TAX INFORMATION BULLETIN

Volume Twelve, No 5 May 2000

Contents

Invitation to comment on drafts 3

Binding rulings

Notice of extension of public ruling 4

Relationship between the "unit trust" and "qualifying trust" definitions 4
Notice of non-renewal of public ruling BR Pub 95/5A

Bad debts – writing off debts as bad for GST and income tax purposes. Public ruling – BR Pub 00/03 5

Product ruling – BR Prd 00/03 17

Product ruling – BR Prd 00/04 21

Interpretation statements

Matrimonial property agreements– GST implications. Notice of withdrawal 25

Financial planning fees – income tax deductibility 26

Standard practice statements

Tape-recording Inland Revenue interviews INV-330 47

Questions we've been asked

Tax residence and eligibility of migrants for returning residents' visas 51

Shortfall penalties for failure to deduct or account for PAYE 51
Sections 3, 4A(4) and 141A–141E of the Tax Administration Act 1994

Regular features

Due dates reminder 55

Your chance to comment on draft taxation items before they are finalised 57

This TIB has no appendix.

ISSN 0114-7161

Inland Revenue
Te Tari Taake

GET YOUR TIB SOONER BY INTERNET

This *Tax Information Bulletin* is also available on the Internet, in two different formats:

Online TIB (HTML format)

- This is the better format if you want to read the *TIB* onscreen (single column layout).
- Any references to related *TIB* articles or other material on our website are hyperlinked, allowing you to jump straight to the related article. This is particularly useful when there are subsequent updates to an article you're reading, because we'll retrospectively add links to the earlier article.
- Individual *TIB* articles will print satisfactorily, but this is not the better format if you want to print out a whole TIB.
- All *TIBs* from January 1997 onwards (Vol 9, No 1) are available in this format.

Online *TIB* articles appear on our website as soon as they're finalised—even before the whole *TIB* for the month is finalised at mid-month.

Printable TIB (PDF format)

- This is the better format if you want to print out the whole *TIB* to use as a paper copy—the printout looks the same as this paper version.
- You'll need Adobe's Acrobat Reader to use this format—available free from their website at:

  www.adobe.com
- Double-column layout means this version is better as a printed copy—it's not as easy to read onscreen.
- All *TIBs* from July 1989 (the start of the *TIB*) are available in this format.

Where to find us

Our website is at:

www.ird.govt.nz

It has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available, and many of our information booklets.

If you find that you prefer the *TIB* from our website and no longer need a paper copy, please let us know so we can take you off our mailing list. You can email us from our website.

THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

Inland Revenue produces a number of statements/rulings aimed at explaining how taxation law affects taxpayers and their agents.

Because we are keen to produce items that accurately and fairly reflect taxation legislation, and are useful in practical situations, your input into the process—as perhaps a "user" of that legislation—is highly valued.

The following items/draft items are available for review/comment this month, having a deadline of 30 June 2000. Please see page 57 for details on how to obtain a copy:

Ref.	**Type**	**Description**
ED 0014	Draft standard practice	**Offsetting and transferring refunds.** The deadline for comment on this draft standard practice statement has been extended from 31 May to 30 June 2000. This draft standard statement practice statement states the Commissioner's practice on the way Inland Revenue offsets and transfers refunds to accounts, whether they be to another period within the same revenue, to another revenue, or to another taxpayer.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates tax liability based on it.

For full details of how binding rulings work, see our information booklet *Guide to Binding Rulings IR 715* or the article on page 1 of *Tax Information Bulletin* Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995). You can order these publications free of charge by downloading them from our website at **www.ird.govt.nz**

NOTICE OF EXTENSION OF PUBLIC RULING

1. This is a notice of extension of a public ruling made under section 91DD of the Tax Administration Act 1994.

2. Public ruling No 97/10 entitled "Importers and GST input tax deductions" was signed on 22 October 1997 and notice of its making appeared in the *Gazette* of 30 October 1997. A copy of the ruling appeared in Inland Revenue's *Tax Information Bulletin* Vol 9, No 11 (November 1997).

3. Public ruling No 97/10 originally applied to claims for input tax deductions on GST levied by the New Zealand Customs Service on goods imported into New Zealand between 1 April 1997 and 31 March 2000. The ruling now applies to claims for input tax deductions between 1 April 2000 and 31 March 2005.

Martin Smith

General Manager (Adjudication & Rulings)

RELATIONSHIP BETWEEN THE "UNIT TRUST" AND "QUALIFYING TRUST" DEFINITIONS

Notice of non-renewal of public ruling BR Pub 95/5A

Ruling number and publication details: BR Pub 95/5A appeared in Vol 8, No 10 (December 1996) of Inland Revenue's *Tax Information Bulletin* at page 15.

Ruling title: Relationship between the "unit trust" and "qualifying trust" definitions.

Ruling application period: Applies from the 1997—98 income year to the 1999—2000 income year.

Date of this notice: 20 April 2000.

The Commissioner has determined that upon expiry the above-referenced public ruling will not be re-issued.

It is considered that the legislation on the subject matter covered by the ruling is clear.

The non-renewal of the ruling should not be taken as indication of change to the interpretation of the legislation as set out in the ruling. The Commissioner's view on the issue remains the same.

Martin Smith

General Manager (Adjudication & Rulings)

BAD DEBTS—WRITING OFF DEBTS AS BAD FOR GST AND INCOME TAX PURPOSES

PUBLIC RULING—BR Pub 00/03

Note (not part of ruling): This Ruling is essentially the same as public ruling BR Pub 96/3A, published in *Tax Information Bulletin* Vol 8, No 10 (December 1996), but this Ruling's period of application is from 1 April 1999 to 31 March 2004. Some formatting changes have also been made. BR Pub 96/3A applies up until the end of the 1998—1999 income year.

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

Taxation Laws

All legislative references to the Income Tax Act are to the Income Tax Act 1994 and all references to the GST Act are to the Goods and Services Tax Act 1985.

This Ruling applies in respect of section DJ 1(a)(iii) of the Income Tax Act and section 26(1)(c) of the GST Act.

The Arrangement to which this Ruling applies

The Arrangement is the writing off of a debt (or part of a debt) as a bad debt, for income tax and/or GST purposes, in the following circumstances:

- An existing debt is owing to the taxpayer; and
- The debt is adjudged as "bad" when, having considered the facts objectively, a reasonably prudent business person would conclude that there is no reasonable likelihood that the debt will be paid; and
- The records kept by the taxpayer comply with the record keeping requirements contained in the Tax Administration Act 1994 and the GST Act; and
- The bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer, involving, at a minimum, write-off:
    - in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, by an authorised person making the appropriate entry in that system recording the debt as written off; and
    - in the case of a company (other than one falling within the above class), by an executive or other responsible officer of the company with the authority to do so, making the appropriate bookkeeping entries in the books of account of the company recording the debt as written off; and
    - in the case of a taxpayer (other than a company) that maintains double-entry accounts, by an authorised person making the appropriate bookkeeping entries in the books of account of the business recording the debt as written off; and
    - in the case of a taxpayer who is an unincorporated sole trader or small unincorporated business taxpayer who does not maintain double-entry accounts, by the taxpayer noting, in the bookkeeping records of the taxpayer setting out the amount owed by the bad debtor, that the debt has been written off, and the date of the writing off.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

1. An income tax deduction is permitted in terms of section DJ 1(a)(iii) of the Income Tax Act.
2. A deduction from GST output tax is permitted in terms of section 26(1)(c) of the GST Act.

The period for which this Ruling applies

This Ruling will apply for the period 1 April 1999 to 31 March 2004.

This Ruling is signed by me on the 20th day of April 2000.

Martin Smith

General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 00/03

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 00/03 ("the Ruling").

Background

The Income Tax Act and the GST Act allow taxpayers and/or registered persons a deduction for bad debts if certain criteria are met. Criteria common to both Acts are the requirements that a debt must be both bad and written off before any deduction can be made. The issues that arise when claiming a bad debt deduction are: when a debt is considered bad, and what is required to write off a debt as bad.

These issues were previously dealt with in public ruling BR Pub 96/3A and that ruling has been replaced by this Ruling from 1 April 1999. The previous ruling concluded that a debt (or part of a debt) must be both bad and written off before any person can claim an income tax deduction or a deduction from GST output tax (assuming that other legislative requirements in the GST Act and the Income Tax Act are also satisfied).

The Ruling sets out the tests to apply in deciding whether or not a debt is "bad" and what is sufficient "writing off" of a bad debt.

Legislation—Income Tax Act

Section BD 2(1)(b) allows a deduction for any expenditure or loss incurred by a taxpayer in deriving the taxpayer's gross income or necessarily incurred in carrying on a business for the purpose of deriving the taxpayer's gross income.

However, notwithstanding section BD 2(1)(b), section DJ 1(a) prohibits the deduction of bad debts, except where and to the extent that a number of requirements are met.

