortfall penalty for evasion on a taxpayer if the following requirements are satisfied:[8]
    - The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[9]
    - Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[10]
    - The taxpayer has evaded the assessment or payment of tax. Evasion requires an intention to avoid the assessment or payment of tax known to be chargeable:
        - The element of intention will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.[11]
        - Recklessness can amount to evasion and involves the conscious taking of risk. Recklessness will be proven where: [12]
            - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
            - The taxpayer made a conscious decision to ignore the facts without making further inquiry.
31. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.
32. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E.[13] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[14]

8 The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: Shortfall Penalty—Evasion as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

9 Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

10 Definition of "tax shortfall" in s 3 of the TAA.

11 *Taylor v Attorney-General* [1963] NZLR 261 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388; *R v G* [2013] NZCA 146.

12 *Case H90* (1986) 8 NZTC 619; *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626; *R v G* [2013] NZCA 146.

13 Section 149A(2) of the TAA.

14 Section 149A(1) of the TAA.

Application

33. TCO concluded that the Taxpayer was liable for evasion shortfall penalties (reduced by 50% for previous behaviour) because:
    - They took tax positions that resulted in tax shortfalls.
    - In taking the tax positions, the Taxpayer evaded the assessment or payment of tax. There was evidence a trustee of the Taxpayer, X, knew that omitting to include the income the Taxpayer received from Company B in the income tax returns was in breach of the Taxpayer's tax obligations.
34. The imposition of shortfall penalties for evasion was appropriate given the seriousness of the Taxpayer's non-compliance. This occurred recurrently over the income years in dispute, involved substantial amounts and was not voluntarily disclosed.

TDS 23/18: Income Tax – Omitted income and liability for shortfall penalties

Decision date | Te Rā o te Whakatau: 26 May 2023

Issue date | Te Rā Tuku: 29 November 2023

Subjects | Kaupapa

INC: Omitted employment income; TAA: Shortfall penalties, onus and standard of proof

Facts | Meka

1. The New Zealand Companies Register showed the Taxpayer was the sole director and shareholder of Company B which carried on a retail business.
2. The Taxpayer also held 49% of the shares in Company A which operated a retail business. Y was Company A's sole director and held the remaining 51% of its shares. The Taxpayer was married to Y.
3. The Taxpayer was also a settlor, trustee, and beneficiary of a Trust which was involved in property investment.
4. The Taxpayer filed income tax returns showing wages from which PAYE had been deducted and shareholder salary from Company B and income from the Trust.
5. Customer Compliance Services, Inland Revenue (CCS) investigated the Taxpayer's income tax affairs and formed the view that:
    - Money from Company B income had been:
        - deposited into the Taxpayer's and Y's personal bank accounts and retained by them
        - used to pay the Taxpayer's and Y's personal expenses
        - used to fund a property purchase made by Company C. The Companies Register showed Y was a director of and held 80% of the shares in Company C.
    - Money from Company B deposited and used in this way was not returned by the Taxpayer for income tax purposes.
    - 50% of the money could be assessed to the Taxpayer as shareholder salary or, alternatively, dividends or income under ordinary concepts.
6. CCS issued a Notice of Proposed Adjustment (NOPA) to the Taxpayer proposing:
    - Income tax adjustments for the applicable income years to include money it considered the Taxpayer had received from Company B as shareholder salary or, alternatively, dividends or income under ordinary concepts.
    - A shortfall penalty for evasion for each income year, reduced by 50% for previous behaviour.
7. The 4-year time bar periods for amending the Taxpayer's income tax assessments had expired in respect of some of the income years and in dispute. However, CCS considered that exceptions applied to allow the assessments to be amended at any time.
8. The Taxpayer rejected the proposed adjustments, and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

9. The main issues in dispute were:
    - Whether money the Taxpayer received from Company B was assessable as shareholder salary or, alternatively, dividends or income under ordinary concepts (ss CE 1, CD 1, and CA 1(2) of the ITA 2007).
    - Whether the Commissioner could increase the Taxpayer's income tax assessments (ss 108(2) of the TAA).
    - Whether the Taxpayer was liable for shortfall penalties for evasion, reduced by 50% for previous behaviour (ss 141E and 141FB of the TAA).
10. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

11. TCO decided that:
    - Money the Taxpayer received from Company B was assessable to the Taxpayer as employment income in the form of additional shareholder salary. If this dispute proceeded to challenge stage and it was found the amount was not the Taxpayer's employment income, the amount was assessable to the Taxpayer as dividend income or income under ordinary concepts.
    - CCS's position that the time bar exception in s 108(2) of the TAA applied was accepted. The Commissioner could increase the Taxpayer's income tax assessments.
    - The Taxpayer was liable for evasion shortfall penalties, reduced by 50% for previous behaviour.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

12. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
13. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer had discharged the onus of proof was considered in the relevant issues.
14. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgement he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[5]

Issue 1 | Take tuatahi: Whether money received from Company B was assessable to the Taxpayer

Employment income

15. Section CE 1 provides that salary or wages derived by a person in connection with their employment or service is income of the person.
16. Under s RD 5, "Salary or wages" means a payment of salary, wages, or allowances made to a person in connection with their employment. It includes a bonus, commissioner, gratuity, or pay of any other kind.
17. An amount will be derived in connection with a person's employment or service if it was received because the person was an employee or because of the service they provided. The amount need not be paid under a contract of employment.[6]
18. Generally, salary and wages are "PAYE income payments" taxable under the PAYE (pay as you earn) rules. If certain requirements are met, a person who is a shareholder and an employee of a company can elect that salary and wages the company pays them is treated as income not subject to PAYE.

