

**SECTION GD 10 – INCOME TAX ACT 2004 – RENT DEEMED TO BE PAYABLE  
BY THE LESSEE**

**PUBLIC RULING – BR Pub 06/02**

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**Note** (not part of ruling): The ruling is a reissue of Public Ruling BR Pub 01/03, issued on 10 April 2001. The Commissioner’s view, as expressed in this ruling, is not intended to differ from BR Pub 01/03. Any changes between this ruling and the previous ruling are only intended to assist the reader’s understanding and reflect the new terminology used in the Income Tax Act 2004.

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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 2004 unless otherwise stated.

This Ruling applies in respect of sections GD 10, DA 1 and DA 2.

**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,” only if and to the extent the leased property is used by the lessee, in the derivation of assessable income or exempt income.

This Ruling applies where any property, owned by any person or by two 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.

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:

For the purposes of section DA 1, rent deemed under section GD 10 to be payable by the lessee to the lessor is expenditure incurred by the lessee.

**The period for which this Ruling applies**

This Ruling will apply for an indefinite period to leases entered into on or following 1 February 2006.

This Ruling is signed by me on the 28th day of April 2006.

Susan Price  
Senior Tax Counsel

## COMMENTARY ON PUBLIC RULING BR Pub 06/02

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 06/02 (“the Ruling”).

### 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”. The section deems the rent thus payable to be income derived by the lessor on the days the rent is deemed to be payable.

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 or by two 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.

Under section GD 10, the amount of adequate rent so determined is deemed to be payable by the lessee to the lessor, and is deemed to be income derived by 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 also an amount deemed payable by the lessee for the purposes of sections DA 1 and DA 2.

The Ruling concludes that rent deemed to be payable is an expenditure or loss incurred by the lessee under section DA 1(1). For the rental to be deductible by the lessee, the expenditure or

loss must meet all of the requirements of the “general permission” in section DA 1 and not be excluded by the “general limitations” in section DA 2.

## Legislation

### DA 1 GENERAL PERMISSION

DA 1(1) NEXUS WITH INCOME A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is -

- (a) incurred by them in deriving -
  - (i) their assessable income; or
  - (ii) their excluded income; or
  - (iii) a combination of their assessable income and excluded income; or
- (b) incurred by them in the course of carrying on a business for the purpose of deriving -
  - (i) their assessable income; or
  - (ii) their excluded income; or
  - (iii) a combination of their assessable income and excluded income.

DA 1(2) GENERAL PERMISSION Subsection (1) is called the **general permission**.

Defined in this Act: amount, assessable income, business, deduction, depreciation loss, excluded income, general permission, loss,

### DA 2 GENERAL LIMITATIONS

#### DA 2(1) CAPITAL LIMITATION

- (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

DA 2(2) PRIVATE LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

DA 2(3) EXEMPT INCOME LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

DA 2(4) EMPLOYMENT LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.

DA 2(5) WITHHOLDING TAX LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving schedular income subject to final withholding. This rule is called the **withholding tax limitation**.

DA 2(6) NON-RESIDENTS' FOREIGN-SOURCED INCOME LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the **non-residents' foreign-sourced income limitation**.

DA 2(7) RELATIONSHIP OF GENERAL LIMITATIONS TO GENERAL PERMISSION Each of the general limitations in this section overrides the general permission.

Defined in this Act: amount, capital limitation, deduction, employment limitation, exempt income, exempt income limitation, general limitation, general permission, income from employment, loss, non-residents' foreign-sourced income, non-residents' foreign-sourced income limitation, private limitation, schedular income subject to final withholding, withholding tax limitation.

### GD 10 LEASES FOR INADEQUATE RENT

GD 10 1) [Deemed adequate rental] Where any property owned by any person or by two 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 is deemed to be payable under the lease a rent that is equal to an adequate rent for the property, and that rent is 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 each day of the term of the lease on a pro rata basis, and is deemed to be 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) is deemed to accrue from day to day during the period in respect of which it is payable, and is apportionable accordingly.

**GD 10(2) [Use of property]** This section applies with respect to any leased property only if and to the extent that it is used by the lessee in the derivation of assessable income or exempt income.

**GD 10(3) [Section to apply]** This section applies whether the lease was granted before or after the commencement of the tax year.

**GD 10(4) [Definitions]** 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 1 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.

#### “RELATIVE”

The definition of relative was amended by section 3(1) of the Income Tax Amendment Act 2005. The amendment added “civil union” to paragraph (c)(ii), this came into force on 26<sup>th</sup> April 2005.