Section DJ 1

The relevant part of section DJ 1 of the Income Tax Act, in force at the date of commencement of this Ruling (1 April 1999), states:

> Except as expressly provided in this Act, no deduction is allowed to a taxpayer in respect of any of the following sums or matters:
>
> (a) Bad debts, except where and to the extent that,—
>
> (i) In the case of a debt which is an amount owing to the taxpayer in respect of a financial arrangement where the accruals rules apply to the taxpayer in respect of the financial arrangement, a deduction is allowed under section EH 5; and
>
> (ii) In any case other than that of a debt which is an amount owing to the taxpayer in respect of a financial arrangement where the accruals rules apply to the taxpayer in respect of the financial arrangement, the bad debt is not a loss of capital subject to section BD 2(2)(e); and
>
> (iii) The debt is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year; and
>
> (iv) In any case where-
>
> (A) The taxpayer is a company; and
>
> (B) The debt is owed by a company (referred to in this subparagraph as the "debtor"); and
>
> (C) The application of the amount giving rise to the debt is taken into account in calculating a net loss (referred to in this subparagraph as the "resultant loss") of the debtor or any other company funded (directly or indirectly) by the debtor; and
>
> (D) Any one or more amounts have been offset under section IG 2 of this Act or section 191A of the Income Tax Act 1976 by the taxpayer (or by any other company which is at any time in the income year in which the resultant loss is incurred in the same group of companies as the taxpayer), in any income year commencing on or after 1 April 1993 and preceding the income year in which the bad debt is written off, in respect of the resultant loss,—
>
> the debt exceeds the aggregate of the amounts so offset.

Section DJ 1(a)(iii) sets out one of the requirements to be satisfied to get a bad debt deduction, namely that the debt must be proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year. It is this part of the income tax bad debt deduction provision that is addressed in the Ruling and discussed more fully in the *Application of the legislation* section of this commentary.

Other section DJ 1(a) requirements (in summary form) that must also be satisfied are:

- Section DJ 1(a)(i)—If the debt is an amount owing under a financial arrangement and the accruals rules apply to the taxpayer in respect of the financial arrangement, a deduction must be allowed under section EH 5. However, any such bad debt deduction is still conditional on satisfaction of the section DJ 1(a)(iii) requirement that the debt is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year. **[NOTE:** *The accruals rules have recently been rewritten by*

the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. Section DJ 1 as set out above has also been amended with effect from 20 May 1999 to take account of consequential changes made by that Act. A more detailed discussion about bad debts that arise where the accruals rules apply, and the changes made by the above Act, appears at the end of this commentary.]; and

- Section DJ 1(a)(ii)—If the debt is **not** an amount owing in respect of a financial arrangement to which the accruals rules apply, the bad debt must not be a loss of capital that is subject to section BD 2(2)(e); and
- Section DJ 1(a)(iv)—If the taxpayer is a company and the debt is owed to that company by another company ("the debtor") and
  - the amount giving rise to the debt is taken into account in calculating a loss incurred by the debtor or any other company funded by the debtor; and
  - any amounts of that loss have been offset under the group company loss offset provisions in section IG 2, or section 191A of the Income Tax Act 1976, by the taxpayer (or any other company in the same group as the taxpayer in the year the loss is incurred), in any income years from 1993—94 and preceding that in which the bad debt is written off,

  the deduction allowed for the bad debt is the amount by which the debt exceeds the total amounts offset.

Bad debts recovered

Under section CE 1(1)(d), amounts received by a person on account of a bad debt for which a deduction has previously been allowed to the person are included as gross income of the person.

Legislation—GST Act

Section 26

The relevant part of section 26(1) of the GST Act states:

> Where a registered person -
>
> (a) Has made a taxable supply for consideration in money; and
>
> (b) Has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and
>
> (c) Has written off as a bad debt the whole or part of the consideration not paid to that person,-
>
> that registered person shall make a deduction under section 20(3) of this Act of that portion of the amount of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

Section 26 is the main provision applying to bad debts for GST purposes. The section applies to registered persons who account for GST on an invoice or hybrid basis. It also applies to registered persons who account for GST on a payments basis when the relevant supply is by way of a hire purchase sale or a door-to-door sale.

Section 26(1) allows a registered person to make a deduction from output tax for that portion of the amount of tax charged in relation to a supply as the amount written off as a bad debt bears to the total consideration for the supply. To claim the deduction, the registered person must satisfy a number of criteria. Section 26(1)(c) sets out one of these, namely that the registered person must have written off as a bad debt the whole or part of the consideration not paid to that person.

The other section 26(1) criteria (in summary form) also to be satisfied are that the registered person must have:

- Section 26(1)(a)—Made a taxable supply for consideration in money (from which the bad debt arose); and
- Section 26(1)(b)—Furnished a return in relation to the taxable period during which the output tax on the supply was attributable, and properly accounted for the output tax on the supply.

A proviso is effective if goods are supplied under a hire purchase agreement to which the Hire Purchase Act 1971 applies. In this case the registered person makes a deduction from output tax of the tax fraction (being the tax fraction applicable at the time the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement.

A special provision exists for registered persons who supply contracts of insurance relating to earthquakes, wars, and fires (see section 26(1A)).

Application of the legislation

As indicated earlier, criteria common to both the Income Tax and GST Acts are the requirements that a debt must be both bad and actually written off before any deduction can be made. This section of the commentary is therefore divided into two parts, discussing firstly the tests to apply in deciding whether or not a debt is "bad", and secondly what is sufficient "writing-off" of a bad debt.

First requirement–debt must be "bad"

A debt must be "bad" before it can be written off and before any deduction can be claimed for that debt. Whether or not a debt (or part of a debt) is bad is a question to be determined objectively, rather than a question to be determined by the subjective opinion of any particular individual. The objective test that any person should ask himself or herself in deciding whether or not a debt is bad, is whether a reasonably prudent business person would conclude that there is no reasonable likelihood that the debt will be paid.

This objective test was outlined by Tompkins J in the High Court decision of *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263, at 12,269:

> The term "bad debt" is not defined in the Act. It, therefore, should be given its normal commercial meaning. It is a question of fact to be determined objectively. A debt becomes a bad debt when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid in whole or in part by the debtor or by someone else either on behalf of the debtor or otherwise.

A similar test was outlined by Barber DJ in *Case N69* (1991) 13 NZTC 3,541, at 3,548:

> Naturally, the debts in question must be "bad" to be written off as bad in terms of s. 106(1)(b). This is a question of fact. Generally, an application of that criterion will not be difficult as the debtor will be insolvent. However, the debtor does not need to be insolvent for the debt to be bad. It is only necessary that there be a bona fide assessment that the debtor is unlikely to make payment of the debt. If there is a clear understanding or arrangement that there be long term credit, and if the taxpayer believes that the terms of the credit will be met, then the debt cannot be treated as bad because it is merely a situation of deferred payment. In my view, as well as the need for the writing off to be made bona fide, the circumstances must indicate to a reasonable and prudent business person that, on the balance of probability, the debt is unlikely to be recovered. This is an objective test.
>
> The creditor taxpayer may, of course still hope for recovery and is quite entitled to institute recovery procedures. It is not necessary to have taken recovery or legal steps. ... It does not follow from the taxpayer hoping for or seeking recovery that a debt is not bad. However, usually, when a debt is assessed as bad, in terms of the type of criteria I have outlined, hopes or efforts of recovery will be futile.

The decision in *Case N69* was cited with approval by Doogue J in the High Court decision of *Graham v CIR, Edwards Graham Ltd & Edwards v CIR* (1995) 17 NZTC 12,107, at 12,111.

As is evident from the quotations above, different wording is used by the High Court in *Budget Rent A Car* and the TRA in *Case N69* to describe the test of when a debt can be considered written off as bad. To summarise these differences, in *Budget Rent A Car* the words used were "**no reasonable likelihood**" that the debt (or part of the debt) will be paid, whereas in *Case N69* the words used were that "**on the balance of probability, the debt is unlikely to be recovered**".

Despite the apparent difference between the words used in the tests applied in *Case N69* and in *Budget Rent A Car*, Barber DJ in *Case T27* (1997) 18 NZTC 8,188, at 8,194 stated that his approach in *Case N69* was confirmed in *Budget Rent A Car*. In saying this Barber DJ first cited his own statement containing the test referred to from *Case N69* and immediately followed this by stating:

> That approach was confirmed in *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 and on that point Tompkins J said at 12,269:

and then citing the objective test from that case included above. Barber DJ regards the "tests" as the same. The Commissioner agrees with this view.

At the time of deciding whether a debt is bad, a person will therefore need to have sufficient information to enable a reasonably prudent business person to form the view that there is no reasonable likelihood that the debt will be paid. The facts needing to be gathered depend on the circumstances surrounding any particular case. While no factor is decisive in itself, factors that are likely to be relevant in most instances are:

- The length of time a debt is outstanding – the longer a debt is outstanding the more likely it is that a reasonably prudent business person would consider the debt to be bad.
- The efforts that a creditor has taken to collect a debt – the greater the extent to which a person has tried (unsuccessfully) to collect a debt, the more likely it is that a reasonably prudent business person would consider the debt to be bad.
- Other information obtained by a creditor - a creditor may have obtained particular information about a debtor, eg through business or personal networks, that would be a factor in leading a reasonably prudent business person to conclude that a debt is bad. For example, a creditor may know that the debtor is in financial difficulties and has defaulted on debts owed to other creditors.

A debtor does not need to be insolvent for a debt to be bad (although this will often be the case).

Taxpayer's opinion

A debt becomes a bad debt when a reasonably prudent business person objectively concludes that there is no reasonable likelihood that the debt will be paid. In many instances, a taxpayer's considered opinion will suffice.