Dividends

19. Under s CD 1 a dividend derived by a person is income of the person. Under s CD 4, a dividend is a "transfer of value" from a company to a person if the cause of the transfer is a shareholding in the company.
20. Section CD 5 provides that a transfer of value occurs when a company provides money or money's worth to a person.

1 Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

2 Section 149A(2) of the TAA.

3 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

4 Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

5 *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

6 *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11,303 (CA), at 11,304 and 11,306.

21. Under s CD 6 a transfer of value to a person is caused by a shareholding in the company:
    - if the person:
        - holds shares in the company, or
        - is associated with a shareholder, and
    - the company makes the transfer because of the shareholding of the relevant person.
22. Associated persons include:
    - A company and a person (not a company) with a 25% or more interest in the company.
    - Two persons connected by marriage.
    - A trust and a person who is a beneficiary in the trust.
    - A trust and its settlor.
    - Two persons associated to the same third person.
23. Case law shows that company money taken and retained by a shareholder, whether deposited in their bank account or used for their personal expenditure, can be dividends under s CD.

Income under ordinary concepts

24. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.
25. The phrase "income under ordinary concepts" is not defined in the ITA 2007. However, income has been described as a flow of money or money's worth arising from the ownership of property or capital, from labour, or from a combination of those things.[7]
26. Regular recurrent payments on which the recipient depends to meet living expenses may be income under ordinary concepts.[8]

Application

27. TCO concluded that the money received from Company B was assessable to the Taxpayer. Half of the money the Taxpayer and Y received from Company B was assessable to the Taxpayer as employment income in the form of additional shareholder salary. This was because there was a connection between the money and the Taxpayer's employment or service with Company B.
28. If the dispute proceeded to challenge stage and it was found that the amount received from Company B was not the Taxpayer's employment income, the amount was assessable to them as dividend income or income under ordinary concepts:
    - Dividend income, because:
        - Company B made transfers of value when it deposited and otherwise made available money to the Taxpayer and Y.
        - The transfers of value were caused by the Taxpayer's shareholding in Company B:
            - The Taxpayer held shares in Company B.
            - There did not appear to be any reason for Company B to have made the transfers of value other than because of the Taxpayer's shareholding.
    - Income under ordinary concepts because:
        - The Taxpayer received a flow of money arising from the ownership of property or capital, from labour, or from a combination of those things.
        - The money was made available to the Taxpayer regularly and recurrently and they relied on the money for regular expenditure.

7 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,355. See also *Tennant v Smith* [1892] AC 150 (HL) and *CIR v Parson* (No 2) [1968] NZLR 574 (CA).

8 *Reid v CIR* (1985) 7 NZTC 5,176 (CA) at 5,183.

Issue 2 | Take tuarua: Whether the Commissioner could increase the Taxpayer's income tax assessments

29. Generally, under s 108 TAA the Commissioner may not amend an assessment to increase the amount assessed if:
    - the taxpayer has furnished an income tax return;
    - an assessment has been made, and
    - four years have passed from the end of the tax year in which the taxpayer provides the tax return.
30. However, under s 108(2) TAA, the Commissioner may amend an assessment at any time if the Commissioner is of the opinion that a tax return provided by a taxpayer is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source.
31. An income tax return is misleading if:
    - it includes something which gives the Commissioner a wrong impression, or
    - it does not include something, the omission of which gives the Commissioner a wrong impression as to the taxpayer's true income tax position.
32. An income tax return will be "fraudulent or wilfully misleading" when the taxpayer:
    - filed it knowing that it did not reflect their true income tax position, or
    - was recklessly careless as to whether the return was wrong.
33. To be "fraudulent or wilfully misleading", the filing of the incorrect return must be deliberate and intentional. Inadvertently filing an incorrect return or filing a return which the taxpayer honestly believes to be correct will not constitute filing a "fraudulent or wilfully misleading" return.

Application

34. CCS argued that s 108(2) of the TAA allowed the Commissioner to amend the assessments. CCS argued that it was of the opinion that the Taxpayer's income tax returns for the income years in dispute were fraudulent or wilfully misleading.
35. TCO concluded that the Commissioner could increase the Taxpayer's income tax assessments. This was because CCS was of the opinion the Taxpayer's tax returns were fraudulent or wilfully misleading. There was evidence supporting CCS's opinion, including evidence showing the Taxpayer's income tax returns were filed deliberately and intentionally with the Taxpayer knowing that they did not reflect their true income tax position. There was nothing to suggest CCS did not hold the opinion or that the opinion was not honestly held.

