

## **INTEREST REPAYMENTS REQUIRED AS A RESULT OF THE EARLY REPAYMENT OF A FINANCIAL ARRANGEMENT – DEDUCTIBILITY**

### **PUBLIC RULING – BR PUB 10/21**

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

### **Taxation Laws**

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

This ruling applies in respect of ss DA 1, DB 6, DB 7, DB 11 and EW 31.

### **The Arrangement to which this Ruling applies**

The Arrangement is as follows:

- A person places an amount of money on term deposit.
- The term deposit is a financial arrangement subject to the financial arrangements rules.
- The term deposit contract provides that the rate of interest payable will be reduced in the event of the withdrawal, in part or in full, of the principal sum before the contractual maturity date.
- The depositor withdraws the whole or part of the term deposit before the contractual maturity date.
- The application of the reduced rate of interest requires the repayment of interest already derived by the depositor or the set-off of interest owed against the principal sum ultimately repaid to the depositor.

### **How the Taxation Laws apply to the Arrangement**

The Taxation Laws apply to the arrangement as follows:

#### ***Full withdrawal of the term deposit***

Where the depositor withdraws the full amount of the term deposit before the contractual maturity date the following applies:

- A base price adjustment is required.
- The amount of repaid interest is included in the “consideration” element of the base price adjustment.
- If the base price adjustment gives rise to a negative amount, that amount is expenditure incurred under the financial arrangements rules.
- Expenditure incurred under the financial arrangement rules is deemed to be interest.
- A deduction may be available under s DB 6 (*Interest: not capital expenditure*) or s DB 7 (*Interest: most companies need no nexus with income*).
- An automatic deduction is allowed under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.

### ***Partial withdrawal of the term deposit***

Where the depositor withdraws part of the amount of the term deposit before the contractual maturity date the following applies:

- A base price adjustment is not required.
- Depositors who are not cash basis persons, and cash basis persons who have elected to adopt a spreading method, must apply Determination G25: *Variations in the Terms of a Financial Arrangement* when the term deposit is varied by the partial withdrawal. The repaid interest is included in the calculation under the determination and an adjustment is made in the year of variation.

#### *Cash basis persons*

- Depositors who are cash basis persons may deduct the repaid interest at the time it is incurred only if the general permission is satisfied. To satisfy the general permission there must be a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers the relationship between the repayment and the interest income earned under the term deposit is insufficient to satisfy s DA 1(1)(a). However, the Commissioner considers that a deduction for the repayment may be available under the general permission, if it can be shown that the expenditure was incurred in the course of carrying on a business for the purposes set out in s DA 1(1)(b).
- If the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with on maturity of the deposit through the base price adjustment.
- The amount of repaid interest is included in both the "consideration" and "expenditure" elements of the base price adjustment.
- If the base price adjustment gives rise to a positive amount, that amount is income derived. However, it is not income to the extent to which it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied.
- Therefore, a positive base price adjustment amount in the final year of the term deposit will be reduced by the amount of interest repaid in the year of partial withdrawal.

### **The period or income year for which this Ruling applies**

This ruling will apply for a three year period beginning on 16 December 2010 and ending on 16 December 2013.

This ruling is signed by me on 16 December 2010.

**Susan Price**

Director, Public Rulings

## COMMENTARY ON PUBLIC RULING – BR PUB 10/21

This commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 10/21 (“the Ruling”). The commentary is not a legally binding statement.

This Ruling is a reissue of BR Pub 97/9, which expired on 31 March 2001. The expired ruling took the view that if a partial withdrawal of a term deposit was to pay a business expense or to apply the amount to derive other assessable income, then the amount of repaid interest was deductible under the general permission at the time of the repayment.

After reconsidering this reissue, the Commissioner takes the view that there is not a sufficient relationship between the repayment of interest and any income to allow a deduction under s DA 1(1)(a) of the Income Tax Act 2007 at the time of the repayment. However, it is accepted that in some cases it may be deductible under s DA 1(1)(b).

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

### Summary

1. A depositor who withdraws funds early may have to repay a portion of the interest previously derived under the term deposit. The issue this ruling and commentary deal with is whether and when the repaid amount is deductible.
2. The fact a depositor may have to repay interest if they withdraw a deposit early does not mean interest they receive during the course of the deposit is not derived by the depositor. At the time of receipt or crediting of interest, the depositor has earned that interest and it is theirs to deal with as they wish. The fact a liability to repay some of that interest may arise later, if certain events occur, does not alter the fact derivation has occurred. Therefore, it is necessary to consider the taxation consequences of the repayment of the interest on the full or partial withdrawal of the term deposit amount.
3. The full withdrawal of a term deposit amount before the contractual maturity date will trigger a base price adjustment (BPA). Where the depositor is required to repay interest previously derived, the amount of repaid interest will be included in the “consideration” element of the BPA. This will generally give rise to a negative BPA amount. A negative BPA amount is expenditure incurred under the financial arrangements rules. Expenditure incurred under the financial arrangements rules is deemed to be interest under s YA 1. A deduction may be available under s DB 6 (*Interest: not capital expenditure*) or s DB 7 (*Interest: most companies need no nexus with income*). An automatic deduction is allowed under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.
4. If a depositor partially withdraws the deposit, there is no maturity of the financial arrangement. Therefore, no BPA is performed. In these circumstances, the deductibility of the repaid interest depends on whether the depositor is a cash basis person.