However, the Commissioner also recognises that taxpayers have a financial interest in treating a debt as bad. Writing off a debt as bad entitles a taxpayer to:

- A deduction in calculating income for income tax purposes, worth up to 39% of the debt, depending on the taxpayer's marginal income tax rate:
- A GST deduction from output tax of the tax fraction of the debt.

Because of this, the Commissioner may inquire into the decision to treat a debt as bad in the course of tax audits or other enquiries. It is desirable, therefore, that taxpayers document and retain evidence in relation to their decisions to treat debts as bad to show that they made reasonable decisions. Documentation may include noting down the information from which the decision was made that the debt was bad, and keeping copies of any correspondence relating to the debt.

Information required

The amount of information required to decide whether a debt is bad depends on the particular circumstances of each case. If the amount involved is small, a reasonably prudent business person is likely to make limited enquiries and take limited recovery action. Particular knowledge or information obtained by a taxpayer may also reduce the need for enquiry. In the final analysis however, the test is always whether the taxpayer has sufficient information to reasonably draw the conclusion that there is no reasonable likelihood that the debt will be paid, even if further or any recovery action were to be taken.

Recovery action

A creditor is likely to have taken recovery action in most cases before a deduction for a bad debt is made, although it is not a requirement that such action be taken before a decision is made that a debt is bad. However, it is through taking recovery action that most creditors will form an opinion as to whether a debt is bad. While recovery action is being taken, a debt can only be considered bad to the extent that a reasonably prudent business person would consider there is no reasonable likelihood that the debt will be paid.

In some instances, taking recovery action may carry with it the reasonable expectation of recovery of some part of the amount involved. However, this will not always be the case. The decision to take recovery action and the extent of that action will depend on the circumstances surrounding any particular case. In some cases, the creditor may take no or only limited recovery action because enough information is held to form a reasonable view that the debt is bad. The amount of information needed depends on the circumstances.

Conversely, the creditor may take recovery action even when a reasonable view has been formed that the debt is bad. For a number of reasons the creditor might take recovery action even when it is believed that there is no reasonable likelihood that the debt will be recovered. This may be the case, for example, when the creditor has a policy of pursuing debtors to a certain extent to discourage customers defaulting on debt.

Provision for doubtful debts

Persons in business who provide credit often find it prudent to make some provision for the likelihood that some of their debtors will not pay. This allowance is generally calculated by estimating a percentage on the basis of past history, and applying that percentage to the total amount of debts owed to the business at balance date.

Bad debts are individually identifiable debts that are unlikely to be recovered (in practical terms). The provision for doubtful debts is an estimate of the amount that will become bad debts in the future. The Income Tax Act and the GST Act do not allow any deduction for provisions for doubtful debts.

Debts that are partially bad

In some cases there may be no reasonable expectation that the debt will be fully recovered, but there may be a reasonable expectation of partial recovery. In this case the part that the creditor has no reasonable expectation of recovering is a bad debt. It is only that part of the debt that the creditor is entitled to write off as bad and claim as a deduction for income tax and GST purposes.

Examples of when a debt is/is not bad

Example 1

A supplier has supplied goods on credit to Mr B. Mr B owes the supplier $2,000 for the goods. The supplier knows that Mr B has left town, and that mail addressed to him is returned marked "Gone No Address".

In this case it is reasonable to assume that the debt will not be recovered. The money owed by Mr B is a bad debt.

Example 2

C owes $100,000 to a company. The credit controller for the company has considered the likelihood of default on every loan currently owing to the company. The credit controller has estimated the likelihood of default for C to be 5%, and wants to know if the company can consider $5,000 of that loan (5% of the $100,000 owing) to be a bad debt.

Making an estimate of the likelihood of default on debts is not sufficient for a debt (or a percentage thereof) to be bad. It is not reasonable to assume that the debt is bad.

Example 3

A local dairy has supplied $64 worth of bread and cigarettes to Mrs D on credit. Mrs D used to call into the shop every other day, but has not called into the shop for eight weeks and the dairy has heard that someone else is living in the house Mrs D used to rent. The $64 is still owing.

Given the relatively small amount owing and the information known to the dairy, it is reasonable for the dairy to make no further enquiries. On the basis of the dairy's information, it can be assumed that the money is unlikely to be recovered. It is a bad debt. However, if the sum involved was somewhat larger, it may be reasonable to expect the dairy to make some further enquiry.

Example 4

A solicitor has done work for Mr O and billed him for $1,700. The solicitor is on the Board of Trustees of the school attended by Mr O's children. The solicitor has sent out a number of reminder bills because the bill is four months overdue, but has had no response. Several of the solicitor's friends and associates have mentioned that Mr O is in financial difficulty and has had one of his vehicles repossessed. The solicitor's office clerk has noted that Mr O's name has been cited in the *Gazette* several times over recent months in respect of court action for unpaid debts.

It is reasonable for the solicitor to characterise Mr O's debt as a bad debt.

Example 5

A debtor of Mr F is a company in liquidation. Mr F has given the liquidator notice of a debt of $10,000 owed for goods and services supplied. Mr F is an unsecured creditor. The liquidator has held a meeting of creditors. Mr F attended the meeting and received formal notice of the outcome of the meeting. The liquidator has stated that unsecured creditors will probably receive something between 45 and 50 cents in the dollar.

It is reasonable for Mr F to assume that $5,000 of the total debt is bad. He is entitled to write off that part of the debt that is bad in the income year in which he received the formal notice, and to claim a deduction for income tax and GST purposes.

Example 6

The same facts exist as in Example 5, but at a later date Mr F receives a letter from the liquidator who advises that the estimate of the likely recovery has been revised. It is now expected that unsecured creditors will be paid between 70 and 75 cents in the dollar.

This does not affect the answer given above in Example 5. Also, it has no effect on Mr F's GST return or income tax return if Mr F has claimed a deduction for the bad debt. If at any stage Mr F receives payment of any part of the 50 cents in the dollar written off, Mr F must:

- include it as gross income in the income tax return for the year in which it is received (this will give rise to an income tax liability unless there are losses to offset against it, and may give rise to a provisional tax liability, depending on the taxpayer's circumstances); and
- account for GST on the amount recovered in the same proportion as Mr F was allowed a deduction from output tax when the bad debt was written off.

Second requirement–debt must be "written off"

The Income Tax Act and the GST Act allow taxpayers and/or registered persons deductions for writing off bad debts. It is not enough that a debt is bad: the bad debt must also be actually written off. Writing off the bad debt is important because this will fix the time at which the deduction can be made. Note that there is no requirement that a debt be written off in the year it becomes bad. As Tompkins J in the High Court decision of *Budget Rent A Car Ltd v CIR* (supra) at 12,271 stated:

> A debt is not normally deductible. It does not become a deductible debt if and when it becomes a bad debt. It becomes a deductible debt, if it has been incurred in the production of assessable income, when it is written off. It is the writing off that converts the debt into a deductible debt. It follows that the crucial time is the time of the writing off, not the time the debt becomes a bad debt. It also follows that the income year referred to in s 106(1)(b) is not the year the debt became bad. In my view, the income year referred to is the year during which the bad debt was "actually written off".
>
> There is no provision in the Act that requires the bad debt to be written off in the year the debt became bad. Had that been the intention of the legislature, it would have said so ...

Barber DJ in the Taxation Review Authority discussed the requirement to write off bad debts in *Case N69* (1991) 13 NZTC 3,541. Barber DJ said at 3,547:

> I consider it elementary that the writing off of a debt as bad requires something more than the mere recognition by the taxpayer, or one or more of its executives, that a debt is unlikely to be paid. It could be reasoned that only a decision of the taxpayer to write off a debt is needed, subject to the debt being bad. However, I consider that, in terms of sec 106(1)(b), book-keeping steps must also be taken to record that the debt has been written off. Desirably, the steps would comprise a directors' resolution, if the taxpayer is a corporate, and appropriate book-keeping entries. However, it would be adequate for a responsible officer or executive of a corporate or business to merely make the appropriate book-keeping entries if he or she has that authority. An unincorporated sole trader or small unincorporated business would not, of course, have a directorate so that book entries by the trader or his or her manager will suffice. In my view, it is not possible to write off a debt as bad without the making of authorised journal entries in the books of account of the business.

In *Case T48* (1998) 18 NCTC 8,325 the Taxation Review Authority held that for a private individual trader, as distinct from an incorporated company, words on ledger cards such as "written off" with the relevant date are sufficient to indicate that the debt had been actually written off as bad. The taxpayers did not have to meet any other book-keeping requirements.

Taxpayers must therefore be able to clearly show that the debt has been actually written off as bad. Case law indicates that the minimum requirements to satisfy the *actually written off as bad* test may vary for different classes of taxpayer based on the differing nature and level of sophistication of the taxpayer's accounting records. However, no matter what form a taxpayer's books of account or accounting records may take, those existing in respect of a debt owed by a bad debtor must record that the taxpayer, or an authorised person on behalf of the taxpayer, having decided the debt is bad, has written off the debt accordingly.

