[Interpretation statement IS0044 issued by Adjudication & Rulings in May 2000]

FINANCIAL PLANNING FEES—INCOME TAX DEDUCTIBILITY

SUMMARY

All references are to the Income Tax Act 1994 unless otherwise stated.

This interpretation statement considers the deductibility under section BD 2, of a range of financial planning fees charged to investors. In this regard the status of the investor will be important, i.e. whether the taxpayer is a passive investor, a speculative investor, or in the business of trading in investments.

This statement replaces Public Ruling BR Pub 95/10 that appeared in *Tax Information Bulletin* Vol 7, No 7 (January 1996), and the Taxation (Core Provisions) Act 1996 re-issue BR Pub 95/10A published in *Tax Information Bulletin* Vol 8, No10 (December 1996). The Public Ruling ceased to apply at the end of the 1998-1999 income year.

Some of the conclusions in this statement differ from those in Public Ruling BR 95/10, reflecting experience and case law arising from decisions from the Taxation Review Authority (TRA) and the High Court since that Ruling was issued. These changes will impact most on those investors coming within the definition of "passive investor" described in the statement. This category of investor will now, in certain circumstances, be entitled to deduct a greater range of fees than detailed in the earlier binding ruling.

In general, financial planning fees will be deductible if they are incurred in deriving the taxpayer's gross income, under section BD 2(1)(b)(i), or incurred in the course of carrying on a business for the purposes of deriving gross income under section BD 2(1)(b)(ii). Deductibility is prohibited if the fees are of a capital nature under section BD 2(2)(e).

The deductibility of financial planning fees depends on whether the investment to which the fees are paid relates to:

- an "excepted financial arrangement" (e.g. shares and options to purchase shares), or

- a "financial arrangement" (e.g. bonds, bank loans, mortgages, and government stock).

If the investment is an excepted financial arrangement, deductibility of fees will depend on whether the fee is part of the cost of the investment, and whether that investment is "trading stock" or "revenue account property" of a business or speculative investor respectively. The primary focus of this interpretation statement is on this type of investment.

If the investment is a financial arrangement, the accruals rules apply and the treatment of planning fees will depend on whether the financial arrangement was entered into

before or after the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 received its royal assent on 20 May 1999. Full details of how the "old" and "new" accrual rules apply to financial planning fees are discussed later.

Planning fees will be non-deductible if the income derived from the investments is exempt income or non-assessable income.

Fee categories

The fees charged by financial advisers vary from one adviser to another, but generally can be separated into a number of categories. Financial planners give the fees they charge various names, but the crucial point is the nature of the fees charged and when they are incurred. The nature and the timing of when the fees are incurred will determine whether they are of a revenue nature and therefore deductible for income tax purposes, or whether they are of a capital nature and not deductible.

The fees can be summarised as:

(a) *Initial planning fees*: Fees charged in relation to services provided by the adviser for the initial interview where the investor and the adviser discuss the investor's investment goals, savings objectives, cash requirements, and life and general insurance requirements. The adviser then prepares a draft portfolio plan for the investor. Further interviews, discussions, and adjustments to the draft plan may follow until it is acceptable to the investor.

(b) *Implementation fees*: All fees for services associated with implementing the draft plan devised in (a). They will include any one-off up front fees paid to or made in respect of services or charges to advisers, administrators, executors, fund managers, etc., to purchase or acquire the investments. They include brokerage, and any payments to custodians on implementation of the plan or charges by fund managers for entry into the investments.

(c) *Administration fees*: Generally described by advisers as "annual on-going" fees. They are charged by the adviser to cover the costs of maintaining records of the investor's transaction with the adviser. This category also includes charges relating to the handling of cash for the investor, such as the withdrawal and deposit in the investor's account with the administrator, bank charges, and other administration fees. Also included are any fees or commissions charged by the adviser for collecting income from the investments and arranging this to be paid to or credited to the investor's account with the adviser or to the investor's own bank account.

(d) *Monitoring fees*: Annual charges for monitoring and reporting to the investor on the performance of the portfolio (including the performance of the fund managers and the adviser) in terms of the investor's goals and relaying this information to the investor. The adviser will, from time to time, report on the portfolio's performance and relay this information to the investor.

(e) *Evaluation fees*: Any fees for services relating to an evaluation of an existing portfolio. Typically, where an investor has an existing portfolio of

investments and either seeks a financial adviser's advice for the first time, or seeks confirmation that the portfolio's performance is matching the goals originally set either by the investor or with the assistance of a financial planner at the initial planning stage. This is a more detailed examination of performance of the portfolio than simply monitoring performance and reporting to the client. It may or may not result in a recommendation from the adviser to make changes to investments within the portfolio to maintain the investor's aims.

(f) *Re-planning fees*: Fees for services relating to the re-planning of a portfolio arising from category (e) services due to changes to the investor's objectives. This could entail minor changes, or the complete restructuring of investments and a change in investment strategy. Re-planning fees do not necessarily refer to advice supplied by the same adviser. The fees could be for advice by an adviser to a new client who had previously managed his or her own portfolio or had previously engaged a different adviser. Included in this category are any other fees as described in *Initial planning fees* at (a) above, when there has been a complete restructuring of investments.

(g) *Switching fees*: Fees related to the costs involved in selling existing investments and/or purchasing new investments arise from a recommendation by the adviser as a result of category (e) or category (f) services. The fees will be charged by the adviser for changing investments within the portfolio. Also included are any fees relating to the withdrawal in whole or in part from an existing portfolio.

Financial planners may charge a global fee that will include fees for more than one of the above categories. It will then be necessary for the fees to be apportioned between the categories, based on the actual work done, to ensure the fees are correctly treated for deductibility purposes.

A similar apportionment exercise needs to be undertaken in the case of "performance fees", where an investor may have the option of being able to elect to pay a performance fee instead of fees for some or each of the categories noted above. Performance fees are a form of global fee paid to advisers based on how well the portfolio of investments selected by the adviser and agreed to by the investor, is performing against some pre-determined measure.

The calculation of the seven categories of fees noted above might be based on a standard fee structure, hours of work put in by the adviser, the amount of the investments made by the investor, or a combination thereof. Performance fees on the other hand, are calculated under some pre-determined formula based on how well the investor's portfolio, as recommended by the adviser, performs over a period of time. These fees could include a standard amount, plus a percentage based on the extent to which the level of growth or return from the portfolio exceeds previously agreed targets, or the fee could be based solely on a percentage of the returns/agreed targets.

Irrespective of the name given to the fee, or the basis of its calculation, the income tax treatment of the fees will be determined having regard to the services performed in establishing, administering and altering the investor's portfolio, based on the seven

categories of services mentioned above. It may be that in certain cases the performance fee is paid in respect of all the seven categories of services, while in other instances the fee may be only for the services coming within some of the categories, e.g. the administration and monitoring fee categories. In view of this, it is not the description (label) that the adviser attaches to the fee charged that is relevant, rather it is what service(s) the fee is actually paid for that determines whether or not the fee is deductible. Performance fees are in reality no different to any other global or multi-service fee charged by an adviser . How the amount is apportioned among the categories of services is a question of fact to be determined in the circumstances of the particular case.

Investor categories

Investors fall within one of three categories:

Passive investors: Persons whose primary aim is to derive dividend and interest income from a secure investment portfolio. There may also be a secondary hope or possibility that the investments will provide long-term capital appreciation. They will make changes to their investment portfolio from time to time to achieve this aim. Some investors may also be "actively" involved in monitoring their investment portfolios (or engage a financial adviser to do this for them) to ensure that the primary aim of maximising dividend and interest yield is maintained.

The passive investor will not be in business as an investor, nor will the investor buy or sell investments for short-term gains (speculator).

Speculative investors: Investors who acquire an investment with the intention of selling it for the purpose of making a profit from the transaction. These acquisitions and sales are generally of a one-off nature.

Business investors: Persons are in the business of investing when the nature of their activity, and their intention in respect of that activity, is sufficient to amount to a business (as discussed later in this statement).

The following table is a summary of the income tax treatment of financial planning fees as they apply to excepted financial arrangements (e.g. shares and share options and interests in unit trusts) discussed in this statement. The table also indicates when the fees will be deductible. The deductibility of fees relating to financial arrangements is discussed later.

TYPES OF INVESTORS	PASSIVE	SPECULATIVE	BUSINESS
Initial planning fees	Non-deductible	Deductible (2)	Deductible (2)
Implementation fees	Non-deductible	Deductible (1)	Deductible (3)
Administration fees	Deductible (1)	Deductible (1)	Deductible (1)
Monitoring fees	Deductible (1)	Deductible (1)	Deductible (1)
Evaluation fees	Deductible (4)	Deductible (1)	Deductible (1)
Re-planning fees	Deductible (4)	Deductible (1)	Deductible (1)
Switching fees	Deductible (4)	Deductible (1)	Deductible (1)
Fees incurred in earning exempt income or non-assessable income	Non-deductible	Non-deductible	Non-deductible

Key

(1) Deductible in income year incurred, unless
- the fee is "accrual expenditure" (i.e. paid in respect of a future period also).

(2) Deductible in the year incurred, unless
- the fee is "accrual expenditure", or
- the fee is in respect of "preliminary expenses" (i.e. paid before any such activity has commenced).