Issue 3 | Take tuatoru: Whether the Taxpayer was liable for shortfall penalties for evasion

36. Section 141E(1)(a) imposes a shortfall penalty for evasion on a taxpayer if the following requirements are satisfied:[9]
    - The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[10]
    - Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[11]
    - The taxpayer has evaded the assessment or payment of tax. Evasion requires an intention to avoid the assessment or payment of tax known to be chargeable:
        - The element of intention will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.[12]

9 The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: Shortfall Penalty—Evasion as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

10 Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

11 Definition of "tax shortfall" in s 3 of the TAA.

12 *Taylor v Attorney-General* [1963] NZLR 261 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388; *R v G* [2013] NZCA 146.

- Recklessness can amount to evasion and involves the conscious taking of risk. Recklessness will be proven where: [13]
  - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
  - The taxpayer made a conscious decision to ignore the facts without making further inquiry.

37. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.

38. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E.[14] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[15]

Application

39. TCO concluded that the Taxpayer was liable for evasion shortfall penalties (reduced by 50% for previous behaviour) because:
    - They took tax positions that resulted in tax shortfalls.
    - In taking the tax positions, the Taxpayer evaded the assessment or payment of tax. There was evidence they knew that omitting to include the income they received from Company B in the income tax returns was in breach of their tax obligations.

40. The imposition of shortfall penalties for evasion was appropriate given the seriousness of the Taxpayer's non-compliance. This occurred recurrently over the income years in dispute, involved substantial amounts and was not voluntarily disclosed.

13 *Case H90* (1986) 8 NZTC 619; *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626; *R v G* [2013] NZCA 146.

14 Section 149A(2) of the TAA.

15 Section 149A(1) of the TAA.

TDS 23/19: Income Tax – Omitted income and liability for shortfall penalties

Decision date | Te Rā o te Whakatau: 26 May 2023

Issue date | Te Rā Tuku: 29 November 2023

Subjects | Kaupapa

INC: Omitted employment income; TAA: Shortfall penalties, onus and standard of proof

Facts | Meka

1. The Taxpayer was the sole director of, and held 51% of the shares in, Company A. The Taxpayer's spouse, X, held the remaining 49% of the shares. Company A operated a retail establishment.
2. The Taxpayer was also a director of and held 80% of the shares in Company C.
3. In addition, the Taxpayer was a settlor, trustee, and beneficiary of a Trust which was involved in property investment.
4. The Taxpayer filed income tax returns showing wages from which PAYE had been deducted from Company A and Company C, and also Company B. The New Zealand Companies Register showed X was the sole director and shareholder of Company B. The returns also showed a shareholder salary from Company A and income from the Trust.
5. Customer Compliance Services, Inland Revenue (CCS) conducted an investigation into the Taxpayer's income tax affairs and formed the view that:
    - Money from Company B income had been:
        - deposited into the Taxpayer's and X's personal bank accounts and retained and not returned by them for income tax purposes
        - used to pay the Taxpayer's and X's personal expenses
        - used to fund a property purchase made by Company C.
    - 50% of the money could be assessed to the Taxpayer as unimputed dividends or, alternatively, employment income or income under ordinary concepts.
6. CCS issued a Notice of Proposed Adjustment (NOPA) to the Taxpayer proposing:
    - Income tax adjustments for the applicable income years to include money it considered the Taxpayer had received from Company B as unimputed dividends or, alternatively, employment income or income under ordinary concepts.
    - A shortfall penalty for evasion for each income year, reduced by 50% for previous behaviour.
7. The 4-year time bar periods for amending the Taxpayer's income tax assessments had expired in respect of some of the income years and in dispute. However, CCS considered that exceptions applied to allow the assessments to be amended at any time.
8. The Taxpayer rejected the proposed adjustments, and the matter was referred to the Tax Counsel Office, Inland Revenue (TCO) for adjudication.

Issues | Take

9. The main issues in dispute were:
    - Whether money the Taxpayer received from Company B was assessable as dividends or, alternatively, employment income or income under ordinary concepts (ss CD 1, CE 1, and CA 1(2) of the ITA 2007).
    - Whether the Commissioner could increase the Taxpayer's income tax assessments (ss 108(2) of the TAA).
    - Whether the Taxpayer was liable for shortfall penalties for evasion, reduced by 50% for previous behaviour (ss 141E and 141FB of the TAA).
10. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

11. TCO decided that:
    - Money the Taxpayer received from Company B was assessable to the Taxpayer as dividend income. If the dispute proceeded to challenge stage and it was found the amount was not the Taxpayer's dividend income, the amount was assessable to the Taxpayer as employment income or income under ordinary concepts.
    - CCS's position that the time bar exception in s 108(2) of the TAA applied was accepted. The Commissioner could increase the Taxpayer's income tax assessments.
    - The Taxpayer was liable for evasion shortfall penalties, reduced by 50% for previous behaviour.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

12. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
13. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer had discharged the onus of proof was considered in the relevant issues.
14. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgement he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[5]

Issue 1 | Take tuatahi: Whether money received from Company B was assessable to the Taxpayer

Dividends

15. Under s CD 1 a dividend derived by a person is income of the person. Under s CD 4, a dividend is a "transfer of value" from a company to a person if the cause of the transfer is a shareholding in the company.
16. Section CD 5 provides that a transfer of value occurs when a company provides money or money's worth to a person.
17. Under s CD 6 a transfer of value to a person is caused by a shareholding in the company:
    - if the person:
        - holds shares in the company, or
        - is associated with a shareholder, and
    - the company makes the transfer because of the shareholding of the relevant person.
18. Associated persons include:
    - A company and a person (not a company) with a 25% or more interest in the company.
    - Two persons connected by marriage.
    - A trust and a person who is a beneficiary in the trust.
    - A trust and its settlor.
    - Two persons associated to the same third person.
19. Case law shows that company money taken and retained by a shareholder, whether deposited in their bank account or used for their personal expenditure, can be dividends under s CD 1.

