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by

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The Concept of Income within the New Zealand Taxation System

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Abstract

The paper looks at the core provisions used in the procedure for calculating and satisfying income tax liability as applied by the New Zealand Income Tax Act 2004. This Act has introduced an additional part to the subpart BC flowchart and a new term “non-residents’ foreign-sourced income” to assist in the determination of income. The authors review these additions to the Income Tax Act and suggest that further improvements can be made. To this end they include proposed amendments to Part B (including the subpart BC flowchart) and Part C of the ITA 2004.

1. INTRODUCTION

The first stage of rewriting the New Zealand Income Tax Act was the reorganisation of the Income Tax Act 1976 and the Inland Revenue Department Act 1974 into the Income Tax Act 1994 (ITA 1994) and the Tax Administration Act 1994, with effect from 1 April 1995. This was not intended to change the underlying policy of the legislation, but to make it more accessible with organisation into parts, using an alphanumeric numbering system for the ITA 1994.

The second stage, which involved the rewrite of the core provisions (Part B) of the ITA 1994, was completed in 1996, and enacted along with a revised Part A, with effect from the 1997-98 income year. The core provisions incorporate certain fundamentals upon which tax legislation is based and taxable income is ascertained. The third stage involves rewriting (and restructuring) the ITA 1994 using plain language drafting techniques without substantially changing the policy content. Re-written Parts C (income), D (deductions) and E (timing of income and deductions) along with aspects of Parts A and B of the ITA 1994 were included in a 2,000-page bill (the Income Tax Bill 2002) which was enacted as the Income Tax Act 2004. The remainder of the ITA 2004 is being rewritten progressively and it is anticipated that the rewrite will be complete during 2007. The IRD have released a number of exposure drafts of rewritten parts of the ITA 2004.

This paper considers the core provisions of the ITA 2004 used in calculating and satisfying a person's income tax liability. It reflects on the structure, format and meaning of the terms used in the core provisions, while comparing the changes that have been made from the earlier income tax acts. It concludes that not all the changes made in the ITA 2004 are in the best interest of a clearer, logical and more easily understood income tax act and provides variations to the current structure and framework.

The taxation of "income" is central to the New Zealand tax system; indeed the main taxation statute is called the *Income Tax Act 2004* (ITA 2004). Section AA 1 ITA 2004 states:

The main purposes of this Act are:

- (a) to *define*, and *impose tax* on, net *income*; and
- (b) to impose obligations concerning tax; and

- (c) to set out rules for calculating tax and for satisfying the obligations imposed.(emphasis added)¹

A lay person could therefore be forgiven for being surprised that there is no exhaustive definition of the term “income” in the ITA 2004.

The ITA 2004 contains a number of specific provisions (currently in Part C of the ITA 2004) which outline what is included in the term for income tax purposes. In addition, there is a “catch-all” provision, s CA 1(2) ITA 2004 (previously s CD 5 Income Tax Act 1994 (ITA 1994)) which provides that amounts which are not specifically referred to in the ITA 2004 but fall within the concept according to general and ordinary concepts are also income.

Despite the lack of a comprehensive definition in the Act and the difficulty in defining the concept of income, the term income is in everyday use and as the Income Tax Act taxes it, taxpayers’, their advisors, the courts and the Inland Revenue Department (IRD) have no choice but to work with the concept with all its limitations. The challenge is to have a framework which is understandable and workable. This paper looks at aspects of the concept of income in the ITA 2004 with this in mind.

Section two of this paper reviews the concept of income and the difficulties in comprehensively defining the term. Subpart BC ITA 2004 outlines the process for calculating and satisfying income tax liabilities. Subpart BD, Income deductions, and timing, supplements the operation of subpart BC by explaining a number of core concepts in the Act including, for the purpose of this paper, income. Subparts BC and BD are covered in section three of the paper. To assist in the interpretation of the legislative provisions three flowcharts are included in Subpart BC – the first giving an overview of the steps involved in calculating a person’s income tax liability.

The first page of this flowchart is discussed in section four of the paper and hereafter referred to as the subpart BC flowchart. The Subpart BC flowchart excludes from income “Capital and windfall gains not taxed”. These concepts plus those of gifts and private receipts are discussed in section five.

¹ In fact, s AA 1 ITA 2004 arguably places a greater emphasis on the role of the Act to define income, with the inclusion of the word “define”, than did its predecessor, s AA 1 Income Tax Act 1994 which provided: “The main purposes of this Act are (a) to impose tax on income; (b) to impose obligations in respect of tax; (c) to set out rules to be used to calculate the tax and to satisfy the obligations imposed.”

New Zealand bases its jurisdiction to tax income on the concept of residence and the concept of source. In order for assessable income which is subject to New Zealand income tax to be correctly identified it is important that these two concepts are clearly outlined in the Income Tax Act. The rules for determining residence and source are discussed along with the new concept of “non-residents’ foreign-sourced income” in section six.

In section six the authors also recommend improvements to the subpart BC flowchart as well as to Part B of the Act. An alternative framework in which to consider and explain the terms “income” and “assessable income” is proposed in section seven. The paper concludes in section eight by returning to the first page of the subpart BC flowchart, which has been revised to include the suggestions proposed in earlier sections of the paper. Having established the framework for determining and calculating income and assessable income, where it is derived by New Zealand residents or sourced in New Zealand, it is then possible to define these terms by utilising this framework.

2. THE CONCEPT OF INCOME

2.1 Defining income

Much has been written on the concept of income and why it is hard to define. An in-depth study of this topic is beyond the scope of this paper. However, it has been suggested one such reason is the complexity of the concept itself. According to Prebble the concept of income is: “in some senses an artificial construct, to the extent that it may almost be thought of as a fiction.”²

In addition, the term “income” means different things to different groups. For example “In economic terms, income and gain are interchangeable terms”³ and are equivalent to increases in wealth (Ross and Burgess⁴).

Simons defined income as follows:

Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in value of the store [sic] property rights

² J Prebble, “Can Income Tax Law Be Simplified?” (1996) Vol 2:4 *New Zealand Journal of Taxation Law and Policy* 187, at 190.

³ W Chan, “Income – A Subjective Concept” (2001) Vol 7:1 *New Zealand Journal of Taxation Law and Policy* 26.

⁴ S Ross and P Burgess, *Income Tax: A Critical Analysis*, (Sydney, The Law Book Co Ltd, 1996), p 40.

between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to ‘wealth’ at the end of the period and then subtracting ‘wealth’ at the beginning. The sine qua non of income is *gain*, as our courts have recognised in their more lucid moments and gain to someone during a specified time interval.⁵

By comparison, for accounting purposes, “income” is defined by Robb as:⁶

The maximum value that could be withdrawn by the owners of an entity during a period without reducing the value of their stake in the entity below the level at the beginning of the period. Calculated in accounting as the excess of revenues and gains over expenses and losses for a period.

The lawyer’s concept of income “emerges as a gain, heavily qualified not by grand design but by a long series of ad hoc decisions”.⁷ As the first modern income tax (which originated in England) had its basis in earlier English property taxes:⁸

There is thus a close relationship between the legal concept of income and the legal concept of property, and it is not surprising that notions of income developed for the purposes of property and that trust law should have been adapted for use in the income tax area.⁹

Due to the difficulty of defining income, Prebble¹⁰ observes that income tax law generally taxes the results of legal transactions, rather than their underlying economic effect. Returning to Prebble’s earlier point, the concept of income is artificial as it taxes the legal forms that are used to represent economic transactions.¹¹ This is because the “legal substance of a transaction is a simulacrum of its economic substance.”¹² Prebble also observes:¹³

Income tax law will never exactly fit the economic activity to which it relates. The compromise and adjustments that must be made to make the system work mean that there can never be a single, coherent system of income taxation. This is sad, but bearable once you get used to it. However, the lack of basic principle does distinguish taxation from other branches of the law.

⁵ H Simons, *Personal Income Taxation* (1938), p 50 as cited in S Ross and P Burgess, *Income Tax: A Critical Analysis*, (Sydney, The Law Book Co Ltd, 1996), p 40.

⁶ A J Robb, *A Dictionary of Accounting Terms*, (University of Chicago Press, Whitcoulls Publishers, Christchurch, 1981), p 38.

⁷ S Ross and P Burgess, *Income Tax: A Critical Analysis*, (Sydney, The Law Book Co Ltd, 1996), p 42.

⁸ See n7 p 42.