The minimum requirements considered necessary to meet the *written off* test for various classes of taxpayer are as follows. The bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer, involving, at a minimum, write-off:

- in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, by an authorised person making the appropriate entry in that system recording the debt as written off; and
- in the case of a company (other than one falling within the above class), by an executive or other responsible officer of the company with the authority to do so, making the appropriate bookkeeping entries in the books of account of the company recording the debt as written off; and
- in the case of a taxpayer (other than a company) that maintains double-entry accounts, by an authorised person making the appropriate bookkeeping entries in the books of account of the business recording the debt as written off; and
- in the case of a taxpayer who is an unincorporated sole trader or small unincorporated business taxpayer who does not maintain double-entry accounts, by the taxpayer noting, in the bookkeeping records of the taxpayer setting out the amount owed by the bad debtor, that the debt has been written off, and the date of the writing off.

Further details of the specific form the necessary write off of a bad debt may take in the creditor taxpayer's books are outlined in the next section of this commentary.

It is the writing off that determines the time when a deduction for a bad debt can be claimed. The necessary writing off must therefore take place before the end of the income year or GST taxable period in which the bad debt deduction is claimed. Writing off a bad debt cannot be backdated. Therefore, if there are numerous debts to review, it is important to allow sufficient time for this exercise, as well as for completing all necessary "writing off" accounting entries before the end of an income year or GST taxable period, to enable any bad debts to be deducted in that year or GST taxable period.

In all cases the business records kept by the taxpayer must comply with the requirements of section 22 of the Tax Administration Act 1994 and section 75 of the GST Act.

Accounts kept by taxpayers

Most taxpayers in business keep double-entry accounts. If a person keeps double-entry accounting records, the bad debt must be struck out of the records on which the double-entry accounts are based. If debtors ledgers are maintained, the writing off will be able to be clearly shown by the appropriate bookkeeping entries having been made in the debtors ledger by authorised persons. Generally, this means that the balance in the debtors ledger for the individual debtor must be reduced by the amount of the bad debt. No matter what processes are followed in the course of preparing a person's double-entry accounts, it is the completion of the appropriate authorised entry(s) actually writing off a debt (which it has been decided is bad in accordance with the tests already outlined) that is essential to deductibility.

In cases where a taxpayer does not keep double-entry accounting records and/or does not keep a debtors ledger, the person must write the debt off according to the form of records used. This means that whatever the form of records used, those showing the amount owed by the bad debtor must clearly record that the creditor, having made the decision that the debt is bad (in accordance with the tests already outlined), has written the debt off accordingly.

Particular examples of bad debts accepted by the Commissioner as having been written off are:

- If a taxpayer's only records of debts are copies of invoices issued, placing the invoice in a "bad debts" file and indicating on the invoice whether all or part of the invoiced amount is bad and the date, is sufficient.
- If a taxpayer's only records of debts are copies of invoices and copies of statements of account issued from a duplicate account book, marking the copy of the final statement sent out "bad debt – written off" (noting the amount of the debt that is bad and the date) is sufficient. Alternatively, it would also be sufficient for the

taxpayer to place the relevant invoice in a "bad debts" file indicating on the invoice whether all or part of the invoiced amount is bad and the date this was done.

Keeping records for credit control or other purposes

For a variety of reasons, a creditor may keep a separate record of bad debts written off. For example, the records may be necessary if the creditor should ever have the opportunity of collecting the debt in the future, or the creditor may want to keep a record of problem customers to avoid future difficulties.

As long as these records are quite separate from the accounting base records they will not affect the write off. If the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off.

More than one set of accounts

Some businesses have more than one set of accounts. For example, a company may prepare:

- financial accounts for financial reporting purposes to satisfy the requirements of the Companies Act 1955 or 1993; and
- management accounts as a basis for management decision-making and control.

The sets of accounts may be prepared in quite different ways. For example, statutory requirements are set out in the Financial Reporting Act 1993 for preparing financial reports that are not required when preparing management accounts; and management accounts may be prepared on the basis of estimates for some elements in order to provide very quick reports.

When the different sets of accounts rely on the same underlying debtor records, no difficulty arises. As long as the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off. However, if the debt is still recognised as an asset in the underlying records, it is not written off.

If the different sets of accounts rely on different underlying debtor records (which is very rare), the creditor should refer to the accounts that are relied on to represent the firm's financial position. For a company, these will be the accounts used to satisfy the company's financial reporting obligations under the relevant Companies Act.

Examples of when a bad debt is/is not written off

General facts

These facts apply to all the following examples:

- The taxpayer's income tax balance date is 31 March.
- The only question is whether a debt has been written off. All other criteria are satisfied.
- The debt is for goods and services supplied for money.
- The supply has been included in the taxpayer's gross income for income tax purposes.

In the examples where the taxpayer is a GST-registered person, the following additional facts apply:

- GST returns are filed on a two-monthly invoice basis.
- The supply has been included in a GST return.

Example 1

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is updated on 31 March 1999. The entries made include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 1999.

Example 2

The taxpayer maintains a debtors ledger and is not registered for GST. The debtors ledger is written up on 1 April 1999. The entries written up include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 2000.

Example 3

The taxpayer does not maintain a debtors ledger and is registered for GST. There is no indication on her underlying debtor records to show the status of the debt. She has claimed a deduction from output tax for the bad debt in her GST return for the taxable period ending 31 January 1999. That return was prepared in February 1999.

The taxpayer is not entitled to the deduction from GST output tax. She is not allowed a deduction for the bad debt in the income year ending 31 March 1999. Claiming the deduction from output tax for GST purposes is not a sufficient writing off of the bad debt.

Example 4

The taxpayer does not maintain a debtors ledger and is not registered for GST. The taxpayer's only records of debts owing to him are copies of issued invoices. The taxpayer maintains only rudimentary books of account, and his unpaid debtors are represented by loose-leaf filing of accounts and/or invoices issued in a ring-binder file. When a debt is paid it (the account and/or invoice) is transferred to a separate file. The taxpayer ceases sending accounts for the debt in question in February 1999, putting a line across the copy of the last statement sent out in respect of the debt and marking it "Final" and leaves it in the unpaid debtors file.

The taxpayer is not entitled to a deduction for the bad debt in the year ended 31 March 1999. Simply marking the last statement issued as "Final" and leaving it in the unpaid debtors file does not amount to writing off of the debt.

Example 5

The taxpayer does not maintain a debtors ledger and is not registered for GST. His only records of debts owing are copies of invoices and statements issued. In February 1999 the taxpayer became aware that a debt was bad. He stopped sending out statements for the debt and took no other action on it. In particular, he sent out no statements on the account in February and March 1999. The taxpayer continued to send out statements on all the other debts owing, including overdue accounts. The taxpayer keeps carbon copies of the statements of account in the duplicate account book from which the statements for issue are prepared. The taxpayer has tagged the final statement sent out in respect of the debt, circling the amount payable and marking it "bad debt – written off – February 1999".

The taxpayer is allowed a deduction for the bad debt in the year ending 31 March 1999. The cessation of statements of account, recorded by their absence in the duplicate account book, and the tagging and marking of the final statement, amount to writing off the debt in his accounting system.

Example 6

The taxpayer maintains a debtors ledger and is not registered for GST. She wrote up the debtors ledger on 31 March 1999. The entries written up include a journal entry writing off a bad debt. Her accountant prepares her accounts in June 1999. In the course of preparing the accounts, the accountant makes a general ledger entry recognising the bad debt as a result of the debtors ledger entry made by the taxpayer on 31 March 1999.

The bad debt is deductible in the year ending 31 March 1999, because the underlying accounting record of the debt was altered to recognise the bad debt on 31 March 1999.

Example 7

The taxpayer does not maintain a debtors ledger and is not registered for GST. Her only records of debts owing are copies of invoices issued. On 15 March 1999 she placed the invoice for the debt in question in a file marked "BAD DEBTS" noting on the invoice next to the total amount "debt bad – filed 15/3/99". The amount of trade creditors in the taxpayer's balance sheet as at 31 March 1999 includes the bad debt. The taxpayer's profit and loss statement for the year ending 31 March 1999 includes as income the sale that has become a bad debt. The profit and loss statement does not recognise any expense for bad or doubtful debts.

The taxpayer's income tax return for the year ending 31 March 1999 includes the profit and loss statement and a "tax reconciliation statement" showing the difference between the accounting income and the amount she believes to be income for income tax purposes. The tax reconciliation statement includes a deduction for the bad debt.

The taxpayer is not allowed a deduction for the bad debt. Although the debt has arguably been written off in the underlying accounting records, she has not ceased to recognise the debt as an asset for accounting purposes.

Accruals rules

General

The accruals rules in Subpart EH of the Income Tax Act provide rules for the timing and recognition of income derived and expenditure incurred in respect of "financial arrangements".

The accruals rules have recently been rewritten by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. The amendments made by this Act apply, in general, to financial arrangements entered into on or after 20 May 1999. The changes made in relation to the allowable deductions for bad debts are discussed later in this item. Two general changes made by the amendment Act are:

- The creation of divisions of rules, one applying to financial arrangements entered into before 20 May 1999, and those that were entered into on or after 20 May 1999. These are referred to as Division 1 and Division 2 respectively.
- Division 1 financial arrangements are referred to as coming within the ***accruals rules***, while Division 2 financial arrangements are referred to as coming within the ***accrual rules***.

