

RENT DEEMED TO BE PAYABLE – DEDUCTIBILITY

PUBLIC RULING - BR Pub 01/03

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

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

This Ruling applies in respect of sections BD 2 and GD 10.

The Arrangement to which this Ruling applies

The Arrangement to which this ruling applies is a “lease” of property (whether real property or personal property), at less than an “adequate rent,” where the property is used by the lessee in the derivation of gross income or exempt income. This ruling applies when the property is owned by any person, any 2 or more persons, or partnership and is leased:

- to a “relative” of any of those persons or of any member of the partnership; or
- to a “related company”; or
- by a company to any person.

For the purposes of this Ruling the terms “lease”, “adequate rent”, and “related company” have the meanings attributed to them by section GD 10(4), and “relative” has the meaning attributed to it by section OB 1.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Rent deemed under section GD 10 to be payable by the lessee to the lessor is expenditure incurred by the lessee for the purposes of section BD 2(1)(b).

The period for which this Ruling applies

This Ruling will apply to leases entered into within the period 1 February 2001 to 31 January 2006.

This Ruling is signed by me on the 10th day of April 2001.

Martin Smith
General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR Pub 01/03

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 01/03 (“the ruling”).

The ruling is a reissue of public binding ruling BR Pub 97/13, issued on 12 December 1997. The Commissioner’s view, as expressed in this ruling, is not intended to differ from BR Pub 97/13. Any changes between this ruling and the previous ruling are only intended to assist the reader’s understanding.

Background

Section GD 10 applies to leases, between a lessor and certain specified classes of lessee, where the rent payable under the lease is “less than an adequate rent”. Section GD 10 allows the Commissioner to notionally increase the amount of rent payable by the lessee to the lessor to an amount equal to an “adequate rent” and the section deems the rent thus payable to be gross income of the lessor.

Section GD 10 is directed against tax avoidance. It controls the shifting of income between family members to take advantage of different marginal tax rates, but is not limited to familial transactions. Progressive tax scales give advantages to the family unit to spread income, resulting in a reduction in the overall amount of tax paid by that unit, or the rate of tax applying to an income stream. Section GD 10 operates to limit this opportunity when related parties lease income-producing property. The effect of deeming income to be derived, based on a rent that should have been paid rather than what was paid, unwinds any advantage.

Section GD 10 applies where property (both personal and real) owned by any person, by any 2 or more persons (whether jointly or in common) or by any partnership is leased:

- to a relative of any of those persons;
- to a relative of any member of the partnership;
- to a related company;
- by a company to any person;

and the rent is either less than an adequate rent for the property or the lease makes no provision for the payment of rent.

Where those circumstances apply, section GD 10 allows the Commissioner to determine an amount of “adequate rent”, being in broad terms an amount of rent considered by the Commissioner to be adequate for the property being leased. This ruling does not consider the basis of such a determination or what is meant by either adequate or inadequate rent.

The amount of adequate rent so determined is, pursuant to section GD 10, deemed to be payable by the lessee to the lessor and is deemed to be gross income of the lessor.

This ruling considers the position of the lessee and, specifically, whether the adequate rent that is deemed payable by the lessee to the lessor is an allowable deduction of the lessee for the purposes of section BD 2.

The ruling concludes that rent deemed to be payable is an expenditure or loss incurred by the lessee under section BD 2(1)(b). It is therefore an allowable deduction if the exclusions in section BD 2(2) do not apply (such as, the exclusion of expenditure to the extent that it is of a private or capital nature, incurred in deriving exempt income, etc).

Legislation

Section BD 2(1) states:

An amount is an allowable deduction of a taxpayer

- (a) ...
- (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,

Section GD 10 states:

- (1) Where any property owned by any person or by 2 or more persons (whether jointly or in common) or by any partnership is leased to a relative of any of those persons or of any member of the partnership or to a related company or by a company to any person and the rent is less than an adequate rent for that property or the lease makes no provision for the payment of rent, -
 - (a) There shall be deemed to be payable under the lease a rent that is equal to an adequate rent for the property, and that rent shall be deemed to be payable by the lessee to the lessor on the days provided in the lease for payment of the rent, or, if no rent is payable under the lease, on such days as the Commissioner determines, and shall be deemed to be gross income derived by the lessor on the days on which the rent is deemed to be payable under this paragraph; and
 - (b) The rent deemed to be payable under paragraph (a) shall be deemed to accrue from day to day during the period in respect of which it is payable, and shall be apportioned accordingly.
- (2) This section shall apply with respect to any leased property only if and to the extent that it is used by the lessee in the derivation of gross income or exempt income.
- (3) This section shall apply whether the lease was granted before or after the commencement of the income year.
- (4) In this section-
 - “**Adequate rent**”, in relation to any property, means the amount of rent that the Commissioner determines to be adequate for that property during the period in respect of which the determination is made:
 - “**Lease**” means a tenancy of any duration, whether in writing or otherwise; and includes a sublease; and also includes a bailment; and “lessor” and “lessee” have corresponding meanings:
 - “**Related company**” means a company that is under the control of the lessor or any relative or relatives of the lessor or any one or more of them, or, where there are several lessors or the lessor is a partnership, under the control of any of the lessors or partners or any relative or relatives of any of the lessors or partners:
 - “**Rent**” includes any premium or other consideration for the lease.