⁹ As New Zealand was originally a British colony it inherited both the legal and taxation systems of the United Kingdom. Thus, the New Zealand courts and legislators, at least initially, referred to English case law and legislation.

¹⁰ J Prebble, “Fictions of Income Tax”, (2002) Paper presented at 14th Annual Australasian Tax Teachers Association Conference, p 1 available at http://pandora.nla.gov.au/pan/23524/20020412/c.fong_unsw.edu.au/prebblepaper.doc.

¹¹ See n 10, p 2. Others have noted that: “... some fundamental concepts which underpin the tax system – such as territoriality, the tax year ending on a particular date (5 April in the UK; other dates in other countries), and the capital/ revenue distinction – are not directly related to the transactions in real life.”: Tax Law Rewrite Project Team, Inland Revenue, UK, “The Audience for Tax Legislation – Is It Different From That for Other Legislation and Should It Be Considered To Be the Same for All Sections or Parts?”, (1997) Vol 3:3 *New Zealand Journal of Taxation Law and Policy* 178, 182.

¹² See n 10, p 3.

¹³ J Prebble, “Why is Tax Law Incomprehensible” (2003) *Victoria University Press*, p 20

2.2 A comprehensive definition in the tax legislation?

In 2004 the IRD published an article entitled “Income Tax Act 2004” outlining various aspects of this Act.¹⁴ Concerning Part C ITA 2004, the IRD article comments that it contains:¹⁵ “An exhaustive list of provisions that state the circumstances in which a transaction or other event gives rise to income”.

By virtue of the catch-all provision, s CA 1(2) ITA 2004, any amounts which are not included in the categories listed in Part C but which are income according to ordinary concepts will be taxed under Part C. As a result, if an amount arising from a transaction is not income under Part C then it will not fall within the scope of the Act. For this reason Part C is therefore self-contained or a ‘code’ (as described by the IRD).¹⁶

However, the IRD statement does not give the complete picture - there is no actual definition outlined in the Act:¹⁷

A number of receipts are deemed to be included in ‘income’, but the Act does not endeavour to define the term exhaustively. Consequently the Act gives little assistance in deciding whether a particular receipt, not expressly mentioned, is or is not income for income tax purposes.

Similarly, concerning Part C ITA 2004, Macalister and Turner comment:¹⁸

However, as this [Part C] includes ‘income under ordinary concepts’, what is (and what is not), income remains to a large extent a matter of common law principle.

2.3 Is there a concept of income within the New Zealand tax system?

As evidenced in comments made in *CIR v Boyton*,¹⁹ it would be incorrect to conclude that because income is not specifically defined in the Income Tax Act there is no general concept or understanding of what constitutes income. In this case the defendant used in the District Court, amongst other defences, the fact that income was not defined in the Act as a reason why he should not pay income tax. Barber DCJ stated:²⁰

The defendant submits that there is no definition of ‘income’ in the Income Tax Act 1994, which is correct, so that he does not know upon what he should pay income tax. However, the meaning of ‘income’ is a matter of settled law and has evolved in the Courts over many years in many cases. Generally speaking, there cannot be the

¹⁴ IRD, “Income Tax Act 2004”, (2004) Vol 16:5 *Tax Information Bulletin*, p 46 - 71.

¹⁵ See n 14, p 46. The Tax Information Bulletin similarly uses the phrase “exhaustive list” on pp 48 and 54.

¹⁶ See n 14, p 51.

¹⁷ J Veal and T Turner, *Staples Tax Guide 2005*, (Wellington, Brookers Ltd, 2005) 65th edition, p 660. See also C Macalister and T Turner, *The Income Tax Act 2004 – The New Rules*, (Wellington, Brookers Ltd, 2005), p 288.

¹⁸ C Macalister and T Turner, *The Income Tax Act 2004 – The New Rules*, (Wellington, Brookers Ltd, 2005), p 287. (2001) 20 NZTC 17,389.

²⁰ See n 19, p 17,394.

slightest doubt that the type of earnings to which the defendant became entitled in the 1998 and 1999 financial years, which I have already described, and which are earnings from personal exertion as a computer consultant and specialist, are income in terms of our laws.

His Honour described the “defences to the charges as quite spurious and silly nonsense”²¹ and held the defendant convicted as charged. Similarly, the authors in “New Zealand Taxation 2005 Principles, Cases and Questions” (New Zealand Taxation 2005) state:²² “the statutory inclusion of the common law definition of income under ordinary concepts [now in s CA 1(2)] has ensured that there is a concept of income” in the tax Act, albeit one that still relies heavily on common law principles as well. However, this ‘concept’ of income is not to be confused with a comprehensive definition of income in taxation statutes – something New Zealand income tax statutes lack.

3. CALCULATING AND SATISFYING INCOME TAX LIABILITIES IN THE ITA 2004

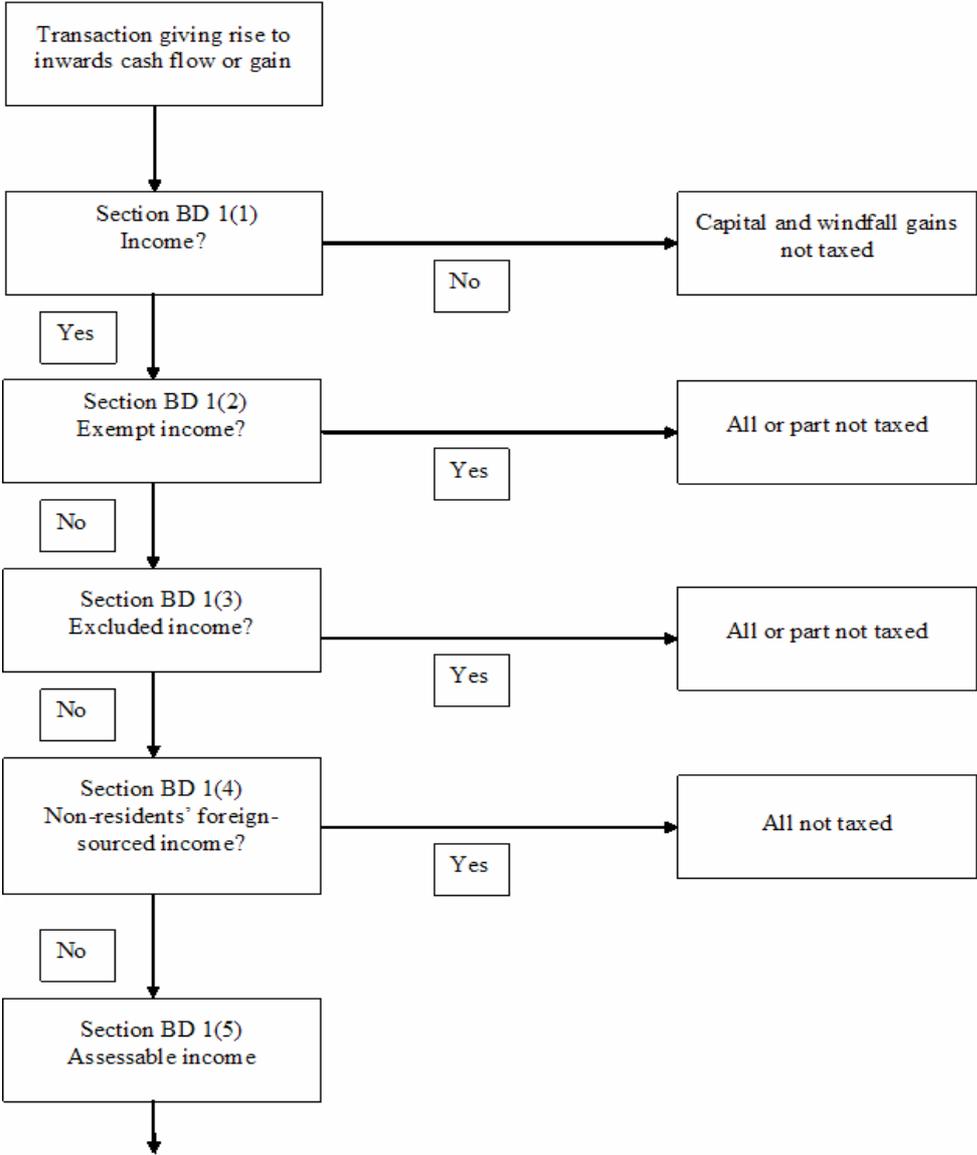
3.1 Subpart BC

Subpart BC of the Act provides the detailed process that must be followed by taxpayers to meet their obligations to calculate and pay income tax for a tax year. The process is outlined in the flowchart “Subpart BC Calculating and satisfying income tax liabilities”. The first page of this chart, Subpart BC ITA 2004, is reproduced on the following page.