The requirement in section DJ 1(a)(iii) that a debt "is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year", must be satisfied before any deduction can be claimed for a bad debt under the accrual(s) rules (sections EH 6(4) and EH 54(1)). Accordingly, the tests used in deciding whether or not a debt is "bad" and what is sufficient "writing off" of a bad debt, apply equally to debts for which a bad debt deduction arises under the accrual(s) rules.

DIVISION 1: Financial arrangements entered into before 20 May 1999

Although the significant accrual(s) rules changes made by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 apply to financial arrangements entered into on or after 20 May 1999, the rules as they affect arrangements entered into before that date have also been rewritten. As part of this process, the accruals bad debt deduction provisions, formerly in section EH 5, have been re-enacted as section EH 6. Apart from the inclusion of headings for each sub-paragraph and necessary updating of some references to other new section and subsection numbers referred to, there are no wording changes between the former section EH 5 and the new section EH 6.

What is a financial arrangement?

A "financial arrangement" is widely defined and means a debt or debt instrument or an arrangement under which a person receives money in consideration for the provision of money to any person, either at a future time, or when an event occurs (or does not occur) in the future. Essentially, a financial arrangement is any transaction that involves deferral of the giving of consideration. Mortgages, bank and other loans, commercial bills, and treasury stock are examples of debt-type financial arrangements.

Certain specific exceptions are created, and they are designated as "excepted financial arrangements". This category includes equity-type instruments (debentures, shares), insurance contracts, employment contracts, games of chance, short term credit agreements and options. Those debts falling within the "excepted financial arrangement" definition have their deductibility as bad debts considered under section DJ 1(a).

The main type of financial arrangement, in relation to bad debts, that is excluded from the Division 1 definition of "financial arrangement", is likely to be a short term trade credit. Short term trade credits are an "excepted financial arrangement". "Short term trade credit" is defined as:

> ... any debt for goods or services where payment is required by the vendor-
>
> (a) Within 63 days after the supply of the goods or services; or
>
> (b) Because the supply of the goods or services is continuous and the vendor renders periodic invoices for the goods or services, within 63 days after the date of an invoice rendered for those goods or services:

Therefore, a short term trade credit is a debt for goods or services owed to a vendor within 63 days after supply or, where the supply is continuous, the vendor expects payment within 63 days after the date an invoice is issued for those goods and services.

Arrangements entered into before the introduction of the accruals rules are also excluded from the definition of "financial arrangement".

What this means as far as a deduction for bad debts is concerned is that the deduction for bad debts arising in respect of a short term trade credit is considered under the general bad debt deduction provision in section DJ 1(a) and not under the accruals rules' section EH 6.

Revenue bad debts

Section EH 6(1) will only apply in limited circumstances to a cash basis holder. A cash basis holder is a natural person for whom either the total value of all financial arrangements held by that person will not exceed $600,000 or the income derived during the income year from financial arrangements does not exceed $70,000. Furthermore, the difference between the income that would be returned under the accruals rules, and the income returned as a cash basis holder, must not exceed a $20,000 deferral threshold.

Section EH 6(1) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- the person derives gross income in respect of the financial arrangement under:
  - section EH 1 – one of the methods of calculating accrual income; or
  - section EH 3(4) – the adjustment required in any year when a person ceases to be a cash basis holder; or
  - section EH 4 – the base price adjustment calculated in the year a financial arrangement matures or is transferred; or
  - section EH 8 – the post facto adjustment for financial arrangements which have the effect of defeating the intent and application of the accruals regime; and
- the amount written off is attributable to that gross income.

In other words, a bad debt comprising income from a financial arrangement previously returned by the taxpayer under the accruals rules is allowed as a deduction under section EH 6(1).

The purpose of the base price adjustment is to ensure that all income derived and all expenditure incurred is taken account of for that financial arrangement when it is either sold, matures, is remitted or transferred.

The post facto adjustment is used to recalculate assessable income or any loss incurred in respect of the financial arrangement using the yield to maturity method in certain circumstances where:

- any amount payable under the financial arrangement is determined, according to the terms of the financial arrangement, at the discretion of the holder or the issuer, or any other person who is an associated person of the holder or the issuer; and
- when exercising this discretion the change in the amounts payable under the financial arrangement does not reflect changes in economic, commodity, industrial or financial indices or banking or commercial rates; and
- the making of such a financial arrangement is not a generally accepted commercial practice; and
- the effect of the arrangement is to defeat the intent and application of the accruals rules.

"Yield to maturity" is a method of spreading income and expenditure over the life of the financial arrangement.

Under the Income Tax Act, where the parties to a transaction are in a close relationship with each other they are classed as associated persons: for example relatives, partnerships and individuals that hold majority interests or voting rights in a company. Association is measured by reference to voting and, where applicable, market value interests, rather than to nominal and paid-up capital. The relationship of association is defined in section OD 7(1).

Section EH 6(4) provides that the requirement in section DJ 1(a)(iii), that a debt "is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year", must still be satisfied before any deduction can be claimed.

Capital bad debts

Section EH 6(2) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 6(2) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 6(1)) where:

- the person carries on a business comprising the holding or dealing in such financial arrangements and the person is not associated with the person owing the amount written off (see section OD 7 for test of association); or
- the financial arrangement is a trade credit and the person carries on the business of dealing in the goods or services for which the trade credit is a debt. "Trade credit" is defined in section OB 1 to mean any debt for goods and services, other than a short term trade credit.

As with *Revenue bad debts* above, section EH 6(4) requires (through section DJ 1(a)(iii)) that a debt "is proved to the satisfaction of the Commissioner to have been actually written off as a bad debt by the taxpayer in the income year" before any deduction can be claimed.

Security payments

Under section EH 6(3), if a person receives a security payment for a loss and a deduction is not otherwise allowable for the loss, the person may be allowed a deduction for the loss up to the amount of the security payment. The purpose of section EH 6(3) is to avoid the situation where the person is taxed on the security payment but does not receive a deduction for the loss incurred.

A "security payment" means money received by, and that is gross income of, the holder of a security arrangement for any loss suffered because that arrangement is not performed. A "security arrangement" is a financial arrangement that secures the holder against failure of a person to perform their obligations under another arrangement. That other arrangement does not need to be a financial arrangement. A payment made under a guarantee is a security payment.

DIVISION 2: Financial arrangements entered into on or after 20 May 1999

This section briefly outlines the effect of the changes made by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 in the context of deductions allowed for bad debts under the accrual rules. As stated above, the amendments apply, in general, to financial arrangements entered into on or after 20 May 1999.

Allowable deductions for bad debts

Deductions for bad debts under the accrual rules are now contained in section EH 54. Section EH 54, by and large, replicates the bad debt deduction provisions from the former section EH 5 (now re-enacted as section EH 6), while the security payments and share loss deduction provisions from these sections are now contained in section EH 55. The most significant changes as they relate to the deduction of bad debts, are:

- The cash basis threshold is increased from \$600,000 to \$1,000,000 and income from investments from \$70,000 to \$100,000. In addition, the \$20,000 deferral threshold, the maximum allowable difference between the income that would be returned under the accruals rules and the income returned as a cash basis holder, has been increased to \$40,000.

- There is only one excepted financial arrangement for short-term agreements for the sale and purchase of property or services, unless a person elects otherwise, and this is for those agreements where settlement or performance must occur within 93 days.
- Deductions are allowed for dealers or providers of goods and services when credit is extended under an agreement for the sale and purchase of property or services.

Revenue bad debts

Section EH 54(2) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- the person derives gross income in respect of the financial arrangement; and
- the amount written off is attributable to the income.

Capital bad debts

Section EH 54(3) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 54(3) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 54(2)) where:

- the person carries on a business that includes holding or dealing in financial arrangements that are the same or similar; and
- the person is not associated with the person owing the amount written off.

Bad debts–agreements for sale and purchase of property or services

Section EH 54(4) allows a person a bad debt deduction (for an amount that is not allowed as a deduction under section EH 54(2) or (3)) where:

- the financial arrangement is an agreement for the sale and purchase of property or services; and
- the person carries on a business of dealing in the property or services that are the subject of the agreement.

Previous rules applying to trade credits have been integrated with the rules for agreements for the sale and purchase of property, and these have also been extended to apply to the provision of services. As a result of the integration, the bad debt provisions are extended to taxpayers in the business of dealing in the goods or services that are the subject of the agreements for the sale and purchase of property or services.

Transitional adjustments

As mentioned earlier, the amended accrual rules (Division 2) apply to financial arrangements entered into on or after 20 May 1999. However, under section EH 17 taxpayers are able to elect to apply these new rules to financial arrangements entered into before that date (ie Division 1 financial arrangements). This will be useful if taxpayers wish to account for all arrangements on a similar basis. Further details of this option, and other changes to the accruals rules, are included in the full discussion on the amending legislation in *Tax Information Bulletin* Vol 11, No 6 (July 1999).

PRODUCT RULING - BR PRD 00/03

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Edison Contact Finance Limited.

Taxation Laws

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

This Ruling applies in respect of:

- The definition of "non-participating redeemable share" as defined in section CF 3(14);
- Section CF 2;
- Section CF 3(1)(b).

The Arrangement to which this Ruling applies

The Arrangement is the issue of non-voting redeemable preference shares ("RPS") by Edison Contact Finance Limited ("ECF") to public investors. Further details of the Arrangement are set out in the paragraphs below.