1 Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

2 Section 149A(2) of the TAA.

3 *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

4 Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

5 *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

Employment income

20. Section CE 1 provides that salary or wages derived by a person in connection with their employment or service is income of the person.
21. Under s RD 5, "Salary or wages" means a payment of salary, wages, or allowances made to a person in connection with their employment. It includes a bonus, commissioner, gratuity, or pay of any other kind.
22. An amount will be derived in connection with a person's employment or service if it was received because the person was an employee or because of the service they provided. The amount need not be paid under a contract of employment.[6]
23. Generally, salary and wages are "PAYE income payments" taxable under the PAYE (pay as you earn) rules. If certain requirements are met, a person who is a shareholder and an employee of a company can elect that salary and wages the company pays them is treated as income not subject to PAYE.

Income under ordinary concepts

24. Section CA 1(2) provides that an amount is income of a person if it is their income under ordinary concepts.
25. The phrase "income under ordinary concepts" is not defined in the ITA 2007. However, income has been described as a flow of money or money's worth arising from the ownership of property or capital, from labour, or from a combination of those things.[7]
26. Regular recurrent payments on which the recipient depends to meet living expenses may be income under ordinary concepts.[8]

Application

27. TCO concluded that the money received from Company B was assessable to the Taxpayer as dividend income. This was because:
    - Company B made transfers of value when it deposited and otherwise made available money to the Taxpayer and X.
    - The transfers of value were caused by a shareholding in Company B:
        - X held shares in Company B.
        - The Taxpayer was associated with X by marriage.
        - There did not appear to be any reason for Company B to have made the transfers of value other than because of X's shareholding.
28. If this dispute proceeded to challenge stage and it was found that the amount received from Company B was not the Taxpayer's dividend income, the amount was assessable to the Taxpayer as employment income or income under ordinary concepts:
    - Employment income, because there was a connection between at least some of the money and the Taxpayer's employment or service with Company B.
    - Income under ordinary concepts because:
        - The Taxpayer received a flow of money arising from the ownership of property or capital, from labour, or from a combination of those things.
        - The money was made available to the Taxpayer regularly and recurrently and they relied on the money for regular expenditure.

6 *Shell New Zealand Limited v CIR* (1994) 16 NZTC 11,303 (CA), at 11,304 and 11,306.

7 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,355. See also *Tennant v Smith* [1892] AC 150 (HL) and *CIR v Parson* (No 2) [1968] NZLR 574 (CA).

8 *Reid v CIR* (1985) 7 NZTC 5,176 (CA) at 5,183.

Issue 2 | Take tuarua: Whether the Commissioner could increase the Taxpayer's income tax assessments

29. Generally, under s 108 TAA the Commissioner may not amend an assessment to increase the amount assessed if:
    - the taxpayer has furnished an income tax return;
    - an assessment has been made, and
    - four years have passed from the end of the tax year in which the taxpayer provides the tax return.
30. However, under s 108(2) TAA, the Commissioner may amend an assessment at any time if the Commissioner is of the opinion that a tax return provided by a taxpayer is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source.
31. An income tax return is misleading if:
    - it includes something which gives the Commissioner a wrong impression, or
    - it does not include something, the omission of which gives the Commissioner a wrong impression as to the taxpayer's true income tax position.
32. An income tax return will be "fraudulent or wilfully misleading" when the taxpayer:
    - filed it knowing that it did not reflect their true income tax position, or
    - was recklessly careless as to whether the return was wrong.
33. To be "fraudulent or wilfully misleading", the filing of the incorrect return must be deliberate and intentional. Inadvertently filing an incorrect return or filing a return which the taxpayer honestly believes to be correct will not constitute filing a "fraudulent or wilfully misleading" return.

Application

34. CCS argued that s 108(2) of the TAA allowed the Commissioner to amend the assessments. CCS argued that it was of the opinion that the Taxpayer's income tax returns for the income years in dispute were fraudulent or wilfully misleading.
35. TCO concluded that the Commissioner could increase the Taxpayer's income tax assessments. This was because CCS was of the opinion the Taxpayer's tax returns were fraudulent or wilfully misleading. There was evidence supporting CCS's opinion, including evidence showing the Taxpayer's income tax returns were filed deliberately and intentionally with the Taxpayer knowing that they did not reflect their true income tax position. There was nothing to suggest CCS did not hold the opinion or that the opinion was not honestly held.