²¹ See n 19, p 17,395.

²² C Alley, C Chan, D Dunbar, P Flannery, A Frost, A Maples, N Smith, J Veal, *New Zealand Taxation 2005 Principles, Cases and Questions*, (Wellington, Brookers Ltd, 2005), p 70.

Subpart BC Calculating and satisfying income tax liabilities: Income Tax Act (2004)



3.2 Subpart BD and Assessable Income

Subpart BD supplements the operation of subpart BC as it explains several core concepts including “assessable income”. The term is significant as it is this amount of income that is included in the determination of a person’s income tax liability for a tax year, subject to the allocation of such amounts between tax years under s BD 3 ITA 2004.²³ Section BD 1(5) defines “assessable income” in the following terms:

²³ A consideration of the timing or allocation of income is beyond the scope of this paper.

An amount of income of a person is assessable income in the calculation of their annual gross income if it is not income of any of the following kinds: (a) their exempt income; or (b) their excluded income; or (c) their non residents' foreign-sourced income.

In order to calculate a person's assessable income it is necessary to determine their income. The term "income" is defined in s OB 1 ITA 2004 by reference to s BD 1(1) ITA 2004. This section states "an amount is income of a person if it is their income under a provision in Part C (Income)."

Part C contains a list of what is income for income tax purposes (but does not define the term). Amounts that are not included as income under Part C are not subject to income tax. The subpart BC flowchart includes in this category capital profits and windfall gains. Section BD 1(1) ITA 2004: "identifies that Part C is a code in relation to its role of determining whether an amount arising from a transaction or event is *income*."²⁴ (emphasis in original) Therefore, while income is not comprehensively defined in the Act, a list of those items which are income is contained in Part C of the 2004 Act.

Sections BD 1(2) and (3) of the ITA 2004 provide for the treatment of "exempt income" and "excluded income" in subparts CW and CX respectively. The term "exempt income" refers to:²⁵ "amounts that would normally be considered to be income but are exempted by virtue of the nature of the income or by various characteristics of the person who receives the income." Non-business income of charities is one such example.²⁶ The term "excluded income" applies to amounts of income which are generally subject to tax in another way eg under a specific tax regime in the Act and are therefore excluded from income under Part C. For example, a fringe benefit received by an employee is not income of the employee but is subject to tax under the fringe benefit tax (FBT) regime.²⁷

These two terms are not new to the ITA 2004 - exempt income was previously defined in s BD 1(2)(a) ITA 1994 and excluded income in s BD 1(2)(b) ITA 1994. However, unlike the current Act, the specific types of income which were excluded were to be found throughout the ITA 1994 rather than grouped together.

Part C does not contain any general territorial exclusion to either the residence of the recipient or the source of income. Rather the scope of the New Zealand tax base is established by s BD

²⁴ IRD, "Income Tax Act 2004", (2004) Vol 16:5 *Tax Information Bulletin*, 46 at 51.

²⁵ See n 14, p 57.

²⁶ See s CW 34 ITA 2004.

²⁷ See s CX 3 ITA 2004.

1(4) ITA 2004. The effect of the section, which introduces a new term “non-residents’ foreign-sourced income”, is that the only amounts of income that are subject to tax in New Zealand are those derived by New Zealand residents or, where a non-resident is involved, amounts which are sourced in New Zealand. However this is an indirect statement for something which should precede the prescription for income. Apart from section HH 4(3)²⁸ (overseas trustees’ income), any income which is non-residents’ foreign-sourced income falls outside the income tax system of New Zealand. The regulations and law outlined in the ITA 2004 do not apply. Therefore, and contrary to the current subpart BC flowchart, in determining income it is not a matter of subtracting non-residents’ foreign-sourced income from transactions which give rise to inwards cash flow or gain (and which can become income) as such amounts should never be included as a possible source of income in the first place.

After applying the various exclusions from income discussed in the above paragraphs the resulting amount is assessable income.

4. SUBPART BC - THE FIRST PAGE OF THE FLOWCHART

The first part of the subpart BC flowchart (through to the box “BD 1(5) Assessable income”) covers the procedural concepts in determining assessable Income. It is not found in the equivalent flowchart in subpart BC of the ITA 1994. The flowchart in the ITA 1994 (s BC 1) commences from subpart D at what is now “Assessable income” (referred to as “Gross income” in the ITA 1994 version). As a consequence the flowchart in the ITA 1994 did not give the reader the full picture as it omitted the first crucial steps in the process of determining what gross income is. The inclusion of this first part of the subpart BC flowchart in the ITA 2004 is commendable as it attempts to represent the whole process of calculating a person’s income tax liability. Due to the difficulty in defining “income”, any additional assistance for users by way of an expanded flowchart can only be a positive addition to the Act.

²⁸ S HH 4(3) Subject to subsection (7) and section HH 2, if a trustee who is not resident in New Zealand derives in a tax year any amount from outside New Zealand that would be income if derived by a resident of New Zealand, that amount is deemed to be income of the trustee if at any time in the tax year -

- (a) any settlor of the trust is resident in New Zealand; or
- (b) the trust is a superannuation fund; or
- (c) any trustee of the trust was resident in New Zealand and the trust is a testamentary trust or an inter vivos trust where any settlor of the trust died resident in New Zealand, whether in that tax year or otherwise.

The first document published by the Government on this stage of the rewrite, “Rewriting the Income Tax Act: Parts C, D and E - A discussion document”,²⁹ incorporated a flowchart for determining whether an amount was gross income. However, this flowchart bore little resemblance to the equivalent part in the subpart BC flowchart.

The draft flowchart included in “Rewriting the Income Tax Act 1994 – Exposure Draft” (the 2001 exposure draft), issued in 2001³⁰ and the subsequent Bill, as initially introduced into Parliament, did not describe this part of the process, but rather was essentially a reproduction of the flowchart in subpart C ITA 1994 with relevant terminology changes. In fact, the first page of the subpart BC flowchart now in the ITA 2004 was only introduced into the Bill as it was going through the Parliamentary process.

How important are flowcharts in the Act?³¹ Clearly, they are subservient to provisions in the Act. On the interpretation of the Act, s AA 2 ITA 2004 states that “Diagrams, flowcharts ... are included in this Act only as interpretational aids. If there is conflict between an interpretational aid and a provision of this Act, the provision prevails.” The flowchart is only an aid – it does not carry the weight of sections of the Act.

However, one of the aims of the rewrite process is to “make it easier for taxpayers to identify and comply with their income tax obligations”³² and therefore, in this respect, flowcharts play an important role in the Act. With this objective in mind and, in an attempt to make the subpart BC flowchart as user friendly as possible, the drafters of the Act have not been restricted to using words or terms from the Act. Thus, the subpart BC flowchart commences in coherent language with “Transactions giving rise to inwards cash flow or gain” and proceeds to exclude “Capital and windfall gains not taxed”.

²⁹ New Zealand Government, *Rewriting the Income Tax Act: Parts C, D and E – A discussion document*, (Wellington, 1997), p 45 (Figure 2), available at <http://www.taxpolicy.ird.govt.nz/publications/index.php?catid=2>.

³⁰ Policy Advice Division of Inland Revenue Department, *Rewriting the Income Tax Act 1994 – Exposure Draft Volume 2 Parts A to E*, (Wellington, 2001), p 10.

³¹ For a discussion of principles in rewriting tax legislation see K Keith, “The Need to Rewrite Tax Legislation” (1997) Vol 3:2 *New Zealand Journal of Taxation Law and Policy* 96 and papers from the “1996 Tax Drafting Conference” in (1997) Vol 3:3 *New Zealand Journal of Taxation Law and Policy* pp 148 – 192.

³² Policy Advice Division of Inland Revenue Department, *Rewriting the Income Tax Act 1994 – Exposure Draft. Volume 1, About the rewrite*, (Wellington, 2001), p 4. There has been some debate about who the ‘audience’ is of tax legislation: Tax Law Rewrite Project Team, Inland Revenue, UK, “The Audience for Tax Legislation – Is It Different From That for Other Legislation and Should It Be Considered To Be the Same for All Sections or Parts?”, (1997) Vol 3:3 *New Zealand Journal of Taxation Law and Policy* 178. The aim of the rewrite here, in Australia and the United Kingdom is to make it accessible to a wider group of people (p180).