(3) Deductible in the year incurred, unless
- the fee is "accrual expenditure", or
- paid in respect of a "financial arrangement"

(4) Deductible in the year incurred, unless
- there is a significant change to the investment structure (e.g. a change from a rental producing structure to a share investment portfolio resulting in a changed income flow)

ISSUES

The question considered in this statement is: in what circumstances will the Commissioner allow financial planning fees as a deduction under either section BD 2 or the accruals rules of the Income Tax Act 1994? This will be determined by the following:

- Whether the taxpayer is a passive, speculative, or a business investor.
- The nature of the service fees charged to the investor by the financial adviser, and whether these fees are on revenue or capital account.
- If the fees are paid before the commencement of a speculative or business undertaking, whether the fees are "preliminary expenditure" and not deductible.
- How the trading stock and revenue account property rules affect the deductibility of planning fees.
- If the planning fees are "accrual expenditure", how deductibility is affected.
- If the investment is a "financial arrangement" as defined, whether the arrangement was entered into before or after 20 May 1999 - the date of royal assent of the Taxation (Accruals Rules and Other Remedial Matters) Act 1999.

  If the arrangement was entered into before 20 May 1999, whether:

  - the investor is a cash basis holder or a non-cash basis holder,
  - the fees are contingent or non-contingent on the implementation of the financial plan.
  - if the fees are non-contingent, whether they are more or less than 2% of the "core acquisition price".

  If the arrangement was entered into on or after 20 May 1999, whether:

  - the investor is a cash basis person.
  - the fees are non-contingent. If they are non-contingent, they are excluded from the accrual rules and treated under normal income tax deductibility rules.

Distinction between "excepted financial arrangements" and "financial arrangements"

Given that the focus of this statement is on excepted financial arrangements, it is important to know the distinction between excepted financial arrangements and financial arrangements. Both terms are defined in the Act. In the context of this statement excepted financial arrangements are basically equity investments that rely on the profitability of the entity invested in to determine the return to the investor. Shares and share options are a more common form of excepted financial arrangements as far as investors are concerned.

On the other hand, financial arrangements are debt instruments that will generally have a fixed rate of return in the form of interest. The definition in the Act describes a financial arrangement as any debt or debt instrument, or any arrangement whereby a person obtains money in consideration for a promise by any person to provide money at some future time or upon the occurrence or non-occurrence of some future event or events. It also includes any arrangement that is substantially similar in nature. Bonds, bank loans, mortgages, and government stock are examples of financial arrangements.

BACKGROUND

An investor who seeks advice from a financial adviser will be charged for the services provided. Whether any of these fees are deductible for income tax purposes will depend on the type of fee expense incurred and the type of investor who incurs the fee.

When an initial financial plan has been devised, agreed to by the investor, and implemented by the adviser, that is not necessarily the end of the matter. Usually systems are in place that require the adviser's continual involvement. Most financial advisers offer a continuing monitoring service that is generally part of an overall advisory package. The investments are often (but not always) placed in the care of a custodian (presumably for security reasons), the income derived from the investments passes to the adviser or custodian where it is placed in a trust account before being able to be drawn upon by the investor. The maintenance of these trust accounts by the adviser usually incurs costs that are charged to the investor. As part of the service, the adviser may monitor the portfolio to ensure that the aims of the investor are continually met. For this service the investor will often pay further fees. From time to time as part of this monitoring service the adviser can recommend changes to the investment mix. If the investor accepts these recommendations to change investments, further fees are incurred which may include brokerage and switching fees.

It is the Commissioner's view that Public Ruling (BR Pub 95/10) has been useful in respect of the deductibility of expenditure incurred in deriving gross income by investors. However, despite the issue of the Ruling there has been occasional uncertainty on how it should be applied. This is especially so for passive investors, and how the continuing on-going costs should be dealt with. Although some of these were discussed within the commentary definitions of the three categories identified, investors, especially passive investors, may have difficulty in applying the Ruling. It seemed logical to extend and further define the present three categories to make it easier for investors to decide whether or not the fees they pay are deductible.

An issue that was not fully considered in Br Pub 95/10 was the deductibility of fees incurred by business and speculative investors before their activity commenced. Another issue not fully considered was the deductibility of fees once a speculative activity had commenced. These issues are now reconsidered, as are legislative changes to the trading stock rules and the accrual rules.

Financial advisers charge for a number of services provided to their clients, sometimes using different names for these component services. The tax treatment of the fees depends not on the name given to the service, but on the nature of the service. To determine the correct tax treatment of a service, it is important to identify the exact service a financial adviser provides.

The adoption of the expanded categorisation of fees in this statement is intended to make it easier for passive investors to determine whether the fees they pay will be deductible for income tax purposes. The categories correspond to the process usually followed when an investor seeks the assistance of a financial adviser.

In some instances financial advisers will charge a global fee that may include fees for more than one of the categories of fees described in this statement. Then it will be necessary to apportion the fees into the appropriate fee categories in order to determine deductibility.

In addition, since the issue of Public Ruling BR Pub 95/10, the question of the deductibility of financial planning fees has been considered in three cases before the Taxation Review Authority (TRA). One of these cases was appealed by the Commissioner and heard before the High Court. These cases have established a framework of case law that requires some amendments to the Commissioner's position set out in BR Pub 95/10.

LEGISLATION

Deductibility

Expenditure can be deducted from gross income if it is provided for in the Income Tax Act 1994. Section BD 2 states:

An amount is an allowable deduction of a taxpayer -

(a) if it is an allowance for depreciation that the taxpayer is entitled to under Part E (Timing of Income and Deductions), or

(b) to the extent that it is an expenditure or loss

(i) incurred by the taxpayer in deriving the taxpayer's gross income, or
(ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or
(iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

Prohibition on deductibility

Section BD 2(2) qualifies the general deductibility test in section BD 2. Section BD 2(2)(e) prohibits the deduction of capital. It denies a deduction for expenditure:

(e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined), E (Timing of Income and Deductions).

Section BD 2(b) prohibits a deduction where the expense relates to exempt income, denying a deduction for expenditure:

(b) incurred in deriving exempt income under Part C (Income Further Defined), D (Deductions Further Defined), or F (Apportionment and Recharacterised Transactions).

Assessability

Under section BD 1, certain types of income are assessable. Sections CD 3, CD 4, and CE 1 further define income. The following income types are relevant to this statement:

- Business profits - section CD 3.
- Personal property sales - section CD 4.
- Interest, dividends, and annuities - section CE 1(1)(a).
- Benefits from money advanced - section CE 1(1)(b).
- Accruals income - section CE 1(1)(c).

Definition

"Business" - Includes any profession, trade, manufacture, or undertaking carried on for pecuniary profit:

Qualified accruals rules

The qualified accruals rules in Part EH provide rules for the timing and recognition of income derived and expenditure incurred in respect of financial arrangements. A financial arrangement is widely defined and means: a debt or debt instrument, an arrangement whereby a person receives money in consideration for a promise for repayment of that money at some future time or at the occurrence of any event, and any arrangements that are substantially similar. Bonds, bank loans, mortgages, and government stock are examples of financial arrangements.

The deductibility of financial adviser's fees paid in respect of these financial arrangements is dealt with under the accruals rules and could result in a different tax treatment to investments such as company shares, which are not financial arrangements (i.e. they are "excepted financial arrangements"). The legislation provides a method for calculating the income (or loss) from financial arrangements. Basically, this methodology compares the total amounts paid out, with the total amounts received, from each financial arrangement. The difference is either gross income or expenditure incurred from the arrangement. Implementation fees paid to a financial adviser for the acquisition of a financial arrangement are included in the calculation of the income (or loss). This matter is further considered in this statement under the heading *Qualified accruals rules and implementation fees.*

If a planning fee is paid in advance to cover future income years, the fees may be "accrual expenditure", and deductibility may be spread over the number of years to which the fees relate. This too is discussed in more detail later in the statement under the heading *Where the fee is 'accrual expenditure'*.

Definitions

"Accrual expenditure", in section EF 1 and EF 4, in relation to any person, means any amount of expenditure incurred on or after 1 August 1986 by the person that is allowed as a deduction under this Act, ………., other than expenditure incurred -
(a) In the purchase of trading stock; or
(b) In respect of any financial arrangement; or
(c) In respect of a specified lease, or a lease to which section EO 2 applies, or

"Core acquisition price"

(i) In relation to the holder of the financial arrangement, the value of all consideration provided by the holder in relation to the financial arrangement; or

(ii) In relation to the issuer of the financial arrangement, the value of all consideration provided to the issuer in relation to the financial arrangement.

"Excepted financial arrangement" means any of the following arrangements:

(includes)

(f) In relation to a holder or an issuer, shares, other than withdrawable shares, or an option to buy shares, other than withdrawable shares, where those shares were or that option was acquired or issued by the person before 8.00 p.m. New Zealand Standard Time on 18 June 1987;

(g) In relation to a holder or an issuer, shares, other than withdrawable shares, or an option to acquire or to sell or otherwise dispose of shares, other then withdrawable shares, where those shares were or that option was acquired or issued by the person after 8.00 p.m. New Zealand Standard Time on 18 June 1987:

"Financial arrangement" -

(a) Subject to paragraph (b), means -

(i) Any debt or debt instrument; and

(ii) Any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice); and

(iii) Any arrangement which is of a substantially similar nature (including, without restricting the generality of the preceding provisions of this subparagraph, sell-back and buy-back arrangements, debt defeasances, and assignments of income); -

but does not include any excepted financial arrangement that is not part of a financial arrangement:

(b) …

Trading stock

Changes have been made to the tax rules regarding the valuation of trading stock. The Taxation (Tax Credits, Trading Stock, and Other Remedial Matters) Act 1998 made changes that will affect business and speculative investors. The amending legislation inserted a new subpart EE into the Income Tax Act 1994.

The definition of "trading stock" has been clarified so that it is limited to anything that is manufactured, produced, or acquired and held for sale or exchange in the ordinary course of a business.

Generally, commencing from the 1998-1999 income year, business investors will now be required to value their trading stock at cost or, in the case of an excepted financial arrangement where the stock is worthless, at a nil value under section EE 3. The previous valuation options of market value and replacement price are no longer available. For business investors, trading stock will not include any investment that is a financial arrangement to which the qualified accruals rules apply. However, excepted financial arrangements (shares, options, and other equity type investments) must be valued at cost under section EE 13.