Section OB 1 defines “relative” as:

“Relative” –

- (a) ...in relation to any person, means any other person connected with the first-mentioned person by blood relationship, marriage, or adoption; and includes a trustee of a trust under which a relative has benefited or is eligible to benefit; and for the purposes of this paragraph –
- (i) Persons are connected by blood relationship if within the fourth degree of relationship:
 - (ii) Persons are connected by marriage if one is married to the other or to a person who is connected by blood relationship to the other:
 - (iii) Persons are connected by adoption if one has been adopted as the child of the other or as a child of a person who is within the third degree of relationship to the other....

Application of the legislation

How section GD 10 operates

When does the section apply?

Section GD 10 operates, in limited circumstances, following a determination by the Commissioner. In order for section GD 10 to apply, the following requirements must be satisfied:

- There must be the leasing of property;
- The owner of the property must be:
 - A person (as defined in the Act, and includes a company); or
 - Any 2 or more persons (whether jointly or in common); or
 - A partnership.
- The lessee must be:
 - a relative of an owner (where the owner is a natural person); or
 - a relative of any member of the partnership that owns the property; or
 - a related company of the owner; or
 - where the lessor is a company, any person.
- Where either the stipulated rent is less than adequate or the lease is silent on the payment of rent; and
- The lessee uses the property in the derivation of gross income or exempt income.

What leased property is covered?

“Property” is not defined for the purposes of section GD 10, but in the Commissioner’s view it includes both real property (land and buildings) and personal property (property other than land and buildings). This is the usual legal meaning of “property”, but the definition of “lease” in section GD 10 also supports this interpretation.

“Lease” is defined in section GD 10(4) as a tenancy of any duration, including a sublease, and a bailment. A lease and a tenancy usually only relate to land, i.e. real property. However, a bailment only ever refers to personal property. Therefore, it is clear that section GD 10 is intended to apply to, and the word “property” is meant to refer to, both real and personal property.

Who is a relative?

“Relative” is defined in section OB 1. A relative is a person connected by “blood relationship”, marriage, or adoption. “Blood relationship” means a relationship within the fourth degree, which is ascertained by counting the relationship steps between the two people. For example, A and B are first cousins, so they are within the fourth degree of relationship, as follows:

A – A’s parent (1) – Grandparent (2) – B’s parent (3) – B (4).

Any person who marries another person within the fourth degree of relationship automatically assumes the same relationship. For example, B’s spouse is within the fourth degree of relationship to A. Similarly, both A and B’s spouses are within the fourth degree of relationship to each other.

Children adopted by a person within the third degree of relationship are also relatives.

The deeming effect of section GD 10

If the section applies to a transaction, section GD 10(1)(a) explicitly deems:

- An adequate rent to be payable under the lease;
- That adequate rent to be payable by the lessee to the lessor on the days provided in the lease for rent payment, or, where no rent is payable under the lease, on such days as the Commissioner determines; and
- Rent to be gross income of the lessor derived on the days on which it is deemed to be payable.

“Deemed” means adding to the normal meaning of words

If the Commissioner determines an adequate rent, the amount of rent payable by the lessee to the lessor is increased by the deeming effect of section GD 10 to reflect the Commissioner’s determination. In a Canadian decision, *R v Vermette* [1978] 2 SCR 838 at page 845, the Court gave a useful description of the legal effect of a deeming provision. It said:

A deeming provision is a statutory fiction; as a rule it implicitly admits that a thing is not what it is deemed to be but decrees that for some particular purpose it shall be taken as if it were that thing although it is not or there is doubt as to whether it is. A deeming provision artificially imports into a word or expression an additional meaning which they would not otherwise convey beside the normal meaning which they retain where they are used; it plays a function of enlargement analogous to the word “includes” in certain definitions; however, “includes” would be logically inappropriate and would sound unreal because of the fictional aspect of the provision.

In this case, section GD 10 deems an amount of adequate rent to be payable, even though in terms of the contract between the lessor and the lessee it is not. The section then further deems the fictional rent to be payable on specified days and finally deems the rent to be gross income of the lessor.

The section applies to a lessee

Although the section deems the rent determined by the Commissioner to be gross income of the lessor, it does not expressly state that the deemed rent is deductible by the lessee. The absence of a specified mirror treatment for the lessee could arguably support an interpretation of the section based on the proposition that it does not apply to a lessee. However, in the Commissioner's view this is not a correct interpretation because:

1. An adequate rent is deemed by the section to be payable under the lease. The section further deems the rent to be payable by the lessee to the lessor;
2. The application of the section is dependent on the lessee's use of the leased property for the derivation of gross income or exempt income;
3. Subsection (2) is directly concerned with the use of leased property by the lessee.
4. Section GD 10 was originally introduced as section 17 of the Land and Income Tax Amendment Act 1951. Introductory Notes supplied to the Minister on introduction of the Bill said:

This clause is designed to cover the position where a taxpayer owning an income producing property, enters into a lease under which a relative becomes entitled to the full rent or income from the property, and is required to pay to the lessor only a nominal or peppercorn rental. ...The provisions of the clause will not be applied to bona fide leases of property, even though the lessee is a relative, and will be operated by the Commissioner only where it is evident that the lease has the effect of transferring income from the taxpayer to a relative.