This paper proposes amendments to the subpart BC flowchart and subpart BD in the following sections (five and six). These amendments are aimed at providing further clarity to the reader in determining their tax obligations.

5. CAPITAL AND WINDFALL GAINS

The subpart BC flowchart excludes from income “Capital and windfall gains not taxed”. This division of non-income items into two groups may be based on *Ryall v Hoare*³³ in which Rowlatt J specifically excluded from the ordinary concept of income “capital accretion” and “gifts and receipts”. Excluding capital (and other) gains is consistent with the nature of such amounts:³⁴ “Capital gains are not subject to tax (although they are not, in technical terms, ‘exempt’ income, rather they are not ‘income’ at all).”

The authors believe that the above description in the subpart BC flowchart requires expansion as a reader may believe that these are the only two types of receipts which are not subject to tax. In particular the authors recommend the descriptions “some gifts” and “private receipts” should be added to aid users of the Act determining what is income.

This flowchart is not intended to aid users in distinguishing between the different types of non-income³⁵ receipts but to convey as clearly as possible that there is a group of receipts which do not fall within the meaning of “income”. Broadening the description of these receipts to include “some gifts” and “private receipts” provides a more complete picture of this group.

The inclusion of the term “some gifts” acknowledges that a distinction can be made between a windfall gain (which may not be earned but arise by virtue of luck) and payments made by way of personal esteem or testimonial.

The addition “private receipts”³⁶ conveys to the reader the distinction between amounts derived in their personal capacity and those derived from a business or other income earning

³³ [1923] 2 KB 447, 454.

³⁴ The Valabh Committee, *Final Report of the Consultative Committee on the Taxation of Income from Capital*, (Wellington, 1992), p 7.

³⁵ A term already used by for example Holmes, Kevin in *The concept of income a multi-disciplinary analysis* (IBFD Publication Doctoral Series 1 Academic Council2001), eg p vi

³⁶ Alternatively a slightly longer term could be used such as “receipts of a private nature”. This was not chosen by the authors’ in this paper simply in order to keep the descriptions in the box in the subpart BC flowchart as brief as possible.

activity. There is an overlap between “private receipts” and the other descriptors. For example, a windfall gain will often be a private receipt rather than derived from a business or similar activity. However the inclusion of this term provides another aspect to this non-income category in the subpart BC flowchart. Indirectly, this term also provides a link (and explicit symmetry in treatment) with the prohibition from deducting expenditure or loss of a private nature (now contained in s DA 2(2) ITA 2004, the private limitation).

The non-income box in the subpart BC flowchart with the addition of the descriptors “some gifts” and “private receipts” is included in the revised subpart flowchart BC in section 8 of this paper.

6 NON-RESIDENTS’ FOREIGN-SOURCED INCOME

6.1 Background

New Zealand bases its jurisdiction to tax income on the concept of residence and the concept of source. In order for income (and assessable income) subject to New Zealand income tax to be correctly identified it is important that these two concepts are clearly outlined in the Income Tax Act and that the rules for determining residence and source are also explicitly stated.

6.1.1 Jurisdiction to tax income

The taxing of income in New Zealand can be summarised by the following three rules (the three rules):

- (i) A person who is a New Zealand tax resident is liable to tax on all their income, both income derived in New Zealand and foreign income.
- (ii) A person who is non-resident for tax purposes is only liable to New Zealand income tax on New Zealand sourced income.
- (iii) A person who derives only foreign-sourced income and is non-resident for tax purposes is not subject to New Zealand income tax.³⁷

The rules for determining residence and the classes of income which are to be treated as having been sourced in New Zealand are also outlined in the tax legislation.³⁸ These rules

³⁷ Originally enacted in s 242 of the ITA 1976.

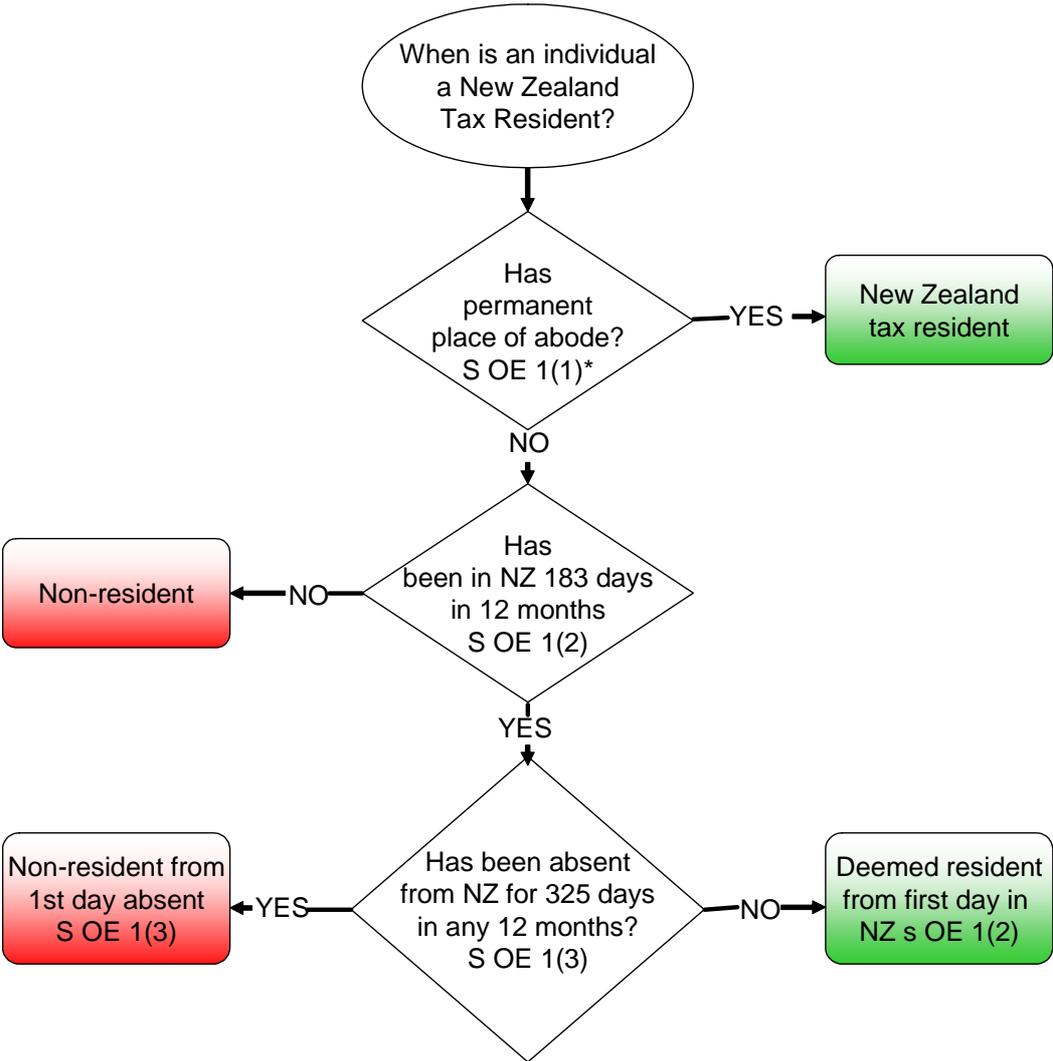
³⁸ For the definition of residence see s OE 1 and 2 ITA 2004. The rules to determine if income is derived in New Zealand are found in s OE 4 ITA 2004.

have remained essentially the same since 1989 following amendments made to the Income Tax Act 1976 (ITA 1976) which took effect from 1 April 1989.³⁹

6.1.2 *Defining when an individual is a New Zealand resident*

The rules for determining tax residency for an individual in New Zealand are outlined in s OE 1 ITA 2004 and can be summarised in the following flowchart:

New Zealand Tax Residency for an Individual



*Any ties to New Zealand (social, economic, employment etc.) NZ is the centre of vital interests. The individual has an enduring relationship with NZ.

Additional Notes:

- 1. An individual present for part of a day, is deemed to be in NZ for whole of that day, OE 1(4).
- 2. An individual absent from NZ on Government service is deemed to be a resident in NZ during that absence, OE 1(5)

³⁹ For the definition of residence in the earlier income tax Acts see s 241 ITA 1976 and ss OE 1 and 2 ITA 1994. The rules to determine if income is derived in New Zealand in earlier tax legislation can be found in s 243 ITA 1976 and s OE 4 ITA 1994. For further information see C Alley, D Bentley and S James, "In Need of Reform? A Trans-Tasman Perspective on the Definition of 'Residence' ", Paper presented at the 13th Australasian Tax Teachers' Association Conference (Sydney, 2001), available at http://pandora.nla.gov.au/pan/23524/20020507/c.fong_unsw.edu.au/PaperAlleyPrint.doc.