For speculative investors, "revenue account property" (property that is either trading stock or would give rise to gross income of the investor when sold or disposed of) that is an excepted financial arrangement, must also be valued at cost. Under section EF 2(1A) these "costs" of acquiring revenue account property (the investments) are not allowed as a deduction until such time as the investments to which they relate are sold.

Definition

"Revenue account property" means, in respect of any person, property which is trading stock of the person or otherwise property in respect of which any amount derived on disposition would be gross income of the person other than under section EG 19 (disposal of depreciable property):

Legislation

Section EE 5(1)

A taxpayer, other than a small taxpayer, that is valuing closing stock at cost, must include all costs required to be included by generally accepted accounting principles and must allocate those costs to closing stock using methods acceptable under generally accepted accounting principles.

Section EE 13

(1) An excepted financial arrangement that is trading stock must be valued at cost.

(2) In calculating the value of an excepted financial arrangement that is trading stock or revenue account property, a taxpayer must use one of the cost-flow methods authorised in section EE 6.

(3) An excepted financial arrangement that is trading stock may be valued at nil if it -

- (a) Has no current or likely future market value; and
- (b) Has been written off as worthless by the taxpayer.

Section EF 2(1)

Subject to subsection (2), a taxpayer must allocate an allowable deduction in respect of the cost of any revenue account property to the later of -

(a) The income year in which the property is disposed of by the taxpayer; and

(b) The income year (or years) in which the gross income is derived by the taxpayer in respect of the disposition of the property.

TYPES OF INVESTOR

The income tax treatment of initial planning, implementation, administration, monitoring, revaluation, re-planning, and switching fees differs, depending on whether the investor is:

- a passive investor
- a speculative investor
- in the business of investing.

These types of investor are defined for the purposes of this statement, and are discussed in more detail below.

When is an investor a passive investor?

A passive investor is a person whose primary aim is to derive dividend and interest income from a secure investment portfolio. There may also be a secondary hope or possibility that the investments will provide long-term capital appreciation. A passive investor will make changes to the investment portfolio from time to time to achieve this aim. Some investors may also be "actively" involved in monitoring their investment portfolios (or engage a financial adviser to do this for them) to ensure that the primary aim of maximising dividend and interest yield is maintained.

The passive investor will not be in business as an investor, nor will the investor buy or sell investments for short-term gains (speculator).

When is an investor a speculative investor?

A speculative investor is someone who either:

- Acquires an investment with the intention of selling it; or
- Carries on or carries out an undertaking or scheme, involving the investment, entered into or devised for the purpose of making a profit.

Profits derived or losses incurred in those circumstances are assessable under section CD 4 and deductible under section BD 2.

Investors are not speculative investors simply because they would like to see their investment capital increase, or that they may sell their investment if the capital

increases. Most passive investors fall within that description. It is the person's dominant purpose that is important in this distinction.

An investor may be a speculative investor in relation to one investment, and not in relation to another. For example: an investor has a number of financial arrangements and investments in unit trusts, and decides as a single transaction to buy some listed shares with the intention of selling them in the next month or so. The dominant purpose for buying the shares is for resale at a profit. In respect of the transaction the investor is a speculative investor.

However, if a speculative investor regularly carries out activities of speculating in investments, the question arises as to whether those activities constitute a business of speculating. As discussed below, whether an investor is in business will be a question of fact in each case. An investor's status as a speculator or in business may affect the deductibility of some planning fees.

When is an investor in business?

Section OB 1 defines "business" to include:

any profession, trade, manufacture, or undertaking carried on for pecuniary profit.

Whether a taxpayer is in the business of investing is dependent on that taxpayer's fact situation. The tests and criteria established by cases such as *Grieve v CIR* (1989) 6 NZTC 61,682 and *CIR v Stockwell* (1992) 14 NZTC 9,191 are relevant to this question.

The leading "business" case in New Zealand is that of *Grieve*. In that case the Court of Appeal concluded that there are two aspects to the concept of a business:

- the nature of the activity; and
- the intention with which the taxpayer undertakes the activity.

This approach was followed in *Stockwell*. The decision in *Stockwell* is useful in determining whether an individual is in the business of investing.

In *Stockwell* the Court of Appeal discussed, as obiter dicta, the question of when a taxpayer is in business. The Court observed that the question of whether a taxpayer was in business for tax purposes depended on whether the activities undertaken by the taxpayer were sufficiently continuous and extensive to constitute being a business. That is a question of fact and degree and is dependent upon the taxpayer's particular fact situation.

In *Grieve*, Richardson J set out some factors relevant to the inquiry as to whether a taxpayer is in business:

- the nature of the taxpayer's activities; and
- the period over which the taxpayer engages in the activity; and
- the scope of the taxpayer's operations; and
- the volume of transactions undertaken; and

- the commitment of time, money, and effort by the taxpayer; and
- the pattern of activity; and
- the financial results achieved by the activity.

These factors were reiterated by the Court of Appeal in *Stockwell*. The Court commented that the test is objective rather than subjective. Taxpayers' intentions are, therefore, evidenced by their activities (the extent and continuity), not by their own personal view of their activities. In *Stockwell* the Court of Appeal also provided some observations or guidelines regarding the extent and continuity of activity required to constitute a business:

- The fact that a taxpayer's activity is sufficient to render his or her returns assessable under section 65(2)(e) (now section CD 4) does not mean that the activity is a business.

- Where the taxpayer's activity is merely a means of supplementing an already adequate income, the taxpayer is unlikely to be in the business from which that supplementary income is derived.

- If the taxpayer is in full-time employment and engages in a spare-time activity, the presumption will be against that spare-time activity being a business.

- If the taxpayer is either unemployed or retired and is only engaged in moderate (investment) activity, the presumption is against that activity being a business.

Ultimately, whether a person is in the business of investing will be a question of fact. In seeking to determine whether a taxpayer is in the business of investing, the Commissioner uses the criteria identified above from the *Grieve* and *Stockwell* decisions.

The following are examples to indicate whether or not an investor is a passive investor, and whether an investor is in the business of investing.

Example 1

Investor A is an investment adviser employed by Bank. She spends most of her day advising investors of their investment opportunities and implementing investments for them.

Investor A and her husband have a young family and have recently bought a larger house. The extent of their personal investments is minimal. Besides Investor A's membership of a superannuation scheme operated by Bank, Investor A and her husband have a few thousand dollars invested as a lump sum in a managed fund. They approached a financial adviser for advice on which fund to invest in.

The continuity and extent of Investor A's investment activities make it unlikely that she is in the business of investing. Her employment activities of investment advice do not have any bearing on her personal activities. They must be viewed separately. Investor A is a passive investor.

Example 2

Investor B is a retired bank manager. Throughout his professional career he has acquired a number of investments from which he has continued to derive both income and capital growth. Investor B uses the services of a financial adviser in managing his investments. While Investor B takes an interest in the performance of his investments, he leaves the majority of the work to his financial adviser. Investor B only undertakes a minimal amount of buying and selling. Except for some superannuation entitlements, Investor B derives all his income from these investments.

If there are no other relevant facts, Investor B is not in the business of investing. Although the investments represent the majority of his income, his activities lack sufficient extent and continuity to constitute a business of investing. Cooke P in *Stockwell* considered there would be a presumption against a taxpayer being in the business of investing where a retired person undertook merely modest investment activity. The fact that the investments represent a taxpayer's primary source of income does not automatically make the activity the taxpayer's business. Investor B is a passive investor.

Example 3

Taxpayer C was made redundant by his employer and received a large severance payment. He wished to buy some form of business but could not decide what type. In the intervening period, rather than invest his severance pay in fixed securities, he decided to undertake some share dealing activity with the purpose of increasing his capital.

Over a period of eighteen-months he spent considerable time pursuing this activity. He instructed and used a regular professional sharebroker from whom he received regular client letters. Taxpayer C received weekly share advice letters from other professional advisors that contained recommendations as to when to buy and sell shares. He studied the daily newspapers, noting share prices of listed companies in which he held shares and the share price movements of other companies. Taxpayer C read articles relating to listed companies' shares and share movements, and watched any sharemarket programs on television. He read annual reports of companies in which he held shares, and of some other market leaders. He regularly received share analysis publications from his sharebroker, which gave detailed analysis of the prospects of a number of leading companies in a wide range of sectors, with recommendations as to the buying and selling of shares.

During this time Taxpayer C purchased and sold many shares. Any shares purchased were only held for as long he considered he could maximise returns on each share parcel. He acquired the shares on all occasions for the purpose of selling them at a profit and did not purchase them for dividend income. During this time he received other income in the form of superannuation payments and some consultancy fees from his former employer.

On the basis of his activities, his purpose and intention with regard to the purchase and sale of shares, Taxpayer C is considered to be in the business of investing.

Deductibility provisions

(a) General deductibility

The general deductibility section is section BD 2(1). Section BD 2(1)(b)(i) applies if the planning expenditure is incurred in gaining or producing gross income.

Section BD 2(1)(b)(ii) applies to expenditure incurred in carrying on a business.

Section BD 2(1) is subject to section BD 2(2). Section BD 2(2)(e) prohibits the deduction of capital expenditure. "Capital" is not defined.

(b) The capital/revenue distinction

The courts have had to decide if expenditure is capital in nature in numerous cases. Often they examine various tests to decide whether expenditure has the features of capital, although they emphasise that tests are merely a guide and the particular facts of each situation will determine the matter.

In deciding whether planning fees are capital or revenue expenditure, the question is whether the fees are incurred in relation to the capital assets (the profit making structure), or in relation to the income that an investor derives from those assets.