5. A depositor who is not a cash basis person, or is a cash basis person who has elected to adopt a spreading method, needs to apply Determination G25: *Variations in the terms of a financial arrangement* when the term deposit is varied by the partial withdrawal. The repaid interest will be brought into the Determination G25 calculation and an adjustment made in the year of variation. A BPA is done when the term deposit finally matures.
6. Where a cash basis person does not adopt a spreading method, expenditure incurred during the term of a financial arrangement will be deductible at the time it is incurred only if the general permission is satisfied. To satisfy the general permission there must be a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers the relationship between the repayment and the interest income earned under the term deposit is insufficient to satisfy s DA 1(1)(a). As the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with through the BPA on maturity of the deposit. However, the Commissioner considers that where the expenditure has been incurred in carrying on a business, a deduction may be available under s DA 1(1)(b). Whether the repayment of interest satisfies the nexus test for a business will depend upon the facts of each case.
7. The amount of the repaid interest will be included in both the "consideration" and "expenditure" elements of the BPA calculation. The application of the BPA at maturity will generally result in a positive amount, which reflects the receipt of interest income in the final year of the term deposit.
8. A positive BPA amount is income, except to the extent to which it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied. Thus, the amount of interest income derived in the final year of the term deposit will be reduced by the amount of interest repaid in an earlier year. However, an amount of repaid interest for which a deduction was available will not reduce the amount of interest income derived in the final year of the term deposit. This ensures the depositor returns the correct amount of interest income over the full term of the deposit.

## **Introduction**

9. A term deposit contract will often include a clause that early withdrawal of the principal sum, in whole or in part, will result in a reduced rate of interest, calculated from the date of the initial deposit. In some cases, this means a depositor who withdraws funds early may have to repay a portion of the interest previously derived under the term deposit.
10. For example, assume that on 1 October 2010 a person invests \$10,000 for 12 months at 7%, interest to be credited to the person's bank account six-monthly. Interest of \$350 is paid to the person on 31 March 2011. However, on 1 May 2011 the person decides to withdraw \$5,000 from the term deposit.
11. The term deposit contract states that the rate of interest on the \$5,000 to be withdrawn is reduced to 5% from the date of deposit, 1 October 2010. Therefore, the amount of interest the person should have received in

relation to the \$5,000 withdrawn is \$146 (seven months interest at 5%). The person has already been credited with \$175 in respect of that \$5,000. Therefore, the person owes the bank \$29.

12. This ruling considers the tax consequences of the depositor's repayment of the interest to the bank.
13. Note that, in practical terms, it is unlikely the depositor would physically repay the interest previously derived to the bank. The more common scenario would be for the bank to deduct the amount of interest owed to it from the amount of the principal to be repaid by it. For example, in the above example the person would receive \$4,971 from the bank on early withdrawal (the \$5,000 principal withdrawn less the \$29 interest to be repaid). Whether such a set-off occurs or not, the transaction is treated for tax purposes as the repayment of the interest owed by the depositor and the return by the bank of the full amount of the principal withdrawn early.

### **Application of the legislation**

14. The tax consequences of the arrangement depend upon whether there is a full or partial withdrawal of the deposit early and whether the depositor repaying the interest is a cash basis person. These scenarios are considered below. However, before turning to these scenarios, it is necessary to consider the preliminary issue of whether the interest under the term deposit is fully derived when received or is only conditionally derived to the extent of the amount liable to repayment.

### ***Derivation of interest subject to repayment on early withdrawal***

15. The fact a depositor may have to repay interest if the deposit is withdrawn early does not mean interest received during the course of the deposit is not derived by the depositor. At the time of receipt or crediting of interest, the depositor has earned that interest and it is theirs to deal with as they wish. The fact a liability to repay some of that interest may arise later, if certain events occur, does not alter the fact derivation has occurred.
16. *Bowcock v CIR* (1981) 5 NZTC 61,062 supports this conclusion. Mr Bowcock was an employee who went on study leave but continued to receive his full salary. The terms of the employment bond provided that if he left his employment within four years of the end of his study leave, he would have to repay some of the amount he had received. He did leave within that time, so was required to repay salary in respect of two income years. He tried to deduct these sums from his income tax returns for the two years. In the High Court Mr Bowcock claimed he had never derived the amounts because they were contingent receipts not absolute receipts.
17. Vautier J rejected Mr Bowcock's argument. He said (at page 61,069):

Upon a consideration of the terms of the bond and the course pursued in this case, I am quite unable to come to the conclusion that the moneys which were paid to the objector during the two years in question can be said to have been received by him conditionally in the sense referred to in the judgments in the High Court in [*Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314]. Those moneys clearly in my view became the absolute property of the objector when they were paid. No conditions or stipulations were attached to those payments themselves. They were

clearly received and accepted as of right. Whether or not any liability arose in the future to repay any part of those moneys depended entirely on the course which the objector chose to take.