Section OE 1 provides:

- An individual is resident in New Zealand if that person:
 - (a) Has a permanent place of abode in New Zealand; or
 - (b) Has been present in New Zealand for more than 183 days of any 12-month period.
- An individual ceases to be a resident in New Zealand if:
 - (a) That person is absent from New Zealand for more than 325 days of any 12-month period; and
 - (b) During that period of absence has at no time a permanent place of abode in New Zealand; and
 - (c) Is not absent in the service of the Government of New Zealand.
- An individual present for any part of a day is deemed to be in New Zealand for the whole of that day.

Thus, a person is a New Zealand resident if they have a permanent place of abode in New Zealand *or* if they have been personally present in New Zealand for more than 183 days in any 12-month period. Only one of those situations need apply for that person to be adjudged a resident. The “permanent place of abode” concept overcomes the arbitrariness of a test based solely on the number of days spent in the country. A person is a non-resident of New Zealand if that person satisfies both the criteria of being out of the country for more than 325 days in any 12-month period and not having a permanent place of abode in New Zealand.

It is easier to become a resident and subject to the tax laws than it is to become a non-resident and fall outside the New Zealand tax laws applicable to residents. The fact that it only takes 183 days to become a resident, as compared to the 325 days to become a non-resident, underlines the importance of the additional permanent place of abode test and the need for the tie-breaker provision in double tax treaties.

6.1.3 Permanent place of abode

The concept of a permanent place of abode is an integral consideration in determining residence. The permanent place of abode test does not focus solely on the ownership or availability for use of a dwelling. Although it is not defined in the ITA 2004 (or earlier Acts),

the IRD has issued the following list as a guide for determining an individual's permanent place of abode:⁴⁰

- (a) The presence of the person in New Zealand, whether continuous or interrupted;
- (b) Accommodation, whether owned or not;
- (c) Social ties, family membership of clubs etc;
- (d) Economic ties, bank accounts, credit cards, investment, superannuation funds etc;
- (e) Employment or business in New Zealand, whether permanent or transient and casual;
- (f) Personal property, whether furniture, clothing, car etc has been maintained in New Zealand;
- (g) Welfare benefits received in New Zealand;
- (h) Intentions, whether the intention is to live in New Zealand or return overseas after a period of time.⁴¹

It is important to note that under domestic law, a taxpayer can maintain similar ties, a residence, a physical home, or a permanent place of abode in other countries but still be a New Zealand resident for tax purposes. If the taxpayer has an enduring relationship in New Zealand that is a permanent place of abode, the taxpayer will always be a resident of New Zealand. This test overrides the provision relating to the number of days the taxpayer is in New Zealand.

6.2 The concept of non-residents' foreign-sourced income in the ITA 2004

The term "assessable income" in the Act excludes "non-residents' foreign-sourced income".

This term is defined in s BD 1(4) as follows:

"An amount of income of a person is non-residents' foreign-sourced income if:

- (a) the amount is a foreign sourced amount; and
- (b) the person is a non-resident when it is derived; and
- (c) the amount is not income of a trustee to which section HH 4(3) (overseas trustees' income) applies."

⁴⁰ IRD, "Determining a person's permanent place of abode", (1995) Vol 7:1, *Tax Information Bulletin*, 10, p 12.

⁴¹ Clarification of these rules has been provided by cases such as *Case Q55* (1993) 15 NZTC 5,313 and *Case U17* (1999) 19 NZTC 9,174.

Section HH 4(3) states that if a trustee who is not resident in New Zealand derives in a tax year any amount from outside New Zealand that would be income if derived by a resident of New Zealand, that amount is deemed to be income of the trustee if at any time in the tax year

- (a) any settlor of the trust is resident in New Zealand; or
- (b) the trust is a superannuation fund; or
- (c) any trustee of the trust was resident in New Zealand and the trust is a testamentary trust or an inter vivos trust where any settlor of the trust died resident in New Zealand, whether in that tax year or otherwise.

This section provides an exception to the source and residence rules and as such must be clearly stated whatever definitions of income are used. The authors believe this exception should be included in the statement of income as a new section CA 1(3) (see Appendix 1) along with income listed in Part C and income under ordinary concepts (see the revised subpart BC flowchart in section 8 of this paper).⁴²

The term “non-residents’ foreign-sourced income” is a new term introduced in the ITA 2004. This term was not contained in the 2001 exposure draft or the Bill as introduced into Parliament; rather it was inserted following submissions on the Bill (see section 6.4 of this paper).⁴³

Concerning this category of income, the IRD states:⁴⁴ “This category of income establishes the role that the source of income and a person’s residence play in determining whether an amount of income is subject to taxation in New Zealand... It also enables New Zealand to identify what deductions a non-resident may or may not be entitled to.”

The term “non-residents’ foreign-sourced income” is also utilised in Part D where s DA 2(6) ITA 2004 specifically provides that no deduction is permitted for expenditure or loss to the extent it is incurred in deriving such income. However if it is not possible (apart from s HH 4(3)) for non-resident foreign-sourced income to become income subject to New Zealand tax legislation there is no need to have a section stating a deduction for this type of income is not permitted. This non-resident foreign-sourced income should not be subject to the legislative

⁴² Along with the more specific explanations given in subsections (3A), (3B), (7) and section HH 2 ITA 2004.

⁴³ Policy Advice Division of the IRD and the Treasury, *Appendix – Table of Officials’ Recommendations on Submissions on the Income Tax Bill 2002*, (Wellington, 2003), p 21.

⁴⁴ IRD, “Income Tax Act 2004”, (2004) Vol 16:5 *Tax Information Bulletin*, p 52.

provisions of income as, by definition, it is not New Zealand income in the first instance. The authors therefore question why it is included as income as this simply then necessitates the need for an exclusion section in the deduction provisions. It is only when there is s HH 4(3) (overseas trustees' income) that any tax obligation arises from non-resident foreign sourced income.

Section BD 1(4) of the 2004 ITA effectively replaces s AA 2 and s BD 1(2)(c) ITA 1994. This new section has already been subject to some criticism. In *New Zealand Taxation 2005* the authors comment:⁴⁵

The equivalent principles [formerly in s AA 2 ITA 1994] are now contained in s BD 1(4), which has been written in a very *clumsy way*. The new s BD 1(4) is *supposed to clarify* the income tax obligations of a new category of taxpayer ... (paragraph removed from original) (emphasis added)

In the following subsections of this paper the authors review the previous provisions outlining the three rules and the background to the new term in s BD 1(4) ITA 2004. They also suggest improvements to the way this definition is framed and its placement in the subpart BC flowchart and Part B.

6.3 The concepts of residence and source of income in the Income Tax Act 1976 and the Income Tax Act 1994

The three rules listed in 6.1.1 were succinctly outlined in s 242 of the ITA 1976 which provided:

Subject to this Act, - (a) All income derived by any person who is resident in New Zealand at the time when he derives that income shall be assessable for income tax, whether it is derived from New Zealand or from elsewhere: (b) All income derived from New Zealand shall be assessable for income tax, whether the person deriving that income is resident in New Zealand or elsewhere: (c) No income which is neither derived from New Zealand nor derived by a person then resident in New Zealand shall be assessable for income tax.

In considering proposals to rewrite the ITA 1976 the Consultative Committee on the Taxation of Income from Capital⁴⁶ recommended s 242 ITA 1976 be included in the core provisions in the rewritten Act. This was supported by the Working Party on the Reorganisation of the Income Tax Act 1976 who noted the scheme of the Act should reflect the importance of “who

⁴⁵ C Alley, C Chan, D Dunbar, P Flannery, A Frost, A Maples, N Smith, J Veal, *New Zealand Taxation 2005 Principles, Cases and Questions*, (Wellington, Brookers Ltd, 2005), p 619. The authors of this paper are also two of the authors' of this book, however, were not involved in the chapter dealing with residence and source (Chapter 17 “International Taxation”).