The Applicant

1. ECF is a special purpose company. It has been established to issue RPS to the public, and using the funds from that issue, to subscribe for RPS in Edison Mission Energy Taupo Limited ("EMETL"). All of ECF's ordinary shares are currently held by TEA Custodians Ltd as trustee of a discretionary trust. EMETL can appoint and remove the trustees. The beneficiaries of the trust are charitable organisations in New Zealand. The Prospectus, dated 9 July 1999 ("the Prospectus"), states that the trustee does not guarantee the payment of dividends on the RPS, the attachment of imputation credits to the dividends, or the redemption (or the payment of any amount on the redemption) of the RPS. ECF may have at least one additional non-resident shareholder with voting interests in the future.

2. EMETL is a New Zealand company incorporated under the Companies Act 1993 ("Companies Act"). All of its ordinary shares are held by EME Royale, an unlimited liability company incorporated in New Zealand under the Companies Act 1993. The ultimate holding company of EME Royale is Edison Mission Energy ("EME"), a company incorporated in the US.

The purchase of Contact shares by EMETL

3. On 24 March 1999, the Crown agreed to sell 40% of Contact Energy Limited ("Contact") to EMETL for $1,208 million. The agreement was settled on 14 May 1999. Contact generates and retails electricity in New Zealand. Its major assets are electricity generation plants in New Zealand. EMETL has used the proceeds of RPS issued to ECF, with other financing, to fund its acquisition of Contact shares.

Issue and terms of the ECF RPS

4. ECF began issuing RPS to investors at an issue price of $1 per share on 23 July 1999. ECF intended to issue up to 240 million RPS before closing the issue on or before 12 November 1999 (or a later date as agreed).

5. ECF has now fully issued 240 million $1.00 RPS to public investors. The number of RPS issued and the dividend rates on the RPS are as follows:

Numbers of RPS issued in each tranche

Expiry date	Fully imputed dividend rate	Number of RPS
30 June 2001	5.00%	7,621,000
30 June 2001	5.30%	8,608,000
30 June 2001	5.63%	47,903,000
30 June 2002	5.50%	18,118,000
30 June 2002	5.80%	14,548,000
30 June 2002	6.03%	9,908,000
30 June 2003	5.75%	47,879,000
30 June 2003	6.20%	66,908,000
30 June 2003	6.37%	18,507,000
Total		240,000,000

6. ECF used the $240 million obtained from the issue of the RPS to subscribe for RPS issued by EMETL. The Terms of Issue of the RPS issued by ECF to the public are contained in the Prospectus. These terms are similar to those of the RPS issued to ECF by EMETL.

7. ECF's constitution allows it to issue up to $400,000,000 of RPS. This Ruling only considers the issue of up to 240,000,000 RPS as part of the public issue described above.

8. The material terms of the RPS issued by ECF are as follows:

   Redemption

   - Holders of RPS are entitled, on the redemption of their RPS, to the "Redemption Amount". The "Redemption Amount" is defined in clause 2 of the Terms of Issue as the issue price of the RPS.
   - Whole, not part RPS, will be redeemed.
   - There are three categories of RPS each scheduled to be redeemed on one of three dates specified in the Terms of Issue being either 30 June 2001 (Year 2 RPS), 30 June 2002 (Year 3 RPS), or 30 June 2003 (Year 4 RPS). It is proposed that 64,132,000 RPS will be redeemed on 30 June 2001, 42,574,000 RPS will be redeemed on 30 June 2002, and 133,294,000 RPS will be redeemed on 30 June 2003. The RPS may be redeemed early by ECF on the occurrence of an Event of Default or if the redeemable preference shares held by ECF in EMETL are redeemed early (clause 7 of the Terms of Issue).

   Dividends

   - Dividends on each RPS are payable semi-annually on 30 June and 31 December, or the next Business Day, or such other dates as may be approved by an Extraordinary Resolution of Holders (clause 3(a) of the Terms of Issue). The first dividend was paid on 31 December 1999 to those investors who initially subscribed for the RPS even if they no longer held the RPS at that time (clause 3(b) of the Terms of Issue). The dividend to be paid in regard to the final dividend period will be paid immediately before the payment of the redemption amount on that RPS (clause 3(e) of the Terms of Issue). If an RPS is redeemed before its scheduled redemption date, the period for calculating the final dividend will be shortened, and the final dividend will be paid immediately prior to redemption of the RPS.
   - The rate of dividend is fixed at the time the RPS are issued. The three categories of RPS (Year 2, Year 3, and Year 4 RPS) carry a number of different dividend rates. The specified dividend rate on each RPS does not change once that RPS is issued. The dividend rates for the RPS are listed in the chart above.
   - ECF will pay fully imputed dividends to the holder of each RPS (clause 3(f) of the Terms of Issue). ECF may also pay supplementary dividends to (actual or deemed) non-resident holders of RPS.

   Other

   - Holders of RPS have no rights to vote on a poll at a meeting of ECF on any resolution made by ECF as described in section 36(1)(a) of the Companies Act 1993, although the RPS holders may exercise class rights under section 117 of the Companies Act 1993 (clause 5.2 of the Terms of Issue).

9. The formula for calculating the dividend amount on the RPS is as follows (in the definition of "Dividend Amount" in clause 2 of the Terms of Issue):

   $$DA = IP \times DR \div 2$$

   Where:

   DA = the amount of dividend payable on each RP Share on each Dividend Payment Date;

   DR = the dividend rate agreed between the Company and the initial Holder, as subscriber, in accordance with the application for the RP Shares, expressed as a percentage rate per annum;

   IP = the Issue Price of the RP Share,

   provided that in the case of the first Dividend Period and the last Dividend Period (where the last Dividend Period does not end on 30 June or 31 December (or if applicable the next Business Day)) the Dividend Amount payable shall be calculated on the number of days elapsed in the Dividend Period ending on that date, calculated as follows:

   $$DA = \frac{IP \times DR \times DE}{R}$$

   Where DA, IP and DR are as defined above,

   DE = the number of days during that Dividend Period;

   and

   R = 365 or, in the case of a leap year, 366.

10. Clause 7 of the Terms of Issue provides for the early redemption of the RPS. The RPS may be redeemed early if there is an Event of Default as defined in the Terms of Issue or if the RPS held by ECF in EMETL are redeemed early.

11. Events of Default under clause 7.1 of the Terms of Issue are :

    (a) Non-payment of redemption amount: The Company fails to pay any part of the Redemption Amount of any RP Share on its due date (or within two Business Days after its due date where non-payment on it due date has arisen solely by reason of a technical, computer or similar error outside the control of the Company); or

    (b) Non-payment: the Company fails to pay any Dividends or other amount due and payable under the RP Shares within five Business Days after its due date; or

    (c) Other breach: EMETL or EME commits any breach of, or omits to observe, any of the Financial Covenants and such breach or omission is not remedied within 30 days of EMETL or EME becoming aware of the breach or omission;

    (d) Cessation of business or dissolution: The Company, ECI, EMETL or Contact ceases or threatens to cease to carry on all or substantially all of its business or operations, or an application of an order is made, or a resolution is passed or proposed, for the dissolution of the Company, ECI, EMETL or Contact except, in each case for the purpose of, and followed by, an amalgamation or solvent reconstruction on terms previously approved in writing by an Extraordinary Resolution of Holders; or

    (e) Receiver, etc: an encumbrancer takes possession, or a trustee, receiver, receiver and manager, administrator, inspector under any companies or securities legislation, or similar official, is appointed in respect of the Company, ECI, EMETL or Contact of the whole of their respective assets; or

    (f) Statutory management: any step is taken to appoint, or with a view to appointing, a statutory manager (including the making of any recommendation in that regard by the Securities Commission) under the Corporations (Investigations and Management) Act 1989 in respect of the Company, ECI, EMETL or Contact or the Company, ECI, EMETL or Contact or any associated person (as that term is defined in that Act) of any of them is declared at risk pursuant to the provisions of that Act; or

    (g) Insolvency: the Company, ECI, EMETL, or Contact is declared or becomes bankrupt or insolvent, is unable to pay its debts when they fall due, or is presumed unable to pay its debts in accordance with section 287 of the Companies Act, or enters into dealings with, or for the benefit of, any of its creditors with a view to avoiding, or in expectation of, insolvency, or makes a general assignment or an arrangement, compromise or composition with or for the benefit of any of its creditors, or stops or threatens to stop payments generally; or

    (h) Analogous process: anything analogous, or having a substantially similar effect, to any referred to in paragraphs (d) to (g) inclusive occurs in relation to the Company, ECI, EMETL, EME or Contact under the laws of a jurisdiction other than New Zealand.

Other relevant information

12. ECF's only material assets are the RPS it has subscribed for in EMETL and a secured indemnity it has from Edison Contact Investments Limited ("ECI") in respect of EMETL's obligations under the EMETL RPS (page seven of the Prospectus). ECF's material liability is under the RPS issued to the public.

13. A number of security arrangements have been entered into by ECF, EMETL, ECI, and other parties to ensure that the various obligations undertaken by the parties are fulfilled. One such arrangement is the ECI Indemnity Agreement entered into by ECF, EMETL, and ECI. Under this agreement ECI has indemnified ECF if EMETL fails to pay ECF certain amounts. EMETL has in turn agreed to indemnify ECI if it is required to pay ECF under the ECI Indemnity Agreement.