18. The *Bowcock* principle supports the view that if a taxpayer is liable to repay an amount previously received (for example, for breaching a bond or for the early withdrawal of funds), the repayment of the amount does not change the nature of the original derivation of the funds from absolute to conditional.
19. Vautier J distinguished the decision in *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 in *Bowcock*. *Arthur Murray* concerned whether income had been derived in the first instance, not the situation where income has been derived but may have to be repaid. It is the latter situation that was covered in *Bowcock*, where the court found that the possibility of repayment did not affect the derivation of the income.
20. In the present arrangement, the depositor has an absolute entitlement to the interest under the term deposit at the time it is received. If the depositor later chooses to withdraw funds before the contracted maturity date, the fact an obligation to repay some of the interest received may arise does not affect that entitlement. The interest has been derived and the nature of the derivation of the funds is not changed from absolute to conditional as a result of the repayment.
21. As the interest income is absolutely derived by the depositor, it is now necessary to consider the taxation consequences of the repayment of interest on the full or partial withdrawal of the term deposit amount.

### ***Full withdrawal of the term deposit amount***

22. A term deposit is a financial arrangement under s EW 3. Therefore, the financial arrangements rules apply. When a term deposit is withdrawn in full, the financial arrangement has matured and a BPA is required under s EW 29.
23. Although many depositors are likely to be cash basis persons under the financial arrangements rules and not required to use a spreading method, they are still subject to the financial arrangements rules and must do a BPA if they withdraw the term deposit in full.
24. The formula for calculating a BPA is in s EW 31(5). The formula is:

consideration – income + expenditure + amount remitted

where:

consideration            is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. Non-contingent and non-integral fees are ignored.

income                    is income derived by the person under the financial arrangement in earlier income years.

expenditure is expenditure incurred by the person under the financial arrangement in earlier income years.

amount remitted is an amount that is not included in the consideration paid or payable to the person because it has been remitted by the person or by law.

25. Where a depositor withdraws a term deposit in full before the contracted maturity date and the depositor is required to repay interest derived in a previous income year, the repaid interest will be included in the "consideration" element of the BPA. The result of the BPA calculation will depend on matters such as the time of receipt of the interest payments, the differential in interest rates and the time of the withdrawal of the term deposit amount.
26. Where the BPA calculation gives rise to a negative amount, s EW 31(4) provides that a negative BPA amount is expenditure incurred by a person in the year the calculation is made. Expenditure incurred under the financial arrangements rules is deemed to be interest.
27. A deduction may be available under s DB 6 (*Interest: not capital expenditure*) or s DB 7 (*Interest: most companies need no nexus with income*). Section DB 6 overrides the capital limitation and allows a deduction for interest where the general permission is satisfied. Where the requirements of s DB 7 are satisfied, a company is allowed a deduction for interest expenditure incurred whether or not the expenditure satisfies the general permission. Section DB 7 also overrides the capital limitation, the exempt income limitation and the withholding tax limitation.
28. Section DB 11 supplements the general permission and overrides all the general limitations. An automatic deduction is allowed for the negative BPA amount under s DB 11 to the extent that the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.
29. Where the BPA calculation gives rise to a positive amount, s EW 31(3) provides that the amount is income derived by the person. A positive BPA amount may occur where the depositor derives interest income in the same year as the year in which the withdrawal and repayment of interest occurs. In these circumstances, the BPA calculation ensures that the positive BPA amount is reduced by the amount of the repaid interest.
30. Examples 1 and 2 illustrate the above points:

***Example 1***

On 1 October 2010 Mary (a cash basis person) invests \$10,000 for 12 months at 7%, with interest to be credited to her bank account six-monthly. Interest of \$350 is paid to Mary on 31 March 2011. However, on 1 May 2011 Mary decides to withdraw the full amount of the term deposit.

On the early withdrawal of the \$10,000, the term deposit contract states that the rate of interest is reduced to 5% from the date of deposit, 1 October 2010. Therefore, the amount of interest Mary should have received in relation to the term deposit is \$292 (seven months interest at 5%). As Mary has already been credited with \$350 interest (for the first six months), she owes the bank \$58. The bank sets off the amount of

interest owed against the amount of the principal to be repaid and Mary receives \$9,942.

Mary will have to apply the BPA formula to the term deposit in the 2012 income year as follows:

consideration – income + expenditure + amount remitted

The consideration Mary received is the repayment of the principal amount of \$10,000 and the interest received of \$350. The consideration Mary paid is the original deposit of \$10,000 and the repayment of interest of \$58.

The amount of income Mary derived in earlier income years is \$350.

There is no expenditure from earlier years.

No amount is remitted.