⁴⁶ The Valabh Committee, *Final Report of the Consultative Committee on the Taxation of Income from Capital*, (Wellington, 1992), p 203.

is taxable and in respect of what income”.⁴⁷ As a consequence the three rules were enacted in the core provisions (s BB 3) of the ITA 1994.⁴⁸

Section BB 3 ITA 1994 was separated into two sections (ss AA 2 and BD 1(2)(c) ITA 1994) with the enactment of the rewritten core provisions in the Taxation (Core Provisions) Act 1996. The first provision, s AA 2 ITA 1994, which essentially reproduced parts (a) and (b) of s 242 ITA 1976 (and of s BB 3 ITA 1994), provided that: “A person who is resident in New Zealand or who has income from New Zealand is subject to this Act and the Tax Administration Act 1994 and must satisfy the obligations imposed by them.”

This provision indicated in very broad terms the range of persons who were subject to the Act ie persons within the scope of the residence and source rules.

The second provision, s BD 1(2) ITA 1994, which was the logical conclusion from s AA 2 ITA 1994 (and reproduced s 242(c) ITA 1976), stated that: “An amount is not gross income of a taxpayer if it is...(c) a foreign-sourced amount and the taxpayer is a non-resident when it is derived.”

The 1995 discussion document stated the rationale for paragraph 2(c) as follows:⁴⁹ “Excluding from the definition of gross income amounts that are foreign-sourced if derived by non-residents is intended to more clearly place the rules within a global/gross context.”

The authors agree with this rationale and query why it has been reinstated as income in the ITA 2004.

6.4 Should non-residents’ foreign-sourced income be classified as exempt or excluded income?

6.4.1 Tax treatment

The classification of income as either exempt or excluded has important implications for the deductibility of expenditure or loss incurred in deriving such income. Expenditure or loss

⁴⁷ The Working Party of the Reorganisation of the Income Tax Act, *Second Report of the Working Party* (Wellington, GP Print Ltd, 1993), pp 33, 35.

⁴⁸ Section BB 3 ITA 1994, which was virtually identical to s 242 ITA 1976, provided: “Subject to this Act, - (a) All income derived by any person who is resident in New Zealand at the time when the person derives that income shall be assessable for income tax, whether it is derived from New Zealand or from elsewhere: (b) All income derived from New Zealand shall be assessable for income tax, whether the person deriving that income is resident in New Zealand or elsewhere: (c) No income which is neither derived from New Zealand nor derived by a person then resident in New Zealand shall be assessable for income tax.”

⁴⁹ New Zealand Government, *Core Provisions: Rewriting the Income Tax Act; A Discussion Document* (Wellington, 1995), p 57.

incurred in deriving exempt income is not deductible.⁵⁰ However, deductions are permitted for expenditure or loss incurred in deriving excluded income provided the general deductibility test is satisfied and the expenditure is not prohibited by one of the general limitations (now in s DA 2 ITA 2004). The rationale for allowing such deductions is that excluded income is taxed in other ways under the Act.

6.4.2 *The 2001 exposure draft and the Income Tax Bill 2002*

The 2001 exposure draft and the Bill proposed to treat foreign sourced income derived by non-residents as exempt income rather than being excluded from a taxpayer's gross income (as was the treatment in the ITA 1994). In the 2001 exposure draft, the IRD commented:⁵¹ "... although the non-New Zealand income of non-residents is currently simply not taxable rather than being exempt, we are proposing that it be treated as exempt income to remove any implication that a deduction can still arise for related expenditure."

However, this poses the conundrum that if it was never "income" then there cannot be any related deduction. There must be a nexus between the deduction and the income from which it arises. The authors are strongly of the opinion that as non-residents' foreign-sourced income is not New Zealand income it should not be included as exempt or excluded income. It is not part of the New Zealand income tax system.

In s BD 1(2) the Bill provided:

An amount of income of a person is exempt income if it is –
... (b) a foreign-sourced amount and the person is a non-resident when it is derived (but for non-resident trustees, this paragraph is subject to section HH 4 (Trustee income)).

The issue of the deductibility of expenses relating to foreign income of a non-resident arguably was not an issue under the ITA 1994 on the basis that the general deductibility rules (s BD 2(1) ITA 1994), subject to certain prohibitions, permitted a deduction for expenditure or loss incurred in the derivation of "gross income". By virtue of s BD 1(2)(c) ITA 1994 foreign-sourced income derived by a non-resident is not "gross income". Accordingly,

⁵⁰ See s DA 2(3) ITA 2004 (the exempt income limitation). In order for an amount to be "exempt income" it must first be income: *CIR v Brierley* (1990) 12 NZTC 7,184 (CA).

⁵¹ Policy Advice Division of Inland Revenue Department, *Rewriting the Income Tax Act 1994 – Exposure Draft. Volume 1, About the rewrite*, (Wellington, 2001), p 14. The IRD alternatively suggested in the 2001 exposure draft that the 'excluded' income category be eliminated entirely (p 14). All excluded amounts would be treated as exempt income. It was acknowledged that this would raise issues concerning the deductibility of expenditure. ICANZ were strongly opposed to this for the same reasons as they opposed treating foreign-sourced income derived by non-residents as exempt income (see section 6.4.3 of this paper): M McHaffie, "Rewriting the Income Tax Act 1994: Exposure Draft", (12 April 2002), ICANZ (Letter to The Rewrite Project, Policy Advice Division of the IRD), available at http://www.icanz.co.nz/StaticContent/AGS/Tax_SubArch.cfm.

expenses relating to this income would not be deductible as, insofar as these expenses are concerned, no “gross income” has been derived.⁵²

However, there was an issue in the context of the Bill because the general deductibility provision referred simply to the derivation of “income” (s DA 1 of the Bill). If foreign-sourced income of non-residents was treated as excluded income rather than exempt income, then off-shore expenditure may be deductible. Therefore under the ITA 2004 (which resulted from the Tax Bill 2002) it is necessary to have another section denying deduction for an amount of expenditure or loss to the extent ...it is incurred in deriving non-residents’ foreign sourced income⁵³. This situation is not desirable as already explained in 6.2. If such amounts were simply not classified as income for New Zealand taxation purposes, there would be no possibility of there being a deduction.

6.4.3 ICANZ submissions on the Income Tax Bill 2002

In its submission to the FEC on the Bill, the Institute of Chartered Accountants of New Zealand (ICANZ) made a number of observations concerning the proposal to define off-shore income derived by non-residents as “exempt” income:⁵⁴

- (a) “Defining off-shore income of non-residents to be ‘*exempt*’ implies that this income should otherwise be taxable.” (emphasis in original)

This approach would clearly be incorrect and inaccurate as there is no basis on which to tax this income – it has no connection with or source in New Zealand and would not otherwise attract tax on the residence basis.

- (b) “[The term] exempt income usually involves some concession and there is no concession being made here.”

As New Zealand has no jurisdiction to tax such amounts in the first place, no concession can be made.

- (c) “... it would result in compliance costs for taxpayers to return income only to exclude it at a subsequent point.”

This approach would be contrary to Government attempts to reduce compliance costs.

⁵² This view was also taken by ICANZ: see ICANZ, “Submission to the Finance and Expenditure Select Committee on the Income Tax Bill – Part Two: Submissions on Parts A to E of the Income Tax Bill, Definitions and Consequential Changes”, (2003), p 4.

⁵³ Section DA 2(6) ITA 2004.

⁵⁴ ICANZ, “Submission to the Finance and Expenditure Select Committee on the Income Tax Bill – Part Two: Submissions on Parts A to E of the Income Tax Bill, Definitions and Consequential Changes”, (2003), p 4, available at http://www.icanz.co.nz/StaticContent/AGS/Tax_SubArch.cfm.

ICANZ were therefore of the view that the exclusion from income of such amounts should remain.⁵⁵ In their submission on the 2001 exposure draft ICANZ had earlier stated their view as follows:⁵⁶ “Having off-shore income of non-residents excluded from income seems to us to be a belts and braces approach and expressing it as exempt would in our view be a wrong characterisation.”

In the Officials’ Report to the FEC on submissions made on the Bill, it was recommended that the ICANZ submission be declined; and instead, officials recommended such foreign-sourced income be treated as a separate class of income that was neither excluded income or exempt income.⁵⁷ This was eventually adopted.

The authors agree with the ICANZ submission that non-residents’ foreign-sourced income should not be exempt income but neither should it be excluded income. In fact it should not be considered as any form of New Zealand income (apart from s HH 4(3)) as it does not fall within the realm of the New Zealand taxation system at all. If it is not classified as New Zealand income the resulting problems of such a classification cease to exist.