The Privy Council in *BP Australia Ltd v FCT* (1965) 3 All ER 209, cited with approval various judgments of the New Zealand Court of Appeal (e.g. *CIR v Mc Kenzies New Zealand Ltd* (1983) 10 NZTC 5233 and *CIR v LD Nathan & Co Ltd (1972)* NZLR 209), and followed the approach of Dixon J in *Sun Newspapers Ltd* v *FCT* (1938) 61 CLR 337 who said that there were three matters to consider when determining whether expenditure is capital or income:

- The character of the advantage sought
- The manner in which it is to be used, relied upon or enjoyed (and in this and the preceding factor recurrence may be relevant)
- The means adopted to enjoy it.

In *BP Australia Ltd* the Privy Council analysed the character of the advantage sought by the expenditure using a number of tests. The Privy Council considered:

- The need or occasion that calls for the expenditure
- Whether the payments were paid out of fixed or circulating capital
- Whether the payments were of a once and for all nature, producing assets or advantages that are of an enduring benefit
- How the sum in question would be treated on ordinary accounting principles
- Whether the sums were expended on the structure within which the profits were to be earned or as part of the income-earning process.

The approach adopted by the Privy Council was to consider what the expenditure was calculated to effect.

BP Australia has recently been cited in a number of cases before the TRA, and one case heard on appeal to the High Court, dealing with the deductibility of financial planning fees. These cases make it clear that there is a difference in treatment between financial planning fees incurred to commence an investment strategy, and fees paid subsequently to monitor or change an existing portfolio of investments. These cases are discussed in more detail under the heading *Case law* later in this statement. The Authorities and the Court applied the criteria from *BP Australia* to the specific fact situation of each case. It is, therefore, considered useful to discuss the capital/revenue distinctions from *BP Australia* in some detail before proceeding further.

The Sun Newspapers *tests*

The first test mentioned in *Sun Newspapers,* and examined in *BP Australia,* was the character of the advantage sought. In the context of financial planning fees, the effect the investor wishes to achieve is a plan or strategy for investing his or her financial assets to achieve investment goals. The need or occasion for the expenditure is the investor's decision to examine his or her financial assets, and to receive initial advice on the best mix and type of assets in which to invest. The investor incurs a planning fee for such advice. The advice received relates to the investor's capital assets.

As a general proposition, the direct purpose of the initial planning advice is to establish the best mix of investments to achieve the investor's investment goals. The result the investor wishes to achieve may be to derive more income from his or her investments, or it may be another result. Following the initial advice, the investor may subsequently wish to reduce or increase the risk of a portfolio, or may wish to change investments to produce tax-paid returns on retirement. He or she may wish to change from intangible assets to property investments. This subsequent advice may relate to the investor's capital assets, which are the investor's profit-earning structure, or to the profit-making process.

Analysis of whether planning advice is capital or revenue expenditure may be similar to analysing whether fees for legal and other professional advice are capital or revenue. It may not always be possible to point to an enduring asset. As with professional advice, the test is to determine whether the expenditure is incurred in relation to the profit-earning structure, or the profit-making process. In *Foley Bros Pty Ltd* v *FC of T* (1965) 13 ATD 562, the full High Court of Australia held that in examining the matter to which legal fees related, "the true contrast is between altering the framework within which income producing activities are for the future to be carried on and taking a step as part of those activities within the framework".

The question is whether the expenditure is incurred to achieve an enduring advantage. This test of capital is not whether expenditure results in a permanent, tangible asset (*Kemball* v *C of T* [1932] NZLR 1305, *John Fairfax and Sons Pty Ltd* v *FC of T* (1959) 101 CLR 30), but if the expenditure is incurred to obtain an advantage or something of lasting value. The financial adviser provides an initial plan that becomes the investment framework for the investor. The plan is of continuing benefit to the investor because it forms the investor's strategy. Using the investor's goals, the adviser provides an approach to investment that takes into account those goals, and may identify particular investments that will enable those goals to be achieved. Over

time, particular investments may no longer serve the purpose of achieving the investor's goals, and the adviser may recommend new investments. When that happens, the adviser's new advice may relate to bringing into effect a new investment strategy.

The time that a plan is of value to an investor will vary. It will be unusual for a plan to be developed each year. Although aspects of the plan may change as the performance of a particular investment changes or if the investor's goals change, the initial plan is nonetheless something of lasting value rather than something that is a regular, recurring expense incurred in deriving investment income.

Fixed or circulating capital

In *BP Australia* the Privy Council considered that the test of whether sums were payable out of fixed or circulating capital tended in that case to favour the payments as revenue expenditure. The members of the Judicial Committee said (14 ATD 1, 8) that fixed capital is that on which a taxpayer looks to get a return by its trading operation, and circulating capital is that which comes back in the taxpayer's trading operations. Their Lordships considered that the amounts paid by BP to a service station owner for exclusive dealership (trade ties) were sums that had to come back penny by penny with every order during the period in order to reimburse and justify the particular outlay for the trade ties. They concluded that the lump sums were part of the consistent demand that must be answered out of the returns of the trade. As such, the Privy Council found that the sums were payable out of circulating capital.

The test that examines whether expenditure relates to fixed or circulating capital is not usually relevant to a passive or speculative investor. "Fixed capital" and "circulating capital" are relevant terms to a business that has fixed plant and circulating capital that are turned over while making profits and would apply to a business investor.

Accounting treatment

In *BP Australia* the Privy Council noted that the sums paid to retailers were entered into the profit and loss account by BP's accountants. The Privy Council considered it would have been inappropriate to put the sums on the balance sheet. However, they accepted it was misleading to put the whole sum into one year's expenses. They contemplated the idea of deducting the payments and adding back the unexpired value, but concluded that accountants did not follow this practice. Allocation to revenue was the "slightly preferable" view.

In *Christchurch Press Company Limited v CIR* (1993) 15 NZTC 10, 206, Gallen J noted that there was no evidence on the appropriate accounting treatment of such a payment. However, his Honour referred to a comment of Lord Donovan in *IRC v Land Securities Investment Trust Limited* [1969] 2 All ER 430, 433 (PC) where his Lordship said that where a company used its own employees to build an extension to its factory, the accountant should debit the wages to the capital account relating to the extension. Although the comments of Lord Donovan were criticised by counsel for the taxpayer in *Christchurch Press*, the Court considered it was at least an indication of what the position was when the case was decided. For passive and speculative investors, the accounting treatment is not relevant as they are not in business.

Benefit obtained and method of payment

The other two considerations mentioned in *Sun Newspapers* are the manner in which the benefit obtained by the expense is used, relied upon, or enjoyed, and the method of payment. The initial planning advice will be used as the investor's on-going investment strategy. The advice forms the basis for investment of the investor's capital assets. The method of payment is usually a one-off payment when a plan is first prepared. Further payments may also be made for planning advice if the adviser suggests modifications to the investor's portfolio, or if the investor's goals change. However, as discussed under *Case Law*, the method of payment is not determinative in deciding whether financial planning fees are on revenue or capital account.

(c) Fees incurred in gaining or producing non-assessable or exempt income

No deduction is available to the extent to which fees are incurred in the production of non-assessable or exempt income. Section BD 2 only allows a deduction for expenditure incurred in the production of gross income, or for expenditure necessarily incurred in the carrying on of a business for the purpose of gaining or producing gross income. Section BD 2(2)(b) denies a deduction for expenditure incurred in gaining exempt income. The link between gross income and planning fees will not be present when investments purchased on the advice in a plan are tax-paid investments, e.g. insurance bonds. Fees paid for investments that do not result in gross income are not deductible for any investor, even if the investor is in the business of investment or is a speculative investor. Therefore, where expenditure on financial planning fees produces non-assessable or exempt income, the fees cannot be deducted.

Having determined the general requirements of deductibility, it is necessary to discuss how these requirements apply to the three categories of investors.

A. Passive investors - deductibility of fees

A passive investor is a person whose primary aim is to derive dividend and interest income from a secure investment portfolio. A secondary hope or expectation may be that the investments will provide long-term capital growth. The passive investor will not be in business as an investor, nor will the investor buy and sell investments for short-term gains.

However, most investors are likely to sell and replace investments, from time to time, to ensure that the aims of their investment strategy are continually met.

Section BD 2(1)(b)(i) applies to passive investors if the planning expenditure is incurred in gaining or producing gross income, i.e. the fees must have the requisite connection with the producing of gross income to be deductible

Section BD 2(1)(b)(ii) does not apply to passive investors or speculative investors because it only applies to expenditure incurred in carrying on a business. In addition, section BD 2(2)(e) prohibits the deduction of capital expenditure.

Fees for financial plans will fail the general deductibility test under section BD 2(1)(b)(i) if the fees do not have the requisite connection with gross income. For example, when the plan is developed, the investor may not have decided whether to implement it. The investor may have received other advice, and see the plan as a possible method of capital asset reorganisation. No direct link may exist between the plan and deriving gross income from investments purchased on the advice contained in the plan. If the investor has already put a plan in place, and receives further advice from an adviser to achieve new goals, the necessary connection with gross income may be present. However, as discussed above, the fees will not be deductible if they are capital in nature.

To determine whether the fees are revenue or capital in nature, it is necessary to examine each of the categories of expenditure charged by financial advisers.

Initial planning fees

These fees are charged for services provided by the adviser for the initial interview where the investor and the adviser discuss the investor's investment goals, savings objectives, cash requirements, and life and general insurance requirements. The adviser then prepares a draft portfolio plan for the investor. Further interviews, discussions, and adjustments to the draft plan may follow until it is acceptable to the investor.

Initial planning fees are not deductible to passive investors because they relate to the creation of a capital structure (the profit or income earning structure) and are therefore capital expenditure. In some situations, planning fees are not deductible for the further reasons that they are not deductible under the general deductibility section, or because they relate to exempt income or private expenditure.