Therefore, the BPA is:

$$\begin{aligned} &(\$10,350 - \$10,058) - \$350 + \$0 + \$0 \\ &= \$292 - \$350 \\ &= -\$58 \end{aligned}$$

The negative BPA amount is expenditure incurred under the financial arrangements rules. Mary has derived income under the financial arrangement in previous income years (\$350) and therefore the negative BPA amount of -\$58 will be deductible to Mary in the income year ending 31 March 2012.

### ***Example 2***

On 1 November 2010 Sally invests \$10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. Interest of \$350 is paid to Sally on 30 April 2011, 30 October 2011 and 30 April 2012. However, on 30 June 2012 Sally decides to withdraw the full amount of the term deposit. Sally has a standard balance date.

On the early withdrawal of the \$10,000, the term deposit contract states that the rate of interest is reduced to 5% from the date of deposit, 1 November 2010. Therefore, the amount of interest Sally should have received in relation to the term deposit is \$833 (20 months interest at 5%). Sally has already been credited with \$1,050 interest, so she owes the bank \$217. The bank sets off the amount of interest owed against the amount of the principal to be repaid and Sally receives \$9,783.

Sally will have to apply the BPA formula to the term deposit in the 2013 income year as follows:

consideration – income + expenditure + amount remitted

The consideration Sally received is the repayment of the principal amount of \$10,000 and the interest received of \$1,050. The consideration Sally paid is the original deposit of \$10,000 and the repayment of interest of \$217.

The amount of income Sally derived in earlier income years is \$700.

There is no expenditure from earlier years.

No amount is remitted.

Therefore, the BPA is:



$$\begin{aligned}
&(\$11,050 - \$10,217) - \$700 + \$0 + \$0 \\
&= \$833 - \$700 \\
&= \$133
\end{aligned}$$

The positive BPA amount is income derived for Sally. The \$133 for the 2013 income year reflects the receipt by Sally of interest income of \$350 on 30 April 2012 and the repayment of interest of \$217.

### ***Partial withdrawal of term deposit amount***

31. If a depositor only partially withdraws the deposit, there is no maturity of the financial arrangement. Therefore, no BPA is performed. In these circumstances, the deductibility of the repaid interest depends on whether the depositor is a cash basis person.
32. Note that this situation assumes the contract between the parties provides that the partial withdrawal of the deposit does not terminate the contract. If the withdrawal results in the existing term deposit contract being terminated and a new term deposit being entered into, a BPA will be required as discussed in paragraph 22 above.

### ***Non-cash basis person***

33. A depositor who is a non-cash basis person needs to apply Determination G25: *Variations in the Terms of a Financial Arrangement* when the term deposit is varied by the partial withdrawal.
34. The formula in Determination G25 is:

$$a - b - c + d$$

where:

- a is the sum of all amounts that would have been income derived by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued
  - b is the sum of all amounts that would have been expenditure incurred by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued
  - c is the sum of all amounts treated as income derived of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year
  - d is the sum of all amounts treated as expenditure incurred of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year.
35. The repaid interest will be brought into the Determination G25 calculation and an adjustment made in the year of variation. When the formula in Determination G25 is calculated, a positive amount is deemed to be income, and a negative amount is deemed to be expenditure incurred. A BPA is done when the term deposit finally matures.

36. Example 3 illustrates this situation:

**Example 3**

On 1 October 2010 Penny invests \$10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. She receives an interest payment of \$350 on 31 March 2011. However, on 1 May 2011 Penny decides to withdraw \$5,000 from the term deposit.

The term deposit contract states that on an early withdrawal the rate of interest is reduced to 5% on the amount of principal withdrawn. The reduced rate applies from the date of the original deposit; in this case, 1 October 2010. Therefore, the amount of interest Penny should have received in relation to the \$5,000 withdrawn is \$146 (seven months interest at 5%). Penny has already been credited with \$175 interest in relation to the \$5,000, so she owes the bank \$29. The bank sets off the amount of interest owed against the amount of the principal to be repaid, and Penny receives \$4,971 on 1 May 2011.

The balance of the principal remains in the term deposit and Penny receives interest payments of \$175 on 30 September 2011 and 31 March 2012. On 30 September 2012, Penny receives \$5,175, being the repayment of the remaining principal and the last interest payment.

Penny is not a cash basis person and has a standard balance date. If she has adopted the straight-line method, the results are as follows:

For the income year ending 31 March 2011, Penny has returned \$350 of income.

For the income year ending 31 March 2012, Penny must apply the formula in Determination G25:

$$a - b - c + d$$

Item a is \$671. This amount is made up of \$525 in respect of the \$5,000 not withdrawn (being \$5,000 at 7% per annum for the 18 month period from 1 October 2010 to 31 March 2012) and \$146 in respect of the \$5,000 withdrawn (being \$5,000 at 5% per annum for the seven months from 1 October 2010 to 1 May 2011).

Item b is nil, because if the changes had been known about at the start of the financial arrangement there would have been no expenditure. There would simply have been less income, which is taken into account in item a.

Item c is \$350.

Item d is nil.