6.5 Section AA 2 ITA 1994 and the rules of residence and source of income

When the ITA 2004 was enacted, s AA 2 ITA 1994 was omitted from the Act. The exclusion of the section could be justified on three grounds:

- (i) According to the IRD, the section was inaccurate:⁵⁸

Section AA 2 has been omitted on the basis that it serves no particular purpose and did not accurately reflect the scope of the 1994 Act. The provision was considered to serve only to point to the concept of source and residence and the related obligations for non-residents that were embedded in the exclusions of a ‘foreign-sourced amount’ from ‘gross income’ in section BD 1(2)(c) of the 1994 Act.

In addition, the 2001 exposure draft comments:⁵⁹ “The provision implies that it is comprehensive but, in fact, it is far from comprehensive; for example, non-resident trustees of trusts with a New Zealand settlor and withholding obligations

⁵⁵ ICANZ, “Submission to the Finance and Expenditure Select Committee on the Income Tax Bill – Part Two: Submissions on Parts A to E of the Income Tax Bill, Definitions and Consequential Changes”, (2003), p 4, available at http://www.icanz.co.nz/StaticContent/AGS/Tax_SubArch.cfm.

⁵⁶ ICANZ, “Submission to the Inland Revenue Department on the Exposure Draft – Rewriting the Income Tax Act 1994 – Parts A and B”, (2002), p 13, available at http://www.icanz.co.nz/StaticContent/AGS/Tax_SubArch.cfm.

⁵⁷ Policy Advice Division of the IRD and the Treasury, *Appendix – Table of Officials’ Recommendations on Submissions on the Income Tax Bill 2002*, (Wellington, 2003), p 21.

⁵⁸ IRD, “Income Tax Act 2004”, (2004) Vol 16:5 *Tax Information Bulletin* 46 at 49.

⁵⁹ Policy Advice Division of Inland Revenue Department, *Rewriting the Income Tax Act 1994 – Exposure Draft. Volume 2, parts A to E*, (Wellington, 2001), p 3.

of non-residents are not covered.” It was also noted in the 2001 exposure draft that it:⁶⁰ “would become too detailed if made accurate.”

ICANZ, in its submission on the 2001 exposure draft agreed with the omission of section AA 2 ITA 1994 from the rewritten legislation on the basis that the section was “inaccurate and misleading.”⁶¹

While clearly s AA 2 ITA 1994 did not fully reflect the scope of the Act, in particular following the current trust regime which took effect from the commencement of the 1988-1989 income year, in the authors’ view, the section did serve a purpose. The section clearly stated, at the commencement of the Act, to what amounts and to whom the Act applied. The authors also do not believe that a more comprehensive statement would necessarily have become “too detailed” – surely the purpose of the new term “non-residents’ foreign-sourced income” is to be a comprehensive statement of the residence and source rules in s BD 1(4) ITA 2004 and proves a comprehensive statement is possible.

- (ii) Unlike its predecessor in the ITA 1976, the section did not incorporate the three principles referred to under 6.1.1. An appreciation of these rules could only be gained by reading the section in conjunction with s BD 1(2)(c) ITA 1994. However, in answer to this view, arguably a reader by a simple process of elimination in s AA 2 ITA 1994 would conclude if they were non-resident and had only foreign-sourced income, they were not subject to the Act, ie in this sense the section was stand alone. In fact, it is arguable that s BD 1(2)(c) ITA 1994 was also stand alone. This latter view is supported by the 1995 discussion document which similarly indicates that s BD 1(2)(c) gave:⁶² “effect to the basic residence and source rules.”
- (iii) The purpose of Part A of the ITA 1994 (and ITA 2004), as provided by s AA 1 ITA 1994 (and ITA 2004) is simply to state the purposes of the ITA as a whole (and provide aids for the interpretation of the Act). The purpose of the core provisions (Part B), which is outlined in s BA 1 ITA 1994 (and ITA 2004), can be summarised as to: “impose a variety of tax obligations and to set out rules for calculating and satisfying

⁶⁰ Policy Advice Division of Inland Revenue Department, *Rewriting the Income Tax Act 1994 – Exposure Draft. Volume 1, About the rewrite*, (Wellington, 2001), p 14 and Policy Advice Division of Inland Revenue Department, *Income Tax Bill – Commentary on the Bill*, (Wellington, 2002), p 4.

⁶¹ ICANZ, “Submission to the Inland Revenue Department on the Exposure Draft – Rewriting the Income Tax Act 1994 – Parts A and B”, (2002), p 2, available at http://www.icanz.co.nz/StaticContent/AGS/Tax_SubArch.cfm.

⁶² New Zealand Government, *Core Provisions: Rewriting the Income Tax Act; A Discussion Document* (Wellington, 1995), p 57.

those obligations”.⁶³ This requires a clear statement of the taxpayers’ subject to the Act and the income sources to which the Act applies.⁶⁴ On this basis s AA 2 ITA 1994 should have been located in Part B of the ITA 1994. Indeed the recommendation of the authors in this paper is that a redrafted definition of non-residents’ foreign-sourced income be inserted as a new s BB 2 ITA 2004 (see section 7 of this paper).

In fact the absence of s AA 2 ITA 1994 in the Act has arguably created some uncertainty. The authors of *New Zealand Taxation (2005)* note:⁶⁵ “... it *appears* that s BD 1(1) and (5) have the same effect as the former s AA 2 ITA 1994” (emphasis added).

In the authors’ view there is a need for a clear statement of the three rules at the commencement of the Act.

7. AN ALTERNATIVE PROPOSAL

The IRD state the primary aim of the rewrite of the Income Tax Act: “... is to produce legislation that clearly and unambiguously states the policy [of the Act]”.

The authors do not believe that the current definition of “non-residents’ foreign-sourced income” is a clear statement of the three rules and, with the aims of the rewrite in mind, recommend the following changes to the ITA 2004:

- (i) The introduction of a section which comprehensively and positively sets out the part that the source of income and a person’s residence play in determining whether amounts of income are liable to taxation in New Zealand. The following is a suggested section:

“BB 2 INCOME SUBJECT TO THIS ACT

BB 2(1) An amount of income of a person is subject to this Act and the Tax Administration Act 1994 if the amount:

- (a) is derived by a person who is resident in New Zealand at the time the amount is derived, whether the amount is derived from New Zealand or from elsewhere; or

⁶³ IRD, “Income Tax Act 2004”, (2004) *Inland Revenue Department Tax Information Bulletin (TIB)* 16:5, 46 at 47.

⁶⁴ To reflect the role of Part A the part heading has been changed from “Purpose and Application” in the ITA 1994 to “Purpose and Interpretation” in the ITA 2004.

⁶⁵ C Alley, C Chan, D Dunbar, P Flannery, A Frost, A Maples, N Smith, J Veal, *New Zealand Taxation 2005 Principles, Cases and Questions*, (2005, Wellington, Brookers Ltd), p 606.

- (b) is derived from New Zealand, whether or not the person deriving the amount was resident in New Zealand or elsewhere when the amount was derived; or
- (c) is derived by a non-resident trustee from outside New Zealand and is subject to section HH 4(3) (overseas trustees' income).

BB 2(2) An amount of income of a person is **non-residents' foreign-sourced income** and not subject to the Act or the Tax Administration Act 1994 if the amount:

- (a) is not derived from New Zealand; and
- (b) is derived by a person who is non-resident when it is derived; and
- (c) is not income of a non-resident trustee to which section HH 4(3) (overseas trustees' income) applies."

The proposed section clearly states when income will and will not be subject to New Zealand tax. The general limitation in s DA 2(6) from deducting expenditure or loss to the extent it is incurred in deriving non-residents' foreign sourced income could remain but would not be necessary.