Implementation fees

Often financial advisers use another organisation (a "custodian") to place investments. Advisers pass on the custodian's implementation charge to the investor, either within their fee, or separately as a disbursement.

Implementation fees include fees payable to investment fund managers for entry into the investments.

Implementation fees are directly related to establishing the investor's income earning structure, and are not related to the income earning process. The effect achieved is that the investor obtains a new capital asset. The investment asset obtained as a result of the investor incurring an implementation fee will endure, because a passive investor does not buy and sell financial assets frequently and will hold the asset for a time. Implementation fees are not regular or recurring expenses and, therefore, are not deductible to passive investors for income tax purposes.

In *Case U53* 87 ATC 351 heard before the Australian Administrative Appeals Tribunal, the taxpayer paid a fee called a service fee that was calculated as a percentage of the value of units the investor bought in a unit trust. (The same unit trust was involved in *Case U160* 87 ATC 935.) The investment document stated that

the service fee was for payment in advance for services to be rendered throughout the life of the fund. No description of the nature of the services was provided in the prospectus of the unit trust. The Tribunal in both cases held that the charges on the basis of a percentage of funds invested indicates that if any services were to be rendered, they would not be in the nature of management services, which were provided for elsewhere in the investment documents. The Tribunal in both cases held that the service fee was in reality part of the cost of the units and was a capital cost.

On the basis of *Case U53* and *Case U160*, fees that are an entry cost are not deductible implementation fees.

An exception to the general position that implementation fees are not deductible to passive investors, relates to implementation fees that are part of the cost of "financial arrangements" - see below under the heading *Qualified accruals rules.*

Administration fees

These fees are paid to reimburse the adviser for the costs incurred in maintaining the investor's portfolio, such as, the collection of income and depositing funds to the investor's bank account or paying direct to the investor. These administration costs are part of the process of the investor earning gross income from the investments. They directly relate to the returns from the investments, rather than relating to the capital investments themselves. Administration fees are often regular, on-going expenses. The investor does not receive an enduring advantage as a result of this expenditure, and the expenses can not be linked to the capital structure of the investments.

Administration fees are deductible to passive investors under section BD 2(1)(b)(i) because they have a nexus with gross income.

In some cases, an administration fee could be paid for several years in advance. Such expenditure could meet the definition of "accrual expenditure" to which section EF 1 applies. The effect of this is that any portion of accrual expenditure not expended in that income year will not be an allowable deduction. That is, the unexpired portion of any such expenditure will be included in the gross income of the passive investor for the income year in which the payment is made, and as such will increase the gross income of the passive investor. See further discussion on this point under the heading *Where the fee is "accrual expenditure".*

Monitoring fees

Monitoring involves the adviser monitoring and evaluating the performance of the investor's portfolio. Monitoring services include collecting data on the investor's investments, and events and research material that have implications for the investor, and reporting to the investor on this data.

The financial adviser may also evaluate performance of the investment portfolio (including performance of fund managers and the adviser) in terms of the investor's goals, and relay this information to the investor.

Monitoring may include arranging the collection of income from investments and exchanging currency. Monitoring fees are usually charged as a percentage of the investment funds under the adviser's management. For passive investors, monitoring is typically on an annual or semi-annual basis. For business investors, monitoring may be more often.

These fees are paid for the adviser to monitor the performance of the investor's investments. These, like the administration fees, are for management services that are part of the process of the investor earning gross income from investments. The services relate more to the returns from the investments than the investments themselves. Monitoring fees are often regular, on-going expenses. The investor does not receive an enduring advantage as a result of monitoring.

Monitoring fees are deductible by passive investors under section BD 2(1)(b)(i).

As noted under *Administration fees*, to the extent that monitoring fees are accrual expenditure, their deduction will be affected by section EF 1.

Evaluation fees

Evaluation fees relate to services for a more extensive evaluation of the investor's investments. These services will occur where the investor, who has already established an income earning structure (in other words an investment portfolio), desires a review to ensure that the investments are meeting the goals and aims decided at the initial planning stage. This is a more detailed examination of the performance of the investments, rather than simply monitoring performance and reporting to the investor. The service may or may not result in a recommendation from the adviser to make changes.

Because these services are directly related to the income earning process, they are revenue in nature. They will qualify for a deduction, provided the advice received and implemented does not result in a significant change to the income earning structure, e.g. changing from a portfolio of rental properties to one of shares and securities. In this latter situation the fees will be a prohibited deduction by the operation of section BD 2(2)(e). They are on capital account being a change in the income earning structure.

Re-planning fees

Re-planning services may be provided as part of the financial adviser's on-going service. Using information received from monitoring or re-evaluating an investor's portfolio, the financial adviser may recommend changes to the investor's investments. The changes may be made to bring the investor's portfolio into line with the investor's goals and risk profile, to take advantage of better or new opportunities, or to take into account a change in the investor's requirements. Some financial advisers may call a fee for this service a monitoring fee. In this situation the service is better described as a planning fee or a re-planning fee, even though some of the original investments may be retained.

As with evaluation fees discussed above, deductibility of this category of fee will depend upon whether the new plan makes some adjustments to the existing income structure or there is a complete or significant change to the income earning structure. For passive investors this means that where the change is only to the type of investments held, the fee will be deductible. On the other hand, if the re-planning fees result in a significant change in the investment structure or a change in investment type (e.g. share to rental properties), the fee will not be deductible. See further discussion below under *Recent case law.*

Switching fees

These fees are the costs incurred by investors for buying, selling, or changing investments. Whether these costs are deductible as a revenue expense or are prohibited for a deduction because they are of a capital nature will depend on the extent of the changes made to the investment structure. As with the discussion above under *Evaluation fees* and *Re-planning fees*, the crucial factor is the extent of the changes. Changes within an investment type will generally be revenue whereas a change to the type of investment structure, or significant changes to an existing structure, will be capital. See further discussion under, *Recent case law* below.

Recent case law

Three recent Taxation Review Authority cases, and one that has been appealed to the High Court, have dealt with the deductibility of what were described by financial advisers as "portfolio establishment (or monitoring) fees". All the cases dealt with the deductibility of fees from the same financial planning firm.

In the first case, *Case T42* (1998) 18 NZTC 8,285, the Authority found in favour of the husband and wife taxpayers. The objectors had claimed a deduction for what was described by the financial planner as "portfolio establishment costs". Up until the time the objectors sought the advice of the financial planner, the husband had managed a portfolio of shares and other income earning investments. One of these investments was a superannuation scheme. This was "cashed up" and added to the other investments that formed the total investment capital from which the financial planner created a new portfolio of investments. The Commissioner of Inland Revenue argued that the portfolio establishment costs were of a capital nature and not deductible, as there was a creation of a new or substantially changed income producing asset. However, Judge Willy determined that the fees were incurred in the monitoring and changing of the taxpayers' existing investment portfolio rather than the planning or implementation of a new one. The taxpayers had previously managed their own portfolio for a number of years and this was significant in Judge Willy's reasoning.

Case T42 was appealed by the Commissioner (*C of IR v BO and M North,* (1999) 19 NZTC 15,219). The High Court confirmed the TRA's decision and dismissed the appeal. Finding for the taxpayers, Williams J said that the payments of the financial planning fees were revenue in nature and deductible for income tax purposes. The fees had been charged for a change in investment without a change in object ("...though the mix of their investments changed markedly, the object of their investments did not"). In applying the tests in *BP Australia,* the Court ruled that it

was not determinative that one of those tests, that the fee was paid "once and for all", was a point in favour of the Commissioner when seen against all the other factors required to be taken into account.

In the second TRA case, *Case T64* (1998) 18 NZTC 8,493, the Authority considered the deductibility of a similar portfolio monitoring fee paid by the objector to the financial adviser. In this case the objector had no previous experience in managing an investment portfolio. Judge Barber found that the costs of the fee were of a capital nature and not deductible to the taxpayer.

The case concerned a taxpayer who on retirement cashed up shares and superannuation benefits from a family company. He then paid a financial consultant to invest the funds for him as a retired person to achieve a particular level of income. At paragraph 34 of the judgment Barber J said:

> The essential issue is whether the costs of becoming involved in such funds is part of an income earning process or is related to establishing a capital structure from which income flows. It must be correct to say that, pending the deposits of the said proceeds into the objector's bank account, he held investments in the family auctioneering company and in the associated company and he held a stake in a superannuation fund. However, these holdings would not be regarded in normal speech as investments for the purpose of gaining investment income, because the main investment (in the auctioneering company) was to provide capital to give the objector (and other family members) a job, salary, and, presumably, some dividends. The other shares and superannuation were part of this concept. Upon retirement and sale of the auctioneering business and maturity of superannuation, the objector was simply holding all his funds in a bank account pending the design for him by experts of a financial investment structure off which he expected to achieve a certain level of income. It seems to me that the fee cannot be fairly regarded as incurred in the course of earning income but as incurred in the course of establishing the structure to obtain income. Accordingly, payment of the said consultancy fee represents capital expenditure.

In the judgment, the Authority distinguished this present case from *Case T42* (discussed earlier). The critical difference is that in *Case T42* the objector had an existing "extensive" share portfolio, and the Authority held that the fee was expended as part of the process by which the taxpayers earned their income from their investment portfolio. On the ordinary principles of commercial accounting, that fee would be treated as a debit to revenue and not capital. Willy J found the expenditure to be part of the income earning process because only the prudent management of investments was involved.

Interestingly, Barber J in *Case T64* stated at paragraph 35, that:

> Even if one would normally regard the holding of shares in the auctioneering company, with its associated entitlement to superannuation, as an investment structure, it seems to me that the fee in question was incurred to completely change and reconstruct that investment structure. Accordingly, the fee can still not be regarded as incurred in the course of an income earning process.