Therefore, applying the Determination G25 formula, the adjustment in the 2012 income year is:

$$\begin{aligned} & \$671 - \$0 - \$350 + \$0 \\ & = \$321 \end{aligned}$$

As the amount is positive, it is deemed to be income Penny derived for the year ending 31 March 2012. Essentially, the formula takes the \$29 of repaid interest and deducts it from the income derived in the 2012 income year.

For the income year ending 31 March 2013, Penny will have to perform a BPA by applying the following formula:

$$\text{consideration} - \text{income} + \text{expenditure} + \text{amount remitted}$$

The consideration Penny received is the \$10,000 principal repaid and the interest payments of \$875 (being \$350 on 31 March 2011 and \$175 on 30 September 2011, 31 March 2012 and 30 September 2012). The consideration Penny paid is the \$10,000 principal invested and the \$29 repaid interest.

The amount of income Penny derived in earlier income years is \$671 (being \$350 in the 2011 income year and \$321 in the 2012 income year).

There is no expenditure incurred in earlier income years.

No amount is remitted.

Therefore, the BPA is:

$$\begin{aligned} &(\$10,875 - \$10,029) - \$671 + \$0 + \$0 \\ &= \$846 - \$671 \\ &= \$175 \end{aligned}$$

As the BPA is positive, it is income derived by Penny. This equates with the interest income received by Penny in the 2013 income year. There is no adjustment for the repaid interest, because it was taken into account in the Determination G25 calculation in the previous income year.

### *Cash basis person*

37. A person is a cash basis person if either:
- the income and expenditure under all the person's financial arrangements for the income year does not exceed \$100,000, or
  - the value of all the person's financial arrangements on every day of the income year does not exceed \$1 million,
- and
- the difference between the accrual treatment and the cash treatment of all the person's financial arrangements does not exceed \$40,000 for the income year.
38. A cash basis person is not required to adopt a spreading method, although they may choose to do so.
39. If a depositor is a cash basis person and adopts a spreading method, they need to apply Determination G25 when the term deposit is varied by the partial withdrawal. This is the same as for a non-cash basis person and is covered in paragraphs 33 to 35 above.
40. Where a cash basis person does not adopt a spreading method, expenditure incurred during the term of a financial arrangement will be deductible when it is incurred if the general permission is satisfied. In the present case, this means the repaid interest on a partial withdrawal would be deductible at the time of the withdrawal, rather than taken into account in the BPA on the eventual maturity of the term deposit.
41. However, to be deductible at the time of the withdrawal, the repaid interest must satisfy the general permission and none of the general limitations must apply.

42. The general permission in s DA 1 provides that a person is allowed a deduction for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred by the person:

- in deriving their assessable income or excluded income or both, or
- in the course of carrying on a business for the purposes of deriving their assessable income or excluded income or both.

43. The leading New Zealand cases on the deductibility of expenditure are the Court of Appeal decisions in *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271. These cases establish that there must be a sufficient nexus between the expenditure incurred and the income earning process in order for the expenditure to be deductible.

44. In delivering the judgment of the court in *Banks*, Richardson J made the following comments (at pages 61,241 and 61,242):

For reasons such as these it seems clear that the application of the first limb must involve an amalgam of considerations. In the Australian cases ... there has been considerable stress on the character of an outgoing in the sense of its being incidental and relevant to the gaining or producing of the assessable income. Statements to that effect emphasise the relationship that must exist between the advantage gained or sought to be gained by the expenditure and the income earning process. They do not, and cannot, specify in concrete terms the kind and degree of connection between the expenditure and the gaining or producing of assessable income required in individual cases for the expenditure to qualify for deduction. ...

Putting it positively, Dixon J. said in *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295, at p. 309 and we respectfully agree:

'The expression "in gaining or producing" has the force of "in the course of gaining or producing" and looks rather to the scope of the operations or activities and the relevance thereto of the expenditure than to purpose in itself.'

It then becomes a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and what it provided, or sought to provide, on the one hand, and the income earning process, on the other, to fall within the words of the section.

45. In *Buckley & Young*, Richardson J stated (at page 61,274):

It is not necessary for the purpose of this case to refer in any detail to the principles of deductibility under those provisions. There are two features of sec. 111 [of the *Land and Income Tax Act 1954*] which are of particular importance in this case. The first is that a deduction is available only where the expenditure has the necessary relationship both with the taxpayer concerned and with the gaining or producing of his assessable income or with the carrying on of a business for that purpose. The heart of the inquiry is the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income earning process. That in turn requires determining the true character of the payment. It then becomes a matter of degree and so a question of fact to determine whether there is a sufficient relationship between the expenditure and what it provided or sought to provide on the one hand, and the income earning process on the other, to fall within the words of the section (*C of IR v Banks* (1978) 3 NZTC 61,236, 61,242). The second feature of sec. 111 is that the statutory language contained in the phrase 'to the extent to which' expressly contemplates apportionment.