- (ii) The placement of the provision outlined in (i) above in a new s BB 2 ITA 2004. The existing s BB 2 and following sections will need to be renumbered. Placement of this section at the commencement of the core provisions gives the section the prominence necessary to be a guide to readers of the Act. For example, for a person deriving only non-residents' foreign-sourced income it will be clear that no further action is required.
- (iii) In line with the importance of these rules, the subpart BC flowchart should incorporate the contents of the box "Section BD 1(4) Non-residents' foreign-sourced income?" with the first box in the revised flowchart "Transaction giving rise to inwards cash flow or gain" elevating it to immediately above the box "BD 1(1) Income?". The revised subpart BC flowchart, which follows in section 8 of this paper, incorporates this recommendation. It also includes the terms "some gifts" and "private receipts" as non-income amounts.
- (iv) To repeal paragraphs BD 1(3)(b) and BD 1(5)(c) and s BD 1(4) and renumber existing s BD 1(5) as new s BD 1(4). Non-residents' foreign-sourced income (with the exception of s HH 4(3) (overseas trustees' income)) is not New Zealand income and is not covered in this Act and is therefore better dealt with in Subpart BB. This also

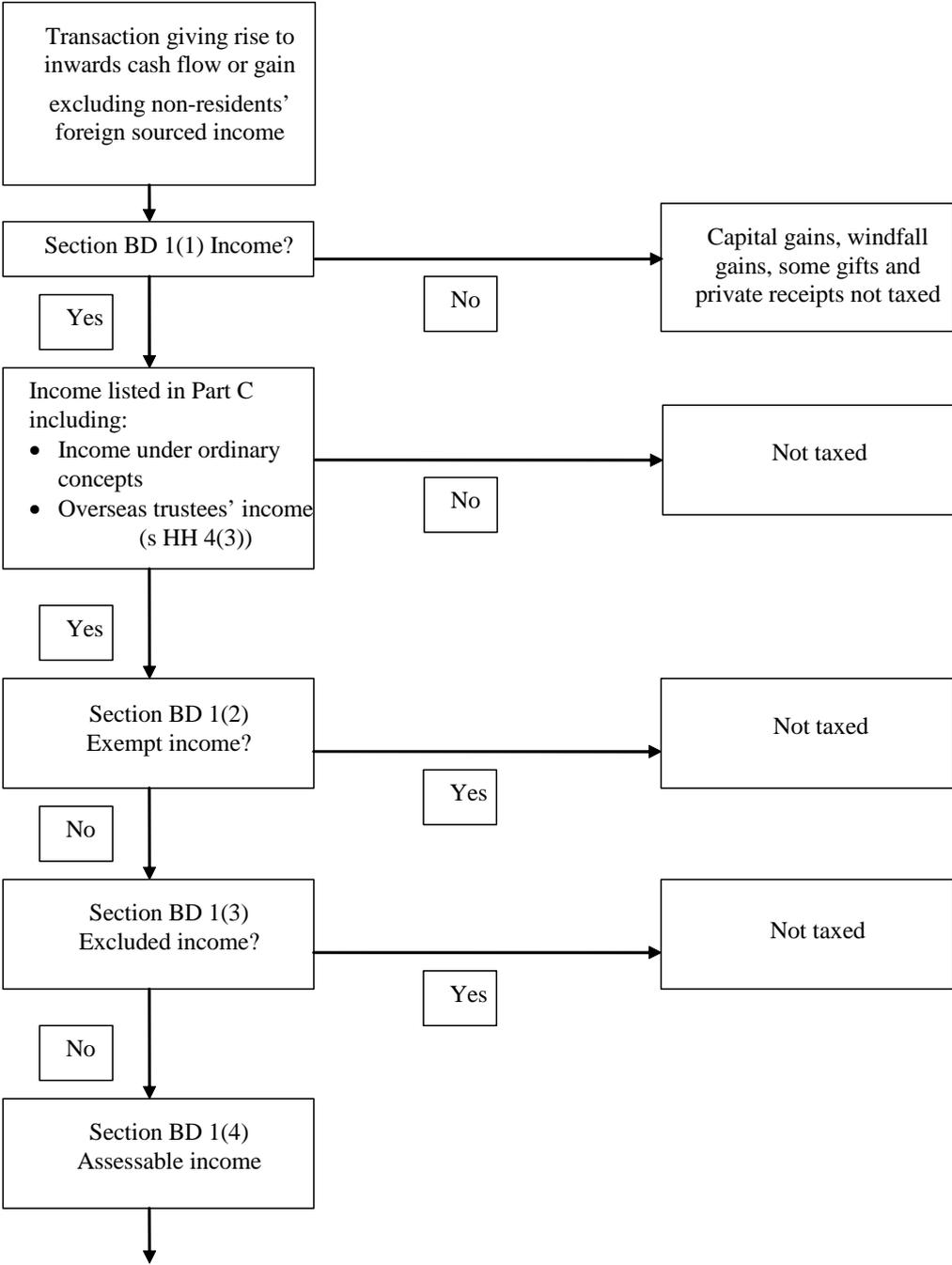
ensures that s BD 1 is aligned with the revised subpart BC flowchart. Appendix 1 outlines the revised section BD 1.

- (v) To repeal s HH 4(3) but include the contents of this subsection in a new s CA 1(3) for overseas trustees' income. The refinements for this subsection could be left in s HH 4 and referenced from the new s CA 1(3), or where relevant included in this subsection.

In addition, currently the subpart BC flowchart contains arrows from the boxes "Section BD 1(2) Exempt income?" and "Section BD 1(3) Excluded income?" to boxes stating "All or part not taxed". In the authors' opinions this is confusing – by including "or part" these boxes indicate that exempt and excluded income may be income. Clearly this is not the case and to clarify this, the authors' revised version of the subpart BC flowchart uses the term "Not taxed".

8. CONCLUSION

The revised first page of the Subpart BC ITA 2004 flowchart would then be as follows.



The process of determining assessable income under the framework proposed by the authors can also be summarised as follows:

Income derived by New Zealand residents or sourced in New Zealand

Term	Example	Authority
Total receipts	Transactions giving rise to inwards cash flow or gains.	Subpart BC Flowchart
<i>Less</i> non-income	Capital gains, windfall gains, some gifts, private receipts.	Case law
<i>Equals</i> income as listed in Part C: including	Income from employment Amounts derived from business.	Section CA 1(1)
• income under ordinary concepts;	Compensation for items of a revenue nature (TRA VI). Proceeds from flood relief.	Section CA 1(2) Case law
• overseas trustees income	Settlor of trust resident in NZ	Section CA 1(3) [former s HH 4(3)]
<i>Less</i> exempt income & excluded income	Pensions, jurors' fees, reimbursement of employees Fringe benefits, employer's superannuation contributions	Subpart CW Subpart CX, & others
<i>Equals</i> assessable income		Section BD 1(4) [as renumbered in section 7 of this paper]

Having established a framework for considering the concepts of income and assessable income within the New Zealand taxation system, it is now possible to define these terms by the use of this framework.

From the total receipts of a taxpayer, excluding non-resident foreign sourced income (which falls outside the New Zealand taxation system), is subtracted non-income (capital gains, windfall gains, some gifts and private receipts) and the result is the income of the taxpayer. This income will be the total income as listed in Part C (including income under ordinary concepts, s CA 1(2), and overseas trustees' income (new s CA 1(3))). From this income is subtracted exempt income and excluded income to give assessable income.

Assessable income is allocated to a particular year to give annual gross income from which annual total deductions are subtracted to give the net income (loss). Taxable income is net income (loss) less any available net losses.

APPENDIX 1

Subpart BD - Income, deductions, and timing

BD 1 INCOME, EXEMPT INCOME, EXCLUDED INCOME, AND ASSESSABLE INCOME

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

BD 1(2) EXEMPT INCOME An amount of income of a person is **exempt income** if it is their exempt income under a provision in subpart CW (Exempt income) or CZ (Terminating provisions).

BD 1(3) EXCLUDED INCOME An amount of income of a person is **excluded income** if it is their excluded income under a provision in subpart CX (Excluded income) or CZ (Terminating provisions).

BD 1(4) ASSESSABLE INCOME An amount of income of a person is **assessable income** in the calculation of their annual gross income if it is not income of any of the following kinds:

- (a) their exempt income;
- (b) their excluded income.

Subpart CA – General rules

CA 1 AMOUNTS THAT ARE INCOME

CA 1(1) AMOUNTS SPECIFICALLY IDENTIFIED An amount is income of a person if it is their income under a provision in this Part.

CA 1(2) ORDINARY MEANING An amount is also income of a person if it is their income under ordinary concepts.

CA 1(3) OVERSEAS TRUSTEES' INCOME Subject to section HH 4(7) and section HH 2, if a trustee who is not resident in New Zealand derives in a tax year any amount from outside New Zealand that would be income if derived by a resident of New Zealand, that amount is deemed to be income of the trustee if at any time in the tax year -

- (a) any settlor of the trust is resident in New Zealand; or
- (b) the trust is a superannuation fund; or
- (c) any trustee of the trust was resident in New Zealand and the trust is a testamentary trust or an inter vivos trust where any settlor of the trust died resident in New Zealand, whether in that tax year or otherwise.

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