This is consistent with the earlier view stated, that a complete change/restructure of investments is on account of capital.

At paragraph 39 Barber J said the fees are capital because they relate to an investment portfolio being "created or substantially modified". This view appears to be consistent with Willy J's view that the planning or implementation of a new investment portfolio is on account of capital.

In the third TRA case, *Case U12*, the Authority considered a similar case. Here, the taxpayer, before undertaking the investment plan devised by her financial advisers, held her funds in fixed interest bank securities. As these bank deposits had frequently matured she had shopped around for the best investment rates. However, this took up much of her time and she thought it attractive to let the financial planning adviser take over the investment activity. About 40% of her investment capital stayed in similar fixed interest investments, the remainder being in equity investments.

The Commissioner, basing his submissions on an analysis of *Cases T42* and *T64,* submitted that there had been either a clear commencement of a totally new investment structure/strategy or a significant change in an investment structure/strategy. Therefore, the fee was incurred to obtain an appropriate structure or investment of capital from which to achieve income and the fee must be of a capital nature and not deductible. It was not part of an income earning process.

In finding for the taxpayer Judge Barber said that the decision was consistent with *Cases T42* and *T64* and with the High Court decision in *CIR v North.* Judge Barber held that the taxpayer was an active investor, and that her investment aims did not alter fundamentally, i.e. the change was to her mix of investments. Hence the fees were paid in relation to changes to the income earning process of the taxpayer and not the income earning structure. If they had been the latter, as in *Case T64,* the payment would be on capital account.

It is clear that two factors emerged from the case law that has determined the deductibility of planning fees. One is whether or not the taxpayer had some form of investment strategy prior to seeking and paying for financial advice. If the taxpayer had an existing portfolio of investments, and had active involvement with managing those investments prior to seeking financial advice, it seems the courts would find that the cost of the fees would be incurred in the income earning process (*Case T42, CIR v North,* and *Case No.U12)*. On the other hand, if there were no prior investment activities, as in *Case T64*, the fees would most probably be incurred in establishing a portfolio from which future income could be derived. The other factor that has emerged from case law is that where investment aims or objects have not fundamentally changed, even though there may be a significant change in the investments held (*TRA CaseU12* and *C of IR v North),* the fees will be on revenue account.

In contrast, where an investment structure has been created or where the investment aims or objects have fundamentally changed, the costs of planning fees will be on capital account. While each case will be decided on its facts, based on the cases cited above, there would need to be either a complete change in investment direction (e.g. a change from a portfolio of shares and fixed interest deposits to rental property), or an almost complete change to an existing portfolio. In this regard, Williams J in *C of IR v North* stated:

> In this case [*Case T42*] Willy DCJ was considering a transposition of investments by an experienced investor without change of object. In *Case T64* Barber CJ was considering a fundamental change from an investment of capital designed to provide employment, salary and associated benefits to the investment of that capital in investments of a very different nature designed to provide income.

… it would be imprudent to go further than the comments already made save to say that *Cases T42* and *T64* clearly indicate the difference in result which is likely to occur between fees charged for a change in investments of a broadly similar nature without change in object by contrast with those charged for fundamental changes in investments where the aim of the objector also alters.

The words "significant" and "substantially modified" are usually interpreted in the context of their use and the facts of the particular case. For example, in the English Court of Appeal in *Granada Theatres v Freehold Investments (Leytonstone)* [1958] 1 W.L.R 845, Jenkins LJ said:

Next, what is meant by the words 'of a substantial nature'? In a South Australian case, *Terry's Motors v. Rinder* ([1945] S.A.R. 167), the word 'substantial' is pilloried as a word devoid of any fixed meaning and as being an unsatisfactory medium for conveying the idea of some ascertainable proportion of a whole. In *Palser v. Grinling, Property Holding Co., Ltd. v. Mischeff* ([1948] 1 All E.R. 1) a question arose as to what was a 'substantial portion' of a rent, and the decision is summarised (not perhaps very helpfully) in the headnote ([1948] A.C. 291), saying that 'substantial' does not mean 'not unsubstantial', but is equivalent to 'considerable', and that the judge of fact must decide the matter according to circumstances in each case;

In *Case TRA No.U12* it was determined that there was a significant change in the investment structure, yet the expenditure was still held to be on revenue account (there being no change to the aims or objects). Therefore, in the context of these cases it seems that the change must be more than significant before a deduction will be prohibited as being on capital account. This is consistent with the earlier view that a considerable change (being nearer to a complete change) in investment structure would need to occur before the expenditure would be denied as a deduction.

For example, a change from the ownership of buildings, from which rental income is derived, to a portfolio of security and equity investments which produces interest and dividend income would be considered to be more than a significant change. In these situations there would be a discontinuation of one income earning process for another. The cost of changing from rental income to interest and dividend income, including planning advice fees, would be on capital account as there is a complete change in the income earning structure (*C of IR v North*).

There will be situations where the investor undertakes a significant change in investment strategy over a period of time, such as selling shares to invest the proceeds in rental properties. The investor sells the shares within the portfolio over a number of years to achieve the best return from those sales. The question this raises is whether the fees, charged by a financial adviser on advice as to the optimum time to sell each bundle of shares, will be deductible as a revenue expense or non-deductible as being capital in nature. In the context of the discussion above it could be argued that each sale of each bundle of shares is not a significant change. However, it is the Commissioner's view that the systematic disposal of the shares is a process of changing the income earning structure, and therefore the fees charged will be on capital account.

Another example of a more than significant or a considerable change is where a taxpayer is made redundant from his work and receives a redundancy payment of $100,000. The money is immediately deposited in a three-month fixed-term account at his local bank while he decides what to do with it. He seeks the advice of a financial planner with the view of investing the redundancy proceeds in shares and

securities from which he intends to derive interest and dividends to supplement some part-time employment income. On the basis of the definitions contained in this statement, the taxpayer can be described as a passive investor. The planning fees incurred in establishing the taxpayer's portfolio will be on capital account as they are the costs of creating an investment structure (*Case T64).* The simple depositing of the money in the fixed-term account could not be considered to be prior investment activity as there was no "active management" of the investment (*C of IR v North*).

The Australian Tax Office (ATO) issued a determination (DT 95/60) in December 1995 dealing with the deductibility of financial planning fees. The conclusion reached by the ATO was basically the same as Public Ruling BR Pub 95/10. That is, that generally the fee for drawing up a financial plan is on capital account. The determination stated:

> In our view, a fee paid to an investment adviser to draw up an investment plan in these circumstances would be a capital outlay even if some or all of the pre-existing investments were maintained as part of the plan. This is because the fee is for the advice that relates to drawing up an investment plan. The character of the outgoing is not altered because the existing investments fit in with the plan. It is still an outgoing of capital … (Emphasis added.)

The ATO determination is consistent with the view of the law taken in BR Pub 95/10, that fees incurred in the creation of, or changes to, an investment plan, are on capital account. Were it not for the recent TRA and High Court cases discussed above, it could be argued that the better view of the law when deciding whether financial planning fees were deductible or not, would be to treat the portfolio as being a collection of individual investments, each investment being a separate asset (unless the taxpayer is a dealer or trader). In applying the capital/revenue deductibility rules on such a basis, the result may be that advice leading to the sale of any such capital asset would be on capital account. Therefore, for passive investors, who sought financial advice that may lead to the sale of one parcel of shares to purchase another parcel, the cost of making those changes (e.g. switching fees) would be on capital account. However, with the decisions of the High Court (*C of IR v North*) and the TRA *(CaseU12),* the Commissioner considers that the matter is now to be determined by the weight of this more recent authority. In these two cases it was held that because the taxpayers had an existing portfolio of investments, and there was no change to the investors' aims or objects, the fees related to the income earning process (rather than to a collection of capital assets) and were deductible.

Apportionment of global fees

This interpretation statement categorises the component parts of financial planning fees, based on the process of obtaining an initial financial plan, subsequent monitoring of the plan, and any following adjustments or alterations to that plan. It is considered that if fees are charged by financial advisers on the basis of the description of these categories, then determining what amount is deductible will be on a more objective basis than the previous Public Ruling. In the event that a financial planner charges a global fee (e.g. performance fees) for all the services, an apportionment of that global fee, based on the categories discussed in this statement, will be required. The amount allocated to each category will be a question of fact in each case.

Example 4

Investor D has a portfolio of investments consisting of shares in listed public companies and deposits in a savings account at his local bank. He seeks advice from a financial adviser as to the appropriateness of these investments, taking into account current dividend and interest income and long-term capital growth. The advice is to completely alter his portfolio by selling off all current investments and investing the proceeds into residential rental properties.

The Commissioner considers that this is more than a significant change to the income earning structure. The former income earning process has ceased and a new one commenced. The fees charged to the investor will not be deductible for income tax purposes as they are of a capital nature.

Example 5

Investor E has an investment portfolio consisting of shares that generate dividends, and fixed interest debentures. The income from the shares has been inconsistent over the last few years despite, from time to time, the investor selling poor performing company shares and replacing them with shares in companies that seemed to paying better dividends. He seeks advice on what is the best option to ensure he has some certainty in future annual income. His financial adviser recommends that to ensure certainty he should cash up all current investments and place the proceeds in long term fixed interest bank deposits. He agrees to this and asks the adviser to arrange the sale of the shares and arrange to deposit the proceeds in fixed interest deposits.

In this situation the Commissioner considers that there has been a significant change in the income earning process. The investor has made a fundamental change to the investment strategy, i.e. changing from an investment portfolio where there was some uncertainty in the income from company shares to the continuing certainty of long-term interest bearing deposits. There has been a significant change in the portfolio's capital structure, and any financial planning fees incurred by Investor E will be of a capital nature and not deductible.