14. The Prospectus states that ECF is not an affiliate of EMETL or any other member of the EME group of companies, nor of Contact. The Prospectus also states that ECF is not managed or controlled by any member of the EME group of companies or Contact, although EMETL has the power to appoint and remove the trustee(s) of the discretionary trust holding the shares in ECF.

15. This Ruling does not consider or rule on any potential application of sections BG 1 and GB 1 to the Arrangement.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

- The amount distributed on redemption of any RPS issued to the public ("the Redeemed RPS") by ECF will be less than or equal to the "available subscribed capital" (as defined in section OB 1) for all the RPS of the same class as the Redeemed RPS.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the condition stated above, the Taxation Laws apply to the Arrangement as follows:

- The RPS issued by ECF are "non-participating redeemable shares" as defined in section CF 3(14);
- The amounts paid by ECF on redemption of the RPS pursuant to the Terms of Issue will be excluded from the definition of "dividends" in section CF 2 by section CF 3(1)(b).

The period or income year for which this Ruling applies

This Ruling will apply from the commencement of the 1999 income year to the end of the 2004 income year.

This Ruling is signed by me on the 20th day of March 2000.

Martin Smith

General Manager (Adjudication & Rulings)

PRODUCT RULING - BR PRD 00/04

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Edison Contact Finance Limited.

Taxation Laws

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

This Ruling applies in respect of:

- Section LE 2;
- Section LE 3.

The Arrangement to which this Ruling applies

The Arrangement is the issue of non-voting redeemable preference shares ("RPS") by Edison Contact Finance Limited ("ECF") to public investors. Further details of the Arrangement are set out in the paragraphs below.

The Applicant

1. ECF is a special purpose company. It has been established to issue RPS to the public, and using the funds from that issue, to subscribe for RPS in Edison Mission Energy Taupo Limited ("EMETL"). All of ECF's ordinary shares are currently held by TEA Custodians Ltd as trustee of a discretionary trust. EMETL can appoint and remove the trustees. The beneficiaries of the trust are charitable organisations in New Zealand. The Prospectus, dated 9 July 1999 ("the Prospectus"), states that the trustee does not guarantee the payment of dividends on the RPS, the attachment of imputation credits to the dividends, or the redemption (or the payment of any amount on the redemption) of the RPS. ECF may have at least one additional non-resident shareholder with voting interests in the future.

2. EMETL is a New Zealand company incorporated under the Companies Act 1993 ("Companies Act"). All of its ordinary shares are held by EME Royale, an unlimited liability company incorporated in New Zealand under the Companies Act 1993. The ultimate holding company of EME Royale is Edison Mission Energy ("EME"), a company incorporated in the US.

The purchase of Contact shares by EMETL

3. On 24 March 1999, the Crown agreed to sell 40% of Contact Energy Limited ("Contact") to EMETL for $1,208 million. The agreement was settled on 14 May 1999. Contact generates and retails electricity in New Zealand. Its major assets are electricity generation plants in New Zealand. EMETL has used the proceeds of RPS issued to ECF, with other financing, to fund its acquisition of Contact shares.

Issue and terms of the ECF RPS

4. ECF began issuing RPS to investors at an issue price of $1 per share on 23 July 1999. ECF intended to issue up to 240 million RPS before closing the issue on or before 12 November 1999 (or a later date as agreed).

5. ECF has now fully issued 240 million $1.00 RPS to public investors. The number of RPS issued and the dividend rates on the RPS are as follows:

Numbers of RPS issued in each tranche

Expiry date	Fully imputed dividend rate	Number of RPS
30 June 2001	5.00%	7,621,000
30 June 2001	5.30%	8,608,000
30 June 2001	5.63%	47,903,000
30 June 2002	5.50%	18,118,000
30 June 2002	5.80%	14,548,000
30 June 2002	6.03%	9,908,000
30 June 2003	5.75%	47,879,000
30 June 2003	6.20%	66,908,000
30 June 2003	6.37%	18,507,000
Total		240,000,000

6. ECF used the $240 million obtained from the issue of the RPS to subscribe for RPS issued by EMETL. The Terms of Issue of the RPS issued by ECF to the public are contained in the Prospectus. These terms are similar to those of the RPS issued to ECF by EMETL.

7. ECF's constitution allows it to issue up to $400,000,000 of RPS. This Ruling only considers the ability of ECF to achieve section LE 3 holding company status in relation to the issue of up to 240,000,000 RPS, as described above.

8. The material terms of the RPS issued by ECF are as follows:

   Redemption

   - Holders of RPS are entitled, on the redemption of their RPS, to the "Redemption Amount". The "Redemption Amount" is defined in clause 2 of the Terms of Issue as the issue price of the RPS.
   - Whole, not part RPS, will be redeemed.
   - There are three categories of RPS each scheduled to be redeemed on one of three dates specified in the Terms of Issue being either 30 June 2001 (Year 2 RPS), 30 June 2002 (Year 3 RPS), or 30 June 2003 (Year 4 RPS). It is proposed that 64,132,000 RPS will be redeemed on 30 June 2001, 42,574,000 RPS will be redeemed on 30 June 2002, and 133,294,000 RPS will be redeemed on 30 June 2003. The RPS may be redeemed early by ECF on the occurrence of an Event of Default or if the redeemable preference shares held by ECF in EMETL are redeemed early (clause 7 of the Terms of Issue).

   Dividends

   - Dividends on each RPS are payable semi-annually on 30 June and 31 December, or the next Business Day, or such other dates as may be approved by an Extraordinary Resolution of Holders (clause 3(a) of the Terms of Issue). The first dividend was paid on 31 December 1999 to those investors who initially subscribed for the RPS even if they no longer held the RPS at that time (clause 3(b) of the Terms of Issue). The dividend to be paid in regard to the final dividend period will be paid immediately before the payment of the redemption amount on that RPS (clause 3(e) of the Terms of Issue). If an RPS is redeemed before its scheduled redemption date, the period for calculating the final dividend will be shortened, and the final dividend will be paid immediately prior to redemption of the RPS.
   - The rate of dividend is fixed at the time the RPS are issued. The three categories of RPS (Year 2, Year 3, and Year 4 RPS) carry a number of different dividend rates. The specified dividend rate on each RPS does not change once that RPS is issued. The dividend rates for the RPS are listed in the chart above.
   - ECF will pay fully imputed dividends to the holder of each RPS (clause 3(f) of the Terms of Issue).
   - If ECF elects to be a section LE 3 holding company, ECF may also pay supplementary dividends to (actual or deemed) non-resident holders of RPS.

   Other

   - Holders of RPS have no rights to vote on a poll at a meeting of ECF on any resolution made by ECF as described in section 36(1)(a) of the Companies Act 1993, although the RPS holders may exercise class rights under section 117 of the Companies Act 1993 (clause 5.2 of the Terms of Issue).

9. The formula for calculating the dividend amount on the RPS is as follows (in the definition of "Dividend Amount" in clause 2 of the Terms of Issue):

$$DA = IP \times DR \div 2$$

Where:

DA = the amount of dividend payable on each RP Share on each Dividend Payment Date;

DR = the dividend rate agreed between the Company and the initial Holder, as subscriber, in accordance with the application for the RP Shares, expressed as a percentage rate per annum;

IP = the Issue Price of the RP Share,

provided that in the case of the first Dividend Period and the last Dividend Period (where the last Dividend Period does not end on 30 June or 31 December (or if applicable the next Business Day)) the Dividend Amount payable shall be calculated on the number of days elapsed in the Dividend Period ending on that date, calculated as follows:

$$DA = \frac{IP \times DR \times DE}{R}$$

Where DA, IP and DR are as defined above,

DE = the number of days during that Dividend Period;

and

R = 365 or, in the case of a leap year, 366.

10. Clause 7 of the Terms of Issue provides for the early redemption of the RPS. The RPS may be redeemed early if there is an Event of Default as defined in the Terms of Issue or if the RPS held by ECF in EMETL are redeemed early.

11. Events of Default under clause 7.1 of the Terms of Issue are :

    (a) Non-payment of redemption amount: The Company fails to pay any part of the Redemption Amount of any RP Share on its due date (or within two Business Days after its due date where non-payment on it due date has arisen solely by reason of a technical, computer or similar error outside the control of the Company); or

    (b) Non-payment: the Company fails to pay any Dividends or other amount due and payable under the RP Shares within five Business Days after its due date; or

    (c) Other breach: EMETL or EME commits any breach of, or omits to observe, any of the Financial Covenants and such breach or omission is not remedied within 30 days of EMETL or EME becoming aware of the breach or omission;

    (d) Cessation of business or dissolution: The Company, ECI, EMETL or Contact ceases or threatens to cease to carry on all or substantially all of its business or operations, or an application of an order is made, or a resolution is passed or proposed, for the dissolution of the Company, ECI, EMETL or Contact except, in each case for the purpose of, and followed by, an amalgamation or solvent reconstruction on terms previously approved in writing by an Extraordinary Resolution of Holders; or

    (e) Receiver, etc: an encumbrancer takes possession, or a trustee, receiver, receiver and manager, administrator, inspector under any companies or securities legislation, or similar official, is appointed in respect of the Company, ECI, EMETL or Contact of the whole of their respective assets; or

    (f) Statutory management: any step is taken to appoint, or with a view to appointing, a statutory manager (including the making of any recommendation in that regard by the Securities Commission) under the Corporations (Investigations and Management) Act 1989 in respect of the Company, ECI, EMETL or Contact or the Company, ECI, EMETL or Contact or any associated person (as that term is defined in that Act) of any of them is declared at risk pursuant to the provisions of that Act; or

    (g) Insolvency: the Company, ECI, EMETL, or Contact is declared or becomes bankrupt or insolvent, is unable to pay its debts when they fall due, or is presumed unable to pay its debts in accordance with section 287 of the Companies Act, or enters into dealings with, or for the benefit of, any of its creditors with a view to avoiding, or in expectation of, insolvency, or makes a general assignment or an arrangement, compromise or composition with or for the benefit of any of its creditors, or stops or threatens to stop payments generally; or

    (h) Analogous process: anything analogous, or having a substantially similar effect, to any referred to in paragraphs (d) to (g) inclusive occurs in relation to the Company, ECI, EMETL, EME or Contact under the laws of a jurisdiction other than New Zealand.