46. In relation to the deductibility of expenditure incurred in carrying on a business, in *Cox v CIR* (1992) 14 NZTC 9,164, Williams J in the High Court stated (at p 9,168):

While in jurisdictional terms para (b) is the narrower of the two limbs, it is generally recognised that for business taxpayers it facilitates deductibility in circumstances where a deduction might otherwise not be available under the first limb. This is so because it has been acknowledged in the authorities that the conduct of a business may require expenditures to be made which cannot be directly linked to the derivation of assessable income in some positive way, but which are made to, say, keep the enterprise on foot or to reduce expenditure: see *Europa Oil* (supra) at pp 61,196 and 61,197.

The inclusion of the word "necessarily" in para (b) might mean that the paragraph is intended to be read in a restrictive sense, for example, disallowing deductions unless they are unavoidable or logically necessary for a business. However, the authorities have taken a more pragmatic and commercially realistic approach to business expenditures. Thus it is established by the cases that when compared to the older test laid down in s 111 of the Land and Income Tax Act 1954, s 104 has set a much wider and more commercially realistic test of deductibility of expenditure: *de Pelichet McLeod & Co Ltd v CIR* (1981) 5 NZTC 61,216, 61,219; (1982) 5 TRNZ 622, 626. Moreover, whether an expenditure can be said to be necessarily incurred in the course of carrying on a business must be decided in each case on the facts and by way of a judgment based on common sense and business realities: *Europa Oil (NZ) Ltd* (supra) at p 61,196 and at p 61,197.

47. The Commissioner considers these decisions remain relevant to the interpretation of s DA 1(1). Earlier provisions that correspond to s DA 1(1)(b) referred to "expenditure necessarily incurred in carrying on a business". Section DA 1 preserves that requirement for nexus, notwithstanding that it has removed the word "necessarily". It is the Commissioner's considered view that the word "necessarily" did no more than indicate a requirement that there be a sufficient degree of connection between the expenditure and the business.
48. Applying the principles from these cases requires asking whether there is a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers there is not a sufficient relationship between the repayment and the interest income earned under the term deposit under s DA 1(1)(a). The interest income is earned as a result of lending money. The advantage gained by the repayment is the ability to withdraw early from the term deposit contract, and therefore to cease earning the interest income. The repayment is not a cost of deriving the interest income; it is a cost of ceasing to derive the income. The repayment is a cost to the depositor of not fulfilling the terms of the contract between the bank and the depositor.
49. The repayment of the interest arises because of the depositor's decision to withdraw a portion of their funds before the maturity date. It is incurred solely because the depositor chooses to make a partial withdrawal; it is not incidental or relevant to the deriving of the earlier income.
50. The decision of the Commonwealth Taxation Board of Review in *Case 50* ((1958) 8 C.T.B.R. (N.S.) 250) supports this approach. In *Case 50* the taxpayer was granted leave from his employment to attend university lectures, but he continued to receive his salary for the times he was absent from work, subject to certain conditions. The taxpayer breached those conditions when he later resigned to accept a higher-paid position, so he had to repay some of the salary he had received. The taxpayer claimed a deduction for the amount of salary repaid.

51. The Board of Review denied the deduction. The Board concluded:

7. The liability on the taxpayer to repay the £412 arose directly from his failure to observe the conditions he had agreed to under which he had been paid salary in respect of periods of leave of absence granted to him for the purpose of attending lectures and examinations set down for the course of study undertaken by him.

The outgoing was not incurred by the taxpayer in the course of gaining or producing his assessable income.... The outgoing was not incidental or relevant to the gaining or producing of his assessable income but was incurred solely because of his failure to observe the conditions laid down when the leave was granted to him.

52. Where the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with through the BPA on maturity of the deposit.
53. However, the Commissioner considers that a deduction may be available where the repayment of the interest was incurred in the course of carrying on a business for the purpose of deriving assessable income, or excluded income or a combination of both assessable and excluded income: s DA 1(1)(b). The courts take a pragmatic and commercially realistic approach to business expenditure. Whether there is a sufficient nexus under s DA 1(1)(b) will depend upon the facts of each case. In this situation, s EW 31(3) and the BPA formula ensure that no double deduction can occur.
54. The amount of the repaid interest will be included in both the "consideration" and "expenditure" elements of the BPA calculation. Where a depositor partially withdraws a term deposit early and is required to repay interest derived in a previous income year, the application of the BPA at maturity will generally result in a positive amount. This reflects the receipt of interest income in the final year of the term deposit. Section EW 31(3) provides that a positive BPA amount is income derived by a person in the year the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied. Thus, the amount of interest income derived in the final year of the term deposit will be reduced by the amount of interest repaid in an earlier year. However, an amount of repaid interest for which a deduction was available (under s DA 1(1)(b)) will not reduce the amount of interest income derived in the final year of the term deposit. This ensures the depositor returns the correct amount of interest income over the full term of the deposit.
55. Example 4 illustrates this for a non-business cash basis holder:

***Example 4***

On 1 October 2010 Penny invests \$10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. She receives an interest payment of \$350 on 31 March 2011. However, on 1 May 2011 Penny decides to withdraw \$5,000 from the term deposit.