Issue 3 | Take tuatoru: Whether the Taxpayer was liable for shortfall penalties for evasion

36. Section 141E(1)(a) imposes a shortfall penalty for evasion on a taxpayer if the following requirements are satisfied:[9]
    - The taxpayer has taken a tax position. A tax position is a position or approach to tax under a tax law as taken in or in respect of a tax return, income statement, or due date.[10]
    - Taking the tax position has resulted in a tax shortfall. A tax shortfall is the difference between the tax effects of the correct tax position and the tax effects of the taxpayer's tax position.[11]
    - The taxpayer has evaded the assessment or payment of tax. Evasion requires an intention to avoid the assessment or payment of tax known to be chargeable:
        - The element of intention will be satisfied if the taxpayer knows that their action or omission will breach a tax obligation. There must be some blameworthy act or omission on the part of the taxpayer. The required intent for evasion can be inferred from surrounding circumstances and conduct.[12]

9 The shortfall penalty for evasion or a similar act is considered in the Interpretation Statement: Shortfall Penalty—Evasion as published in *Tax Information Bulletin* Vol 18, No 11 (December 2006).

10 Definitions of "tax position" and "taxpayer's tax position" in s 3 of the TAA.

11 Definition of "tax shortfall" in s 3 of the TAA.

12 *Taylor v Attorney-General* [1963] NZLR 261 (SC); *Lloyds Bank Ltd v Marcan* [1973] 2 All ER 359; *Case H90* (1986) 8 NZTC 619; *Case N47* (1991) 13 NZTC 3,388; *R v G* [2013] NZCA 146.

- Recklessness can amount to evasion and involves the conscious taking of risk. Recklessness will be proven where: [13]
  - Facts actually known to the taxpayer were such that they must have put the taxpayer on inquiry that a tax obligation may not be met.
  - The taxpayer made a conscious decision to ignore the facts without making further inquiry.

37. The penalty payable for evasion or similar act is 150% of the resulting tax shortfall.

38. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E.[14] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[15]

Application

39. TCO concluded that the Taxpayer was liable for evasion shortfall penalties (reduced by 50% for previous behaviour) because:
    - They took tax positions that resulted in tax shortfalls.
    - In taking the tax positions, the Taxpayer evaded the assessment or payment of tax. There was evidence they knew that omitting to include the income they received from Company B in the income tax returns was in breach of their tax obligations.

40. The imposition of shortfall penalties for evasion was appropriate given the seriousness of the Taxpayer's non-compliance. This occurred recurrently over the income years in dispute, involved substantial amounts and was not voluntarily disclosed.

13 *Case H90* (1986) 8 NZTC 619; *R v Harney* [1987] 2 NZLR 576 (CA); *Case P29* (1992) 14 NZTC 4,213; *Case S100* (1996) 17 NZTC 7,626; *R v G* [2013] NZCA 146.

14 Section 149A(2) of the TAA.

15 Section 149A(1) of the TAA.

TDS 23/20: Deductibility of retention payments

Decision date | Rā o te Whakatau: 13 October 2023

Issue date | Rā Tuku: 7 December 2023

Subjects | Kaupapa

Income tax: Deductibility of expenditure, general permission, capital limitation, consolidated group deductions, timing of deductions.

Taxation laws | Ture tāke

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

Facts | Meka

1. The arrangement in this ruling involved a New Zealand based company (Company A), wholly owned by Company B and a member of a consolidated group of companies (Consolidated Group). Company A and the Consolidated Group were the Applicants.
2. Company B entered into an agreement to sell its interest in Company A to a third party. Upon completion of the sale, Company A ceased membership of the consolidated group (Sale Transaction).
3. Prior to the Sale Transaction, Company A entered into retention agreements with key staff (Retention Agreements). The Retention Agreements were made by offer and accepted as variations to the employment agreements of the key staff.
4. The Retention Agreements entitled the key staff to bonus payments calculated by reference to their salaries (Retention Payments). The objective of the Retention Payments was to incentivise key employees to remain in their employment to enable the ongoing smooth running of Company A's business while the option to sell the business was being considered.
5. The Retention Payments were made prior to the completion of the Sale Transaction and were conditional on the employees remaining continuously employed by Company A on the relevant payment dates.
6. The Applicants considered that a portion of the Retention Payments were capital in nature as they were made to employees involved in the Sale Transaction (Capital Portion). The Applicants accepted that the Capital Portion is not deductible.

Issues | Take

7. The main issues considered in this ruling were:
   - whether the Retention Payments are deductible under s DA 1;
   - whether the Retention Payments (other than the Capital Portion) are denied deduction under s DA 2(1);
   - whether ss FM 12 and DV 17(3) apply to deny deductions for the Retention Payments; and
   - whether the deductible portion of the Retention Payments are deductible in the income year they are paid under s BD 4.

Decisions | Whakatau

8. Based on the specific facts of this ruling application, the Tax Counsel Office (TCO) decided that:
   - the Retention Payments are deductible under s DA 1;
   - the capital limitation in s DA 2(1) does not apply to deny a deduction in respect of the Retention Payments (other than the Capital Portion);
   - sections FM 12 and DV 17(3) do not apply to deny the deduction; and
   - section BD 4 allocates the deduction to the income year in which the payments were made.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Deductibility under s DA 1

9. The general rules for deductibility of expenditure are contained in subpart DA. Section DA 1 is the general permission.

10. Section DA 1(1)(a) provides for the deductibility of expenditure that is incurred in deriving assessable income. Section DA 1(1)(b) provides for the deductibility of expenditure incurred in the course of carrying on a business for the purpose of deriving assessable income. The first limb requires a nexus with the deriving of assessable income, and the second a nexus with the carrying on of a business.