Example 6

Investor F is a retired farmer who used the proceeds from the sale of her farm to buy shares in a number of publicly listed companies in the agriculture sector. After a few years of ownership of these shares, she considered that the dividend yield from some of the companies was inadequate and sought the advice of a financial adviser as to her best option to increase her dividend income. Her financial adviser suggests that she sells the majority of her existing portfolio and uses the proceeds to purchase shares in various telecommunication companies that were expected to perform better than the companies in which she held shares. She asked if the financial planning fees she incurred would be deductible against the dividend income.

On the basis of the case law discussed in this statement it is the Commissioner's view that the change is not a significant change to the income earning structure of Investor F. The changes made to the portfolio are part of the income earning process and the fees incurred are for the purpose of increasing the dividend income. Therefore, they are on revenue account and qualify as a deduction for income tax purposes.

B. *Speculative investors - deductibility of fees*

Speculative investors are investors who acquire an investment with the intention of selling it for the purpose of making a profit from the transaction. These acquisitions and sales are generally of a one-off nature.

For a speculative investor, any difference between the cost of the investment and the amount received on disposal of the investment is gross income or a deductible loss. Their investments are called revenue account property as they have been purchased for the purpose of resale.

Where a speculative investor seeks planning advice, the deductibility of the fees charged by a financial planning adviser, and the timing of such deductions, will depend on the nature of the fees charged.

Preliminary expenditure

Any planning advice received by a speculative investor prior to commencing the speculative activity may not have the necessary nexus between the derivation of income from speculating in investments. For example, in *Case Q18* (1993) 15 NZTC 5,100 the objector intended setting up as a self-employed architect, but before doing so and while still an employee, he undertook a business diploma course at a university. The Commissioner disallowed the claim. In finding for the Commissioner, Barber J at page 5,103 said:

> In other words, the relevant expenditure was incurred by the objector in November 1988 to prepare him to set up his business as a self-employed architect. That business was not established before 18 November 1989. That type of expenditure is capital in nature and is not revenue. Accordingly, the expenditure cannot be deducted. The expenses were preliminary to the establishment of the self-employed architectural business rather than in the course of it. If the objector had been in business at the time he became liable for the course fees, then they would be revenue and deductible. They would not then have been preparatory in nature. (Emphasis added.)

The essential feature of this case is that while the expenditure had a sufficient nexus to an income earning process it was incurred by the objector before he entered into business. Therefore, the expenditure was preliminary to the establishment of the business and of a capital nature. There was not a sufficient nexus between the expenditure and the income earning process that commenced subsequent to incurring the course fees.

Fees for services, such as planning advice (such as how to go about speculating in investments) received before any activity of speculation has commenced will not, on the basis of *Case Q18,* be deductible. The advice will form the base knowledge to be utilised when the speculative activity commences.

Cost of revenue account property

As discussed earlier, investments held for the purpose of resale are revenue account property. Under the new trading stock rules revenue account property must be valued at cost. “Cost” is not defined in the Act in relation to investments that are “excepted

financial arrangements" (e.g. shares and options), and therefore cost must take its ordinary meaning. In general terms, the cost of revenue account property will be its purchase price and the cost of acquisition. Implementation, commissions, and brokerage fees paid by an investor to acquire or sell investments will be part of the cost of those investments. The effect of treating these fees as part of the cost of revenue account property is that they are not deductible when incurred, but when the investments to which they relate are eventually sold.

On-going planning fees

Once a speculative activity has been commenced, an issue arises as to whether subsequent planning advice is deductible, and if so, when.

In the case of planning fees relating to specific investments, it is considered that such fees meet the definition of cost, i.e. they have a direct nexus to the investments and are part of the cost of acquisition. Therefore, the fees will be part of the cost of revenue account property, and deductible when the investments to which the fees relate are later sold.

Where fees do not relate to specific investments, deductibility will depend upon whether they have a sufficient nexus to the gross income derived. Due to the one-off nature of speculative activities, income must be produced (at some stage) from that particular investment. Without this connection, it cannot be said that the fees are incurred in order to derive gross income. As such, the fees will not be deductible.

This raises yet another concern: the extent of the speculation. If the speculation is such that there is an on-going activity, it could be that the nature of the activities are more akin to a business, with the result that fees not relating to specific investments will have a nexus to the gross income. Whether the investor has an activity that is more than of a one-off nature will be a question of fact. If it is determined that the activity is more akin to a business, the fees will have the same tests of deductibility as that for a business investor (discussed below).

Other matters

Due to the one-off nature of a speculative activity, such investors will generally not incur administration, monitoring, administration, evaluation, re-planning and switching fees.

To the extent that a speculative investor's fees are accrual expenditure, the deduction of those fees will be affected by section EF 1. The effect of section EF 1 is that any accrual expenditure that has not been expended in that income year will not be an allowable deduction in that year, and as such will increase the gross income of the investor. See further discussion on this point under the heading *Where the fee is "accrual expenditure"*.

If the investment is a financial arrangement, the treatment of fees paid may be governed by the accruals rules - see details later in this statement.

C. Investors in the business of investing - deductibility of fees

Business investors are in the business of investing when the nature of their activity, and their intention in respect of that activity, is sufficient to amount to a business (as discussed earlier in this statement).

Investors in the business of investing can deduct, with some restrictions as indicated below, all the fees described above (initial planning, implementation, administrating, monitoring, evaluation, pre-planning, and switching fees) under either section BD 2(1)(b)(i) or section BD 2(1)(b)(ii).

If an investor is in the business of investing, any difference between the cost of the investment and the amount received on disposal of the investment is assessable income or a deductible loss. The investments are trading assets and not capital assets of the investor. Therefore, fees do not fail the test of non-deductibility for the reason that they relate to the investor's profit-making process.

To the extent that a business investor's fees are accrual expenditure (as discussed earlier), the deduction of those fees will be affected by section EF 1. The effect of section EF 1 is that any accrual expenditure not expended in that income year will not be an allowable deduction in that year, and as such will increase the gross income of the investor. See further discussion on this point under the heading *Where the fee is "accrual expenditure"*.

Establishment fees

For business investors, planning fees will be deductible under section BD 2(1)(b)(i) or section BD 2(1)(b)(ii) if they have the necessary connection with the derivation of gross income. However, as discussed above under the heading *Speculative investors - deductibility of fees,* consideration would need to be given as to whether the expenditure was incurred in **establishing** the capital base/asset from which the business is carried on. These "preliminary to business" expenses can include costs, such as fees charged by a financial adviser for reporting on an overall business strategy, evaluating business risks, and options. The expenditure is generally incurred before the investor commences a business of investing. In these circumstances, the costs relate to the capital structure of the business rather than being incurred in the course of operating the business. Therefore, the costs are non-deductible.

Implementation fees

The timing of deductions for implementation fees for business investors is subject to either the qualified accruals rules where they are paid in relation to the acquisition of a financial arrangement (discussed below), or the trading stock provisions, i.e. trading stock is valued at cost. For the same reasons discussed above under the heading *Speculative investors - deductibility of fees*, such fees will be added to the cost of the investment. If the relevant investment is still on hand at year's end, the deductibility of implementation fees is effectively deferred until the investment is sold. If the accruals rules apply, they take precedence over the rules applying to trading stock.

On-going planning advice

For the same reasons noted under *Speculative investors - deductibility of fees,* on-going planning advice relating to specific investments are added to the cost of the investment, as such fees meet the definition of cost. However, unlike speculative investors, general planning advice, unrelated to specific investments, will have a nexus to a business investors gross income as the nature of a business investor's activities is to earn gross income from trading in shares or other investments. Therefore, such fees will be deductible when incurred.

Example 7

Investor I is an accountant, employed part-time by a major corporate. Three years ago Investor I inherited a substantial sum of money which she put into a wide range of investments. She actively participates in managing her investments. She uses her tax knowledge and accounting expertise to analyse her investments' performances on a regular basis. She engages the services of a financial adviser so that she can obtain independent, objective, third party advice (and to implement her investment strategies).

Although Investor I derives a significant income from her employment as an accountant, the extent and continuity of her investment activities (and her active participation) should be sufficient for Investor I to be considered to be in the business of investing.

Investor I is a business investor and all fees, within the restriction explained above, are deductible.

Where the fee is "accrual expenditure"

"Accrual expenditure" is a term used to describe a payment that relates to costs that extend past the end of the current income year, i.e. in the context of financial planning fees, payments in advance of the services provided. For example, accrual expenditure could be an up-front payment covering the services of the financial planner for a three-year period.

To the extent that a fee is accrual expenditure, for any type of investor, the deduction of those fees will be affected by section EF 1. Under section EF 1(1), accrual expenditure is allowed as a deduction in the year in which it is incurred. However, the unexpired portion of that expenditure must be returned as gross income. In effect, section EF 1(1) allows only a deduction for the expired portion of the expenditure. The amount returned as the unexpired portion in one year is allowed as a deduction in the following income year or years. However, under the exemptions provided in Determination E10, the accrual expenditure rules would only apply if the unexpired portion of the fee exceeded $12,000 and the services to which the fee relates are due to expire later than six months from the end of the investor's income year. The accrual expenditure rules do not apply where the investment is a financial arrangement.

Example 8

Investor J pays a monitoring fee of $21,000 to a financial advisor to cover all monitoring services for a period of three years - the services are to be equally spread over the three years. The effect of applying the accrual expenditure rules is that in the first income year only one-third ($7,000) of the fee is deductible, i.e. $21,000 is allowed as a deduction. However, $14,000 is added back to income as the unexpired portion of accrual expenditure. The unexpired portion is deducted in the following year and any remaining unexpired portion is added back to income. Effectively this will allow a deduction of $7,000 in each of the three years.