The term deposit contract states that on an early withdrawal the rate of interest is reduced to 5% on the amount of principal withdrawn. The reduced rate applies from the date of the original deposit; in this case, 1 October 2010. Therefore, the amount of interest Penny should have received in relation to the \$5,000 withdrawn is \$146 (seven months interest at 5%). Penny has already been credited with \$175 interest in relation to the \$5,000, so she owes the bank \$29. The bank sets off the amount of interest owed against the amount of the principal to be repaid, and Penny receives \$4,971 on 1 May 2011.

The balance of the principal remains in the term deposit and Penny receives interest payments of \$175 on 30 September 2011 and 31 March

2012. On 30 September 2012, Penny receives \$5,175, being the repayment of the remaining principal and the last interest payment.

These are the same facts as in Example 3 above, except that in the current example Penny is a cash basis person who chooses not to adopt a spreading method. Therefore, in this example, the results are as follows:

For the income year ending 31 March 2011, Penny will have returned income of \$350.

For the income year ending 31 March 2012, Penny will have returned income of \$350 (being the interest payments of \$175 on 30 September 2011 and 31 March 2012). She will not be able to claim a deduction for the \$29 repaid interest on 1 May 2011.

For the income year ending 31 March 2013, Penny will have to perform a BPA by applying the following formula:

$$\text{consideration} - \text{income} + \text{expenditure} + \text{amount remitted}$$

The consideration Penny received is the \$10,000 principal repaid and the interest payments of \$875 (being \$350 on 31 March 2011, and \$175 on 30 September 2011, 31 March 2012 and 30 September 2012). The consideration Penny paid is the \$10,000 principal invested and the \$29 repaid interest.

The amount of income derived in earlier income years is \$700 (being \$350 in each of the 2011 and 2012 income years).

The expenditure incurred in earlier income years is \$29, being the amount of repaid interest.

There is no amount remitted.

Therefore, the BPA is:

$$\begin{aligned} &(\$10,875 - \$10,029) - \$700 + \$29 + \$0 \\ &= \$846 - \$700 + \$29 \\ &= \$175 \end{aligned}$$

As the BPA is positive, it is income Penny derived. However, it is not income to the extent to which it arises from expenditure incurred in earlier years and for which a deduction was denied. A deduction was denied for the \$29 repaid interest in the 2012 income year, so the positive BPA is reduced by that amount. Therefore, in the 2013 income year, Penny derives income of \$146. This amount equates to the interest payment of \$175 received on 30 September 2012, reduced by the interest repaid on 1 May 2011.

## Appendix – Legislation

56. Section DA 1(1) and (2) reads:

### *Nexus with income*

- (1) 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.

### *General permission*

- (2) Subsection (1) is called the **general permission**.

57. Section DA 2(1) reads:

### *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**.

58. Section DB 6(1) and (4) reads:

### **DB 6 Interest: Not capital expenditure**

#### *Deduction*

- (1) A person is allowed a deduction for interest incurred.

...

#### *Link with subpart DA*

- (4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

59. Section DB 7(1), (2) and (8) reads:

### **DB 7 Interest: Most companies need no nexus with income**

#### *Deduction*

- (1) A company is allowed a deduction for interest incurred.

#### *Exclusion: Qualifying company*

- (2) Subsection (1) does not apply to a qualifying company.

...

#### *Link with subpart DA*

- (8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

60. Section DB 11 reads:

### **DB 11 Negative base price adjustment**

#### *Deduction*

- (1) A person who has a negative base price adjustment under section EW 31(4) (Base price adjustment formula) is allowed a deduction for the expenditure to the extent to which it arises from assessable income, under section CC 3



(Financial arrangements), derived by the person under the financial arrangement in earlier income years.

*Link with subpart DA*

- (2) This section supplements the general permission and overrides all the general limitations.

61. Section EW 3(2) and (3) reads:

*Money received for money provided*

- (2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—
- (a) at a future time; or
  - (b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

*Examples of money received for money provided*

- (3) Without limiting subsection (2), each of the following is a financial arrangement—
- (a) a debt, including a debt that arises by law:
  - (b) a debt instrument:
  - (c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:
  - (d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

62. Section EW 29(3) reads:

*Maturity*

- (3) A party to a financial arrangement must calculate a base price adjustment as at the date on which the arrangement matures.

63. Section EW 31 contains the base price adjustment formula and states:

**EW 31 Base price adjustment formula**

*Calculation of base price adjustment*

- (1) A person calculates a base price adjustment using the formula in subsection (5).

*When formula applies*

- (2) The person calculates the base price adjustment for the income year in which section EW 29 applies to them.

*Positive base price adjustment*

- (3) A base price adjustment, if positive, is income, under section CC 3 (Financial arrangements), derived by the person in the income year for which the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred by the person under the financial arrangement in earlier income years and for which a deduction was denied in those income years.

*Negative base price adjustment*

- (4) A base price adjustment, if negative, is expenditure incurred by the person in the income year for which the calculation is made. The person is allowed a deduction for the expenditure under section DB 11 (Negative base price adjustment).