Section 3(2) of the Amendment Act also provides for a future amendment to OB 1 by replacing the expression "marriage or civil union" in paragraph (c)(ii) with the expression "marriage, civil union or de facto relationship". This amendment comes into force 1 April 2007.

#### OB 1 “RELATIVE”

...

- (c) except in the provisions referred to in paragraphs (a) and (b), means a person connected with another person by -
  - (i) blood relationship, that is, one is within the fourth degree of relationship to the other;
  - (ii) marriage or other partnership, that is, one is in a marriage or civil union with the other or with a person who is connected by blood relationship to the other
  - (iii) adoption, that is, one has been adopted as a child of the other or as a child of a person who is within the third degree of relationship to the other;
- (d) except in the provisions referred to in paragraphs (a) and (b), includes a trustee of a trust under which a relative has benefited or is eligible to benefit

## 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. 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 Interpretation Act 1999, and includes a company), or
  - any two 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.
- The stipulated rent must be less than adequate or the lease must be silent on the payment of rent.
- The lessee must use the property in the derivation of assessable 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”. The definition of “lease” in section GD 10 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. 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 with another person by “blood relationship”, adoption, marriage or other partnership, that is, one is in a marriage or civil union with the other or with a person who is connected by blood relationship to the other. “Blood relationship” means a relationship that is 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 or is in a civil union with 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, if no rent is payable under the lease, on each day of the term of the lease on a pro rata basis; and
- the rent to be income derived by the lessor on the days on which the rent 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 Verrette* [1978] 2 S.C.R. 838 at page 845, the Supreme Court of Canada 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 income derived by the lessor.

#### *The section applies to a lessee*

Although the section deems the rent determined by the Commissioner to be income derived by the lessor, it does not expressly state that the deemed rent is expenditure incurred 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 assessable income or exempt income.
3. Section GD 10(2) is directly concerned with the use of leased property by the lessee in the derivation of assessable or exempt income.

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.

The above points also support the conclusion that section GD 10 is intended to apply to both the lessee and lessor in the relevant 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...”. Section GD 10 is not an independent charging provision, and must be read in conjunction with other relevant parts of the Act. For example, rent is included in income by section CC 1. The deemed rent is therefore relevant for other purposes of the Act such as for section DA 1.

#### *Section DA 1: “incurred” requires a legal obligation to pay*

An amount is an allowable deduction under section DA 1, 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), an adequate rent is deemed to be payable on the days provided in the lease for payment, or on each day of the term of the lease on a pro rata basis. This means that the Act operates as if there was an obligation to pay the rent. The Commissioner’s view is that deeming the amount to be payable has the same effect as deeming that a legal obligation has been created and, therefore, as far as section DA 1(1) 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 i.e. an existing legal obligation payable now, 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 assessable or exempt income, any rental deemed payable by the lessee, including a less than adequate rent, is deemed “incurred” by the lessee for the purposes of section DA 1(1). However, the ruling does not go so far as to deem deductibility.

For the deemed “incurred” rental to be deductible by the lessee the expenditure must also meet the express requirements of section DA 1 and not be excluded by the “general limitations” (section DA 2):

- The expenditure must have a “nexus with income” in terms of section DA 1(1) and be incurred by the lessee in “deriving” “assessable” or “excluded” income (section DA 1(1)(a)) or, incurred by them “in the course of carrying on a business” for the purpose of deriving “assessable” or “excluded” income (section DA 1(1)(b)).
- The expenditure must not be excluded from being deductible due to the “general limitations” of section DA 2.

*Conclusion*

Rent deemed to be payable, under section GD 10, is expenditure incurred by the lessee under section DA 1(1).

**Examples**

*Example 1*

A (lessor) leases a flat to her daughter B (lessee) 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 33 cents in the dollar. B has no other income and pays 19.5 cents 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 adequate rent to be the rent payable by B to A. The adequate rent is deemed to be 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 (lessor) leases a property to X (lessee), 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 29 Interpretation Act 1999) and therefore X. Section GD 10(1) applies to a lease of property "by a company to any person" at a less than adequate rent. Under subsection (2), the section applies to the extent that the property is used by the lessee in the derivation of assessable income or exempt income. Therefore, an adequate rent determined by the Commissioner is deemed payable and is also deemed to have been "incurred" by X for the purpose of section DA 1.

However, in this example, the "exempt income limitation" rule in section DA 2(3) will operate to deny X any deduction, because the expenditure is incurred in deriving exempt income.