11. It is a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and the derivation of income, or the carrying on of a business for the purpose of deriving income. The phrase "the occasion of the loss or outgoing should be found in whatever is productive of the assessable income" is a helpful way both of characterising the factual inquiry that the application of the statutory language requires and of describing the nexus that is the focus of that inquiry.[1]

12. TCO considered the general permission is satisfied because:

    - the Retention Payments had been incurred on payment to the key employees, and
    - the payments were made by Company A as part of carrying on its business.

13. Therefore, the Applicants are allowed a deduction for the Retention Payments.

Issue 2 | Take tuarua: Application of the capital limitation

14. For an amount that satisfies s DA 1 to be deductible, none of the general limitations in s DA 2 can apply. The relevant general limitation is the capital limitation in s DA 2(1).

15. The Court of Appeal in *Trustpower*[2] summarised the general (common law) principles that apply for distinguishing between capital and revenue expenditure. The relevant principles to be applied are as follows:

    - The best guides for distinguishing between capital and revenue expenditure are the general principles stated in *Hallstroms*[3] and *Nchanga*[4]. Those cases indicate that it is necessary to consider what the expenditure is calculated to effect from a practical and business point of view (*Hallstroms*). The contrast between the two forms of expenditure corresponds to the distinction between the costs of creating, establishing, acquiring, or enlarging the permanent structure of the business (capital), and the costs of using the structure to earn income, or performing the income earning operations (revenue) (*Nchanga*).
    - The general principles in *Hallstroms* and *Nchanga* were adopted by the Privy Council in *BP Australia*.[5] The Privy Council suggested five indicia that could be considered to determine if an expenditure is capital or revenue in nature. These indicia are guides only and are not determinative. In the end the answer will depend on a close examination of the facts of the particular case and the character of the particular payment. The five indicia, as summarised by the Court of Appeal in *McKenzies*[6], are:
        - the need or occasion which called for the expenditure;
        - whether the payments were made from fixed or circulating capital;
        - whether the payments were of a once and for all nature producing assets or advantages which were of an enduring benefit;
        - how the payments would be treated under ordinary principles of commercial accounting; and
        - whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.
    - In many cases it will not be necessary to look to the *BP Australia* indicia because the answer will already be clear from an application of the general principles stated in *Hallstroms* and *Nchanga*.

1 *CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA), *NRS Media Holdings v C of IR* (2018) 28 NZTC 23-079, *Ronpibon Tin NL v FCT* (1949) 78 CLR 47.

2 *CIR v Trustpower Ltd* [2015] NZCA 253 at [51]-[71], [74]-[76].

3 *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 (HCA).

4 *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 at 960 (PC).

5 *BP Australia Ltd v Commissioner of Taxation for the Commonwealth of Australia* [1966] AC 224 (PC).

6 *CIR v McKenzies (NZ) Ltd* [1988] 2 NZLR 736 (CA).

16. TCO considered that this issue was very finely balanced because the Retention Payments, while incurred as an incentive to retain key staff, were also incurred in the course of the Sale Transaction (ie, disposing of a capital asset).[7]
17. The Applicants stated that the purpose of the Retention Payments was the continuity of key staff in Company A while its options were being considered, prior to the Sale Transaction. The expenditure on the Retention Payments was calculated, from a practical and business point, to affect the retention of staff in the business while the possible sale of the business was considered.
18. On balance, TCO concluded that the Retention Payments were revenue (and not capital) in nature. Therefore, the capital limitation in s DA 2(1) does not apply to deny a deduction in respect of the Retention Payments other than to the calculated Capital Portion.

Issue 3 | Take tuatoru: Consolidated group rules

19. The purpose of the consolidation rules is to treat the members of a consolidated group as if they were a single company (s FM 2). Section FM 3(2) requires each company to calculate the amount that would be its taxable income, as modified by ss FM 4 to FM 13.
20. Sections FM 12 and DV 17(3) operate to deny a deduction for expenditure incurred by a company if the deduction would be denied to the consolidated group, treating the group as one company.
21. TCO considered that the Retention Payments kept their revenue nature, because the payments were calculated, from a practical and business point, to effect the retention of staff in the business while the possible sale of the business was considered.
22. TCO concluded that ss FM 12 and DV 17(3) would not apply to deny any deduction for the Retention Payments in the group context.

Issue 4 | Take tuawhā: Timing

23. Subpart BD sets out the general rules for income, deductions and timing. Section BD 4 provides the general rule that a deduction will be allowed in the income year that the expenditure is incurred, unless there is a specific provision in Parts D to I that provides for that expenditure to be allocated on a different basis. Section BD 4(3) also provides that when determining the time at which an item of expenditure has been incurred, regard must be had to case law which requires some people to recognise expenditure or loss on an accrual basis and others on a cash basis.
24. TCO considered that the starting point must be that the Retention Payments were incurred when they were paid on the basis that is when the obligation to pay them arose. It was also considered that none of the provisions in Parts D to I apply.
25. TCO concluded that, in accordance with s BD 4, the deduction for the Retention Payments (other than the Capital Portion) is allocated to the income year (or part income year) in which the payments were made.