*Formula*

- (5) The formula is—

consideration – income + expenditure + amount remitted

*Definition of items in formula*

- (6) The items in the formula are defined in subsections (7) to (11).

*Consideration*

- (7) **Consideration** is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. For the purposes of this subsection, the following are ignored:
- (a) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D;
  - (b) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D.

*Consideration in particular cases*

- (8) If any of sections EW 32 to EW 48 applies, the consideration referred to in subsection (7) is adjusted under the relevant section.

*Income*

- (9) **Income** is—
- (a) income derived by the person under the financial arrangement in earlier income years; and
  - (b) dividends derived by the person from the release of the obligation to repay the amount lent; and
  - (c) income derived under section CF 2(2) and (3) (Remission of specified suspensory loans).

*Expenditure*

- (10) **Expenditure** is expenditure incurred by the person under the financial arrangement in earlier income years.

*Amount remitted*

- (11) **Amount remitted** is an amount that is not included in the consideration paid or payable to the person because it has been remitted—
- (a) by the person; or
  - (b) by law.

64. Section EW 54 reads:

**EW 54 Meaning of cash basis person**

*Who is cash basis person*

- (1) A person is a **cash basis person** for an income year if—
- (a) 1 of the following applies in the person's case for the income year:
    - (i) section EW 57(1); or
    - (ii) section EW 57(2); and
  - (b) section EW 57(3) applies in the person's case for the income year.

*Persons excluded by Commissioner*

- (2) A person may be excluded under section EW 59 from being a cash basis person for a class of financial arrangements.

65. Section EW 55 reads:

**EW 55 Effect of being cash basis person**

*Use of spreading method*

- (1) A cash basis person is not required to apply any of the spreading methods to any of their financial arrangements, but may choose to do so under section EW 61.

*Calculation of base price adjustment*

- (2) The fact that a cash basis person does not use any of the spreading methods for the financial arrangement does not excuse them from the requirement to calculate a base price adjustment when any of section EW 29(1) to (12) applies to them.

66. Section EW 57 reads:

## EW 57 Thresholds

### *Income and expenditure threshold*

- (1) For the purposes of section EW 54(1)(a)(i), this subsection applies if the absolute value of the person's income and expenditure in the income year under all financial arrangements to which the person is a party is \$100,000 or less.

### *Absolute value threshold*

- (2) For the purposes of section EW 54(1)(a)(ii), this subsection applies if, on every day in the income year, the absolute value of all financial arrangements to which the person is a party added together is \$1,000,000 or less. The value of each arrangement is,—
- (a) for a fixed principal financial arrangement, its face value;
  - (b) for a variable principal debt instrument, the amount owing by or to the person under the financial arrangement;
  - (c) for a financial arrangement to which the old financial arrangements rules apply, the value determined under those rules.

### *Deferral threshold*

- (3) For the purposes of section EW 54(1)(b), this subsection applies if the result of applying the formula in subsection (4) to each financial arrangement to which the person is a party at the end of the income year and adding the outcomes together is \$40,000 or less.

### *Formula*

- (4) The formula is—
- $$(\text{accrual income} - \text{cash basis income}) + (\text{cash basis expenditure} - \text{accrual expenditure})$$

### *Definition of items in formula*

- (5) The items in the formula are defined in subsections (6) to (9).

### *Accrual income*

- (6) **Accrual income** is the amount that would have been income derived by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:
- (a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
  - (b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
  - (c) an alternative method approved by the Commissioner.

### *Cash basis income*

- (7) **Cash basis income** is the amount that would have been income derived by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

### *Cash basis expenditure*

- (8) **Cash basis expenditure** is the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

### *Accrual expenditure*

- (9) **Accrual expenditure** is the amount that would have been expenditure incurred under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:

- (a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
- (b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
- (c) an alternative method approved by the Commissioner.

*Increase in specified sums*

- (10) The Governor-General may make an Order in Council increasing a sum specified in any of subsections (1) to (3).

67. In s YA 1, the definitions of “interest”, “maturity”, “non-contingent fee”, and “non-integral fee” read:

**interest,—**

...

- (c) in sections DB 6 (Interest: not capital expenditure), DB 7 (Interest: most companies need no nexus with income), and DB 8 (Interest: money borrowed to acquire shares in group companies),—
  - (i) includes expenditure incurred under the financial arrangements rules or the old financial arrangements rules

...

**maturity,—**

- (a) in the financial arrangements rules, means,—
  - (i) for an agreement for the sale and purchase of property or services or an option, the date on which the agreement or option ends:
  - (ii) for any other financial arrangement, the date on which the last payment contingent on the financial arrangement is made:

...

**non-contingent fee** means a fee that—

- (a) is for services provided for a person becoming a party to a financial arrangement; and
- (b) is payable whether or not the financial arrangement proceeds

**non-integral fee** means a fee or transaction cost that, for the purposes of financial reporting under IFRSs, is not an integral part of the effective interest rate of a financial arrangement