This demonstrates that the purpose of the provision was to prevent income splitting and the consequential reduction of tax paid. Allowing a deduction to the lessee would not negate this purpose.

These provisions support the conclusion that section GD 10 is intended to apply to both parties to a transaction.

Deeming not limited to section GD 10

The application of the deeming provisions contained in section GD 10 is not limited by the inclusion of any qualification. Elsewhere in the Act, where the effect of a provision is intended to be restricted, such sections contain a qualification such as, "For the purposes of this section...". The absence of such a qualification indicates that the deeming provisions are intended to have effect over the rest of the Act.

In other words, having deemed an amount of adequate rent to be payable by the lessee to the lessor, that rent is payable for the wider purposes of the Act. It is not restricted to only applying to section GD 10.

Section BD 2: "incurred" requires a legal obligation to pay

An amount is an allowable deduction under section BD 2 only if it is "incurred" by the taxpayer. For the deemed adequate rent to be an allowable deduction, it must have been "incurred" by the lessee.

The term “incurred” has been held to mean that the taxpayer has either paid the expenditure or loss, or is otherwise definitively committed to pay it: (see *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351). A taxpayer is said to be definitively committed when a legal obligation to make a payment in the future can be said to have accrued.

Section GD 10 does not specifically deem the adequate rent to have been incurred by the lessee. Rather, the section deems the rent to be payable. In *Re Howell’s Application* [1972] Ch. 509, the phrase “payable by way of rent” was interpreted as meaning “... rent the tenant is under an enforceable obligation to pay...”. New Zealand courts have taken the same view. In *AM Bisley & Co Ltd v C of IR* (1985) 7 NZTC 5,082 at page 5,096, Henry J said:

...that the expenditure is not payable until some future date does not of itself destroy its nature as an existing obligation.

Therefore, where an amount is said to be “payable”, it means that the payer has an enforceable obligation to pay the amount, even where that obligation does not crystallise until some future date.

Under section GD 10(1)(a), adequate rent is deemed to be payable on the days provided in the lease for payment, or on such days as the Commissioner determines. This means that the Act operates as if there was an obligation to pay the rent. The Commissioner’s view is that by deeming the amount to be payable, that has the same effect as deeming that a legal obligation has been created and therefore as far as section BD 2(1)(b) is concerned an expenditure has been incurred.

The obligation in *Bisley* was an existing legal obligation to make expenditure that became payable on a future date. Thus, there are two types of expenditure that qualify as “incurred”: existing legal obligations payable now, and those that will become payable in the future. For expenditure either to be payable or to become payable, there must be an existing obligation to pay either now or later. Rent deemed to be payable falls within the first category, and is clearly “incurred”.

The nexus between expenditure and income is not affected by deeming

If the leased property is used in the derivation of gross income, any rental paid by the lessee, including a less than adequate rent, is deductible (unless specifically excluded by section BD 2(2)). The required statutory nexus establishing deductibility is therefore present between the expenditure and the income. A determination by the Commissioner does not alter the quality of that expenditure, but merely alters the amount of the expenditure.

Conclusion

Rent deemed to be payable under section GD 10 is expenditure incurred by the lessee under section BD 2(1)(b).

Examples

Example 1

A leases a flat to her daughter B for \$10 per week. B then rents it to tenants for \$400 per week. A has other income of \$50,000 and is on a marginal tax rate of 33c in the dollar. B has no other income and pays 19.5c in the dollar. As B's tax bracket is lower than A's, there is less tax being paid overall than if A rented the flat to the tenants directly.

The Commissioner may determine that an adequate rent is higher than \$10 per week. Section GD 10 will apply to deem the determined rent to be the rent payable by B to A. The adequate rent is deemed to be gross income derived by A. The rent deemed payable is expenditure incurred by B, as there is deemed to be a legal obligation to pay.

Example 2

C Ltd, a company, leases a property to X, a charitable body, at an inadequate rental. X uses the property in the derivation of exempt income.

A "person" includes a company and an unincorporated body of persons (section OB 1) and therefore X. Section GD 10(1) applies to a lease of property "by a company to any person" at an inadequate rent. Under subsection (2), the section applies to the extent that the property is used by the lessee in the derivation of gross income or exempt income. An adequate rent determined by the Commissioner is therefore deemed payable. Although a deduction is allowed under section BD 2(1), this is denied by section BD 2(2)(b) as the expenditure is incurred in the derivation of exempt income. In this case, C derives gross income in the amount of the adequate rent, but X is unable to claim a matching deduction.