7 See for example *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295 where the payment was not deductible as business had ceased; *CIR v New Zealand Forest Research Institute Limited (2000) 19 NZTC* 15,690 (Privy Council) where payment was part of consideration for assets.

TDS 24/01: Interest free loan and dividends

Decision date | Rā o te Whakatau: 8 May 2023

Issue date | Rā Tuku: 9 January 2024

Subjects | Kaupapa

Income tax: capitalisation of company structure; interest free loan whether a dividend arises; withholding tax; tax avoidance.

Taxation laws | Ture tāke

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

Facts | Meka

1. This ruling involved the steps by which Company A is funded to enable its indirectly wholly owned subsidiary (Company B) to settle the sale and purchase of certain assets. It particularly includes the resulting interest free shareholder loan from Company C (a non-resident company) to Company A and the ongoing repayments of the loan.

Issues | Take

2. The main issues considered in this ruling were:
   - Whether the interest free loan gave rise to dividends to Company C from Company A;
   - Whether repayment of the interest free loan was subject to withholding;
   - Whether s BG 1 and GA 1 applies.

Decisions | Whakatau

3. The Tax Counsel Office (TCO) concluded:
   - The interest free loan from Company C to Company A does not give rise to a dividend from Company A to Company C under s CD 1 at any point in time, including as a result of the issue or repayment of the loan;
   - Company A is not required to withhold or pay an amount of tax under s RA 6 in relation to the interest free loan repayments made to Company C;
   - Sections BG 1 and GA 1 do not apply to negate or vary the above two tax outcomes.
4. The following condition was included:
   - The only amounts payable under the interest free loan are the lending of the NZD principal by Company C as lender and the repayment of the NZD principal by Company A as borrower.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Whether the interest free loan gave rise to dividends (s CD 1)

5. Section CD 3 provides that ss CD 4 to CD 20 define what is a dividend for tax purposes.
6. The interest free loan provided by Company C would give rise to a dividend in accordance with s CD 4 if:
   - There was a "transfer of company value" from a "company" to a person.
   - The cause of the transfer was due to a "shareholding in the company".
   - None of the exclusions in ss CD 22 to CD 37 apply to the transfer.
7. Under s CD 5, a transfer of company value from a company to a person occurs when:
   - The company provides money or money's worth to the person; and
   - if the person provides any money or money's worth to the company under the same arrangement, the market value of what the company provides is more than the market value of what the person provides.

8. The following cashflow would arise on the interest free loan:
   - Company C would be providing principal to Company A.
   - Over time, Company A would repay the principal lent by Company C.
9. Accordingly, there would be no net cashflow under the interest free loan. However, there is a time value to money. The market value of what Company C would be providing to Company A, may be higher than the market value of what Company A would be providing in the future to Company C. That the provision of money (a loan) at below market interest rates can give rise to a dividend is illustrated by s CD 39 which applies to determine the amount of a dividend that arises because a company makes property available to a person. The deemed dividend is calculated by reference to a benchmark rate of interest.
10. However, any net transfer of value resulting from the interest free loan would arise to Company A (who would benefit from the below market interest rate), not Company C.
11. Therefore, Company C does not derive a dividend from making the interest free loan to Company A.
12. Given the conclusion in [10] above, TCO also considered the dividend implications for Company A.
13. A transfer of value by a company (Company C) to a person (Company A) will be "caused by" a shareholding relationship if the recipient (Company A) holds shares in the company (Company C), or is associated with a shareholder, and the company (Company C) makes the transfer because of that shareholding.
14. TCO determined that Company A did not hold shares in Company C but they were associated companies which meant the relevant shareholding relationship did exist.
15. TCO noted that s CD 4(1)(b), provided that a transfer of company value from a company to a person is a dividend if none of the exclusions in ss CD 22 to CD 37 applied.
16. It was found that the exemption in s CD 27(3) applied because three cumulative requirements were satisfied:
   - Company C, being the "first company", had a voting interest in Company A, being the "associated company": para (a)(i).
   - Company A, being the "associated company" did not have a voting interest in Company C, being the "first company": para (b).
   - No person, other than the parent company of Company C (Company D) had both a voting interest or market value interest in Company C (the "first company") and Company A (as the "associated company"). Company C is a wholly owned subsidiary of Company D. Company D and Company C were both not resident in New Zealand, and therefore Company D could have received the transfer of company value without it being assessable income or non-resident passive income.
17. Therefore, any transfer of company value from Company C to Company A would not be a dividend in accordance with s CD 27(3) and therefore would not give rise to a dividend under s CD 4.

Other rules

18. TCO also considered whether any of the following rules applied:
   - Financial arrangements rules
   - Recharacterisation provisions
   - Hybrid mismatch rules
   - Transfer pricing regime
19. TCO concluded that none of the above applied to affect the outcome.

Conclusion of issue 1

20. TCO concluded that the interest free loan from Company C to Company A did not give rise to a dividend from Company A to Company C under s CD 1 at any point in time, including as a result of the issue or repayment of the loan.
21. The conclusion was subject to the condition that the only amounts payable under the interest free loan were the lending of the NZD principal by Company C as lender and the repayment of the NZD principal by Company A as borrower.