Qualified accruals rules and implementation fees

The Taxation (Accrual Rules and Other Remedial Matters) Act 1999 changed the treatment of financial arrangements entered into on or after 20 May 1999, the date the Act received the Royal Assent.

The changes as they relate to the deductibility of financial planning fees are:

- The removal of the references to "issuer" and "holder". The new legislation only refers to a "party" (to a financial arrangement).

- With the removal of the holder/issuer distinction, the cash basis holder exemption from the spreading methods has been extended to all parties to financial arrangements. These exemption thresholds have been amended by:

  (a) increasing from $600,000 to $1,000,000 the threshold in respect of the value of financial arrangements held, and

  (b) increasing the income and expenditure thresholds from financial arrangements from $70,000 to $100,000, and

  (c) increasing the threshold whereby a breach of the cash basis threshold occurs where the investor creates a deferral of income, or an acceleration of expenditure, in excess of $40,000.

- Removal of the 2% threshold for non-contingent fees. Previously, non-contingent fees up to 2% of the core acquisition price did not have to be spread. This threshold has been removed so that all non-contingent fees are not now spread. The treatment of fees is reflected in the definition of "consideration" in section EH 48.

- Non-contingent fee is defined in section OB 1 as a fee for services provided in relation to a person becoming a party to a financial arrangement that is payable whether or not the arrangement proceeds.

The amended accrual rules apply only to financial arrangements entered into on or after the date the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 received the Royal Assent - 20 May 1999. Any financial arrangements entered into before this date are still dealt with under the former rules. To accomplish the distinction between the former and the new provisions the accrual rules are set out in

two divisions. The rules existing prior to the introduction of the new legislation are contained in Division 1, that is, sections EH A1 to EH 19.

Division 2 has been inserted after section EH 19 and contains the amended accrual rules. These rules apply to financial arrangements entered into after 20 May 1999. The rules dealing with each division are now discussed.

Division 1

Division 1 applies to financial arrangements entered into prior to 20 May 1999. "Financial arrangement" is a defined term in the Act. Broadly, it includes debt instruments, and does not include shares or interests in unit trusts. Therefore, it would apply to such investments as mortgages, loans, government stock, commercial bills, and forward exchange contracts.

Financial arrangement implementation fees

For passive, speculative, and business investors, the deductibility of financial arrangement implementation fees is given special treatment. Such fees must be dealt with under the qualified accruals rules. For such fees the distinction between passive, speculative, and business investors is often no longer important as the deductibility of the fees is provided for by statute. There are, however, some exceptions to the statutory deductibility of the fees where the distinction between passive, speculative, and business investors is still important.

Implementation fees that are part of the acquisition price of the financial arrangement will be allowed as a deduction against income earned from the financial arrangement either:

- On the maturity, remission, or sale of the financial arrangement for cash basis holders; or

- Over the life of the financial arrangement for non-cash basis holders.

Implementation fees that are part of the acquisition price of the financial arrangement include:

- Contingent fees, to the extent that they are provided in relation to the financial arrangement; and

- Non-contingent fees, to the extent that they exceed 2% of the core acquisition price, and to the extent they are provided in relation to the financial arrangement.

Non-contingent fees that are no more than 2% of the core acquisition are deductible under the normal rules for deducting financial planning fees. In this case, the distinction between passive, speculative, and business investors is important.

Contingent implementation fees

Where implementation fees are contingent on the financial arrangement being implemented, the fees are part of the "core acquisition price" of the financial arrangement and as such are subject to the accruals rules. The core acquisition price is defined to include "the value of all consideration provided by [the investor] in relation to the financial arrangement". Implementation fees paid to financial advisers or other organisations for their services in implementing financial arrangements are provided "in relation to the financial arrangement". See *Tax Information Bulletin* Vol 3, No 4 (December 1991) at pages 5 and 6.

Category 1: cash basis holders

A cash basis holder is a natural person for whom either the total value of all financial arrangements held by that person will not exceed $600,000, or the income derived in the year by the person from financial arrangements will not exceed $70,000. A further requirement is that the difference between the income that would be returned under the accruals rules, and the income returned as a cash basis holder, does not exceed $20,000.

An investor who is a cash basis holder returns income and expenditure relating to financial arrangements as and when the income is derived and expenditure incurred. Implementation fees that are part of the acquisition price, however, cannot be taken as a deduction in the year they are incurred. Instead, when the investment matures, is remitted, or is sold, the investor will get credit for the fees when he or she performs a cash base price adjustment.

The cash base price adjustment compares all amounts received by the investor in respect of the investment, with all amounts provided by the investor in relation to the investment. The amounts provided by the investor are the acquisition price. This calculation will usually mean a comparison of the amount returned at the end of the investment and interest received, with the amounts provided and any direct costs of the investment. If the cash base price adjustment results in a positive amount, the amount is income to the investor. If the cash base price adjustment results in a negative amount, the amount is an allowable deduction.

Because implementation fees are part of the acquisition price, they can be offset against income received from the financial arrangement. This has the effect of allowing a deduction for the fees on the maturity, remission, or sale of a financial arrangement.

Accordingly, if an investor is a cash basis holder, he or she may deduct implementation fees, irrespective of whether the investor is a passive investor, in the business of investing, or a speculative investor.

Category 2: non-cash basis holders

If an investor is not a cash basis holder, he or she must return income and expenditure according to the rules set out in section EH 1. Section EH 1(1) requires that for the purposes of calculating income and expenditure under sections EH 1(2) to (6), regard must be had to the amount of consideration provided by the person. The accruals rules spread the difference between amounts received by the person and amounts

provided by the person over the life of the financial arrangement. Where implementation fees are part of the acquisition price of the arrangement, they will be one of the amounts provided by the person that is spread over the life of the arrangement.

While the Act does not strictly allow a deduction for the implementation fees under the accrual rules, the end result is the same as the investor returns less income over the life of the financial arrangement, i.e. on the sale or disposition of the financial arrangement, the accruals rules arrive at a net result for tax purposes taking into account all costs and fees associated with its acquisition.

Non-contingent implementation fees

It is most likely that implementation fees will be contingent on the implementation of a financial plan. However, if implementation fees are not contingent on the implementation of the plan, they are covered by specific rules:

- If the non-contingent fees are no more than two percent (2%) of the core acquisition price, they are excluded from the accruals rules calculations and their deductibility is tested under normal income tax rules.

- If the non-contingent fees are greater than two percent (2%) of the core acquisition price, they are included within the accruals rules calculations to the extent that they exceed 2% of the core acquisition price. The remaining amount of fees (that is equal to 2% of the core acquisition price) is deductible or otherwise under normal income tax rules.

Thus for non-contingent fees amounting to 2% or less of the core acquisition price of the financial arrangement, the distinction between passive, business, and speculative investors is important as the normal income tax rules of deductibility will apply.

For non-contingent fees, to the extent that they exceed 2% of the core acquisition price of the financial arrangement, the discussion above relating to contingent fees is relevant.

Example 9

Investor K is a cash basis holder who has invested in a number of financial arrangements on the advice of her financial adviser. Investor K is a passive investor. She paid a fee of 2% of the cost of the financial arrangements as a commission to her adviser. The fee was contingent on the financial arrangements being purchased.

Investor K may not initially deduct the fee. The fee is a contingent fee and included in the acquisition price of the financial arrangement as a direct cost of the investment. As a contingent fee, it is not deductible until a cash base price adjustment is made on the maturity, remission, or sale of the financial arrangement. At that time it will be allowed as an amount provided by the investor, to be offset against amounts received.

If the fee charged was a non-contingent fee, then, to the extent that it was no more than 2% of the core acquisition price of the financial arrangement, it would be

excluded from the accruals rules and tested according to normal principles. As such it would be non-deductible, as Investor K is a passive investor.

Division 2

This division applies to financial planning fees incurred in respect of financial arrangements entered into on or after 20 May 1999. As discussed earlier the distinction between holder and issuer has been removed and the term "cash basis person" applies to all parties to the financial arrangement who satisfy the following criteria.

Contingent fees - Cash basis person concession

In Division 2, (section EH 27(1)) the concessions for determining whether a person is a cash basis person have been extended. A cash basis person is a natural person who is a party to financial arrangements where the absolute value of each of the person's financial arrangements added together has a total face value of not more than $1,000,000 (up from $600,000). Alternatively, under the new income and expenditure threshold, a person will be a cash basis person if the absolute value of the person's income or expenditure, calculated under the accrual rules, from the financial arrangements is less than $100,000.

The absolute value of the person's income and expenditure means that income is not offset by any expenditure. For example, a person with two financial arrangements, one deriving income of $50,000 and the other incurring expenditure of $20,000, would have an absolute value of $70,000. The income and expenditure threshold ($100,000) is not breached and the person is a cash basis person.

If either one or both of above two threshold tests are met, a further requirement to qualify as a cash basis person is that the taxpayer must also meet the deferral test. A breach of the deferral test occurs if the person creates a deferral of income or an acceleration of expenditure in excess of $40,000 in aggregate. (Section EH 27(3).)

Non-contingent fees

Under Division 2 all non-contingent fees are excluded from the accrual rules calculations, and their deductibility is subject to the normal income tax rules (essentially, whether there is a nexus to the income derived). This means that the deductibility of fees dealt with earlier in this statement under the separate headings of passive, speculative, and business investors will apply instead of the accrual rules.

Transitional adjustments

As discussed above, Division 1 applies to financial arrangements entered into before 20 May 1999. However, under section EH 17, investors may choose to apply the new rules in Division 2 to those financial arrangements. This will be useful, for example, if investors wish to account for all arrangements on a similar basis. Full details of this option and other changes to the accrual rules are included in *Tax Information Bulletin* Vol 11, No 6 (July 1999).