Issue 2 | Take tuarua: Whether repayment of the interest free loan is subject to withholding (s RA 6)

22. Section RA 6 concerns withholding and payment obligations for passive income. Section RA 6(2) applies to a person who makes a payment of non-resident passive income under subpart RF. That person must withhold and pay tax to the Commissioner. This is relevant to the future interest free loan repayments which will be made by Company A to Company C.
23. Section RF 1(2) provides that the NRWT rules apply to a person who pays an amount of non-resident passive income. Section RF 2 defines "Non-resident passive income".
24. For the reasons discussed above, the interest free loan repayments made by Company A to Company C would not constitute a dividend (para (a) of s RF 2(1)) or interest (para (d)) paid to Company C.
25. The new interest free loan repayments do not constitute royalties (para (b)) or investment society dividends (para (c)).
26. Non-resident financial arrangement income (NRFAI) is defined in s RF 2C. In short, it is clear the interest free loan repayments would not constitute NRFAI (para (e)) as no interest is paid on the loan that would otherwise be subject to NRWT absent the NRFAI rules applying. Nor does any financial arrangement expenditure arise in respect of the interest free loan which means there is no deferral of NRWT.
27. Accordingly, the repayment of the interest free loan by Company A to Company C would not constitute a payment of non-resident passive income. Company A would not be required to withhold under s RA 6(2).

Conclusion of issue 2

28. Company A would not be required to withhold or pay an amount of tax under s RA 6 in relation to the interest free loan repayments made to Company C.

Issue 3 | Take tuatoru: Whether s BG 1 applies

29. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. The approach to s BG 1 was settled by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289, which has been followed in subsequent judicial decisions.
30. TCO's approach in making this decision is consistent with Interpretation Statement: IS 23/01 Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007 (3 February 2023) (IS 23/01). IS 23/01 will not be replicated in this TDS but in summary the steps are as follows:
    - Understanding the legal form of the arrangement. This involves identifying and understanding the steps and transactions that make up the arrangement, the commercial or private purposes of the arrangement and the arrangement's tax effects.
    - Determining whether the arrangement has a tax avoidance purpose or effect. This involves:
        - Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
        - Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts.
        - Considering the implications of the preceding two steps and answering the ultimate question under the Parliamentary contemplation test: Does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?
    - If the arrangement does have a tax avoidance purpose or effect, consider the merely incidental test.
31. Taking into account all of the relevant facts and circumstances (noting that as this is a summary it may not contain all the facts or assumptions relevant to the decision and, therefore, cannot be relied on) the TCO concluded as follows:

The arrangement

32. The arrangement is the steps by which Company A is capitalised and funded to enable its indirectly wholly owned subsidiary to settle the sale and purchase of certain assets. It particularly includes the resulting interest free shareholder loan to Company A and the ongoing repayments of the loan.

33. The tax effects regarding the interest free loan are:
    - For the lender Company C:
        - No dividend income will arise under s CD 1.
        - No interest income will arise under s CC 4.
        - No financial arrangements income will arise under subpart EW.
        - No withholding will be required under s RA 6 from the repayments of the money lent by Company A.
    - For the borrower Company A:
        - No dividend income will arise under s CD 1.
        - No financial arrangements income or deductible expenditure will arise under subpart EW, ss CC 3, DB 6 or DB 7.
34. The tax effects did not raise any s BG 1 concerns as the applicable legislative provisions were working as intended. There was no artificiality or circular money flows.

Parliamentary contemplation

35. It was clear from the Act that Parliament contemplated capital could be provided by way of interest free loans, made by a non-resident lender into New Zealand. It was also clear that the focus in the Act is on actual payments and net gains and losses, not the return of money lent. While various provisions are aimed at ensuring excessive interest deductions are not taken in New Zealand, there are no provisions seeking to create income where no amount is actually paid over and above the return of money lent.
36. Considering the above, TCO concluded that the repayment of money lent which does not give rise to income for the lender, did not raise any concerns from a tax avoidance perspective. The legislation was working as intended and the tax effects would be within Parliament's contemplation.
37. TCO discussed the distinction between debt and equity noting that for example, non-participating redeemable preference shares may be considered, in substance, to be very similar to a loan. However, where capital is contributed whether by way of debt or equity, the return of that capital can be made tax free.
38. The main difference was about the relative ease of returning the original capital. From a company law perspective, it is easier to repay or restructure debt than it is return equity. From a tax perspective, the repayment of money lent is not taxable. The same is generally true for shares, but there are additional statutory requirements which revolve around the statutory notion of available subscribed capital which can be returned without being treated as a dividend.
39. TCO concluded that whether capital is contributed by way of debt or equity, Parliament contemplated that capital could be returned tax free as it is not a net gain that should be taxable as income. However, there are more restrictions when returning share capital.

Commercial and economic reality

40. There was nothing in the context of this Arrangement to suggest that, in commercial and economic reality, Company A should be treated as paying a net positive amount rather than returning the capital provided by way of the interest free loan.

Conclusion

41. Accordingly, TCO considered the provisions of the Act were being used and had the effect that Parliament intended. The above analysis indicated that it is likely that Parliament would consider that the Arrangement makes use of the relevant provisions in a manner that is consistent with Parliament's purpose for those provisions. Therefore, the Arrangement did not have a tax avoidance purpose or effect.

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