Other relevant information

12. ECF's only material assets are the RPS it has subscribed for in EMETL and a secured indemnity it has from Edison Contact Investments Limited ("ECI") in respect of EMETL's obligations under the EMETL RPS (page seven of the Prospectus). ECF's material liability is under the RPS issued to the public.

13. A number of security arrangements have been entered into by ECF, EMETL, ECI, and other parties to ensure that the various obligations undertaken by the parties are fulfilled. One such arrangement is the ECI Indemnity Agreement entered into by ECF, EMETL, and ECI. Under this agreement ECI has indemnified ECF if EMETL fails to pay ECF certain amounts. EMETL has in turn agreed to indemnify ECI if it is required to pay ECF under the ECI Indemnity Agreement.

14. The Prospectus states that ECF is not an affiliate of EMETL or any other member of the EME group of companies, nor of Contact. The Prospectus also states that ECF is not managed or controlled by any member of the EME group of companies or Contact, although EMETL has the power to appoint and remove the trustee(s) of the discretionary trust holding the shares in ECF.

15. This Ruling does not consider or rule on any potential application of sections BG 1 and GB 1 to the Arrangement.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

- If ECF elects to be a section LE 3 holding company, it will give notice in writing to EMETL under section LE 3(2)(a) advising EMETL that it is a section LE 3 holding company.
- ECF is not a member of a "consolidated group" (as defined in section OB 1).
- At no time during the period for which this Ruling applies will ECF elect to revoke any notice of section LE 3 holding company status.
- At all times during the period for which this Ruling applies, ECF will have the purpose, in keeping any notice of section LE 3 holding company status in existence, of enabling, directly or indirectly, the payment of a supplementary dividend to a person not resident in New Zealand.
- ECF has at least one non-resident shareholder with a "voting interest" (as defined in section OB 1) in ECF.
- Dividends derived by ECF on the RPS issued by EMETL are gross income under the Act.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the conditions stated above, the Taxation Laws apply to the Arrangement as follows:

- ECF can elect to be a section LE 3 holding company and pay supplementary dividends to actual or deemed non-resident RPS holders for the purposes of section LE 2 and notice to elect to have that status will not be revoked under section LE 3(3).

The period or income year for which this Ruling applies

This Ruling will apply from the commencement of the 1999 income year to the end of the 2004 income year.

This Ruling is signed by me on the 20th day of March 2000.

Martin Smith

General Manager (Adjudication & Rulings)

INTERPRETATION STATEMENTS

This section of the *Tax Information Bulletin* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

MATRIMONIAL PROPERTY AGREEMENTS– GST IMPLICATIONS

NOTICE OF WITHDRAWAL

The Commissioner gives notice of the withdrawal of the item entitled "GST – Matrimonial Property Agreements", published at page 1 in *Tax Information Bulletin* Vol 1, No 6 (December 1989) ("the withdrawn statement").

The withdrawn statement does not, in the Commissioner's view, correctly reflect the law in a number of respects, including the following:

- It is founded in part on the presumption that the Matrimonial Property Act 1976 gives the spouses in a marriage, by virtue of that marriage, property rights in each others' property sufficient to found the presumption that a partnership exists when they enter into a matrimonial property agreement. That is incorrect because the Matrimonial Property Act 1976 does not, of itself, create a partnership between husband and wife. In particular, that Act does not create the relation between persons necessary to create a partnership in terms of section 4(1) of the Partnership Act 1908.
- A matrimonial property agreement may be made between persons who are not married to one another and not associated persons. This may result in tax consequences that differ from those of a matrimonial property agreement between persons who are married to one another and are therefore associated persons.
- The law regarding the transfer of a taxable activity as a going concern has been amended since the withdrawn statement was published, so that the conditions required for the zero-rating of such a supply are not specified in the withdrawn statement.
- It is necessary to identify clearly the distinction between the tax consequences of a taxable activity and the tax consequences of a taxable activity conducted by a registered person.
- It is also necessary to identify clearly exactly what is supplied under the matrimonial property agreement. Particular care may be required to ascertain the legal effect of the matrimonial property agreement and to identify the supply or the various supplies made by or pursuant to it. The transfer or passing of different types of interests in, or rights to or in respect of, property may give rise to different types of "supply" and might create supplies of different "goods" or "services". It may also be necessary to consider whether the transfer of property under the matrimonial property agreement is an application of goods and services to which section 21(1) of the Goods and Services Tax Act 1985 applies.
- It does not distinguish supplies of money, which are not subject to GST.
- It may be necessary in particular cases to distinguish supplies of secondhand goods, which may lead to particular consequences. In this regard it is noted that property supplied under a matrimonial property agreement may include choses in action, which are services for the purposes of the Goods and Services Tax Act 1985 and therefore cannot be secondhand goods.

The Goods and Services Tax Act 1985 makes no specific provision for matrimonial property agreements. Ordinary GST provisions and principles apply in determining the GST consequences of a matrimonial property agreement.

This withdrawal has effect on and after 29 May 2000.

FINANCIAL PLANNING FEES - INCOME TAX DEDUCTIBILITY

Summary

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

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

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

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

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

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

- an "excepted financial arrangement" (eg shares and options to purchase shares), or
- a "financial arrangement" (eg bonds, bank loans, mortgages, and government stock).

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

If the investment is a financial arrangement, the accruals rules apply and the treatment of planning fees will depend on whether the financial arrangement was entered into before or after the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 received its royal assent on 20 May 1999. Full details of how the "old" and "new" accrual rules apply to financial planning fees are discussed later.

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

Fee categories

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

The fees can be summarised as:

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

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

(c) *Administration fees*: Generally described by advisers as "annual on-going" fees. They are charged by the adviser to cover the costs of maintaining records of the investor's transaction with the adviser. This category also includes charges relating to the handling of cash for the investor, such as the withdrawal

and deposit in the investor's account with the administrator, bank charges, and other administration fees. Also included are any fees or commissions charged by the adviser for collecting income from the investments and arranging this to be paid to or credited to the investor's account with the adviser, or to the investor's own bank account.

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

(e) *Evaluation fees*: Any fees for services relating to an evaluation of an existing portfolio. Typically, where an investor has an existing portfolio of investments and either seeks a financial adviser's advice for the first time, or seeks confirmation that the portfolio's performance is matching the goals originally set either by the investor or with the assistance of a financial planner at the initial planning stage. This is a more detailed examination of performance of the portfolio than simply monitoring performance and reporting to the client. It may or may not result in a recommendation from the adviser to make changes to investments within the portfolio to maintain the investor's aims.

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

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

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

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

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

Irrespective of the name given to the fee, or the basis of its calculation, the income tax treatment of the fees will be determined having regard to the services performed in establishing, administering and altering the investor's portfolio, based on the seven categories of services mentioned above. It may be that in certain cases the performance fee is paid in respect of all the seven categories of services, while in other instances the fee may be only for the services coming within some of the categories, eg the administration and monitoring fee categories. In view of this, it is not the description (label) that the adviser attaches to the fee charged that is relevant, rather it is what service(s) the fee is actually paid for that determines whether or not the fee is deductible. Performance fees are in reality no different to any other global or multi-service fee charged by an adviser . How the amount is apportioned among the categories of services is a question of fact to be determined in the circumstances of the particular case.

Investor categories

Investors fall within one of three categories:

Passive investors: Persons whose primary aim is to derive dividend and interest income from a secure investment portfolio. There may also be a secondary hope or possibility that the investments will provide long-term capital appreciation. They will make

changes to their investment portfolio from time to time to achieve this aim. Some investors may also be "actively" involved in monitoring their investment portfolios (or engage a financial adviser to do this for them) to ensure that the primary aim of maximising dividend and interest yield is maintained.

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

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

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

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

Types of Investors	Passive	Speculative	Business
Initial planning fees	Non-deductible	Deductible (2)	Deductible (2)
Implementation fees	Non-deductible	Deductible (1)	Deductible (3)
Administration fees	Deductible (1)	Deductible (1)	Deductible (1)
Monitoring fees	Deductible (1)	Deductible (1)	Deductible (1)
Evaluation fees	Deductible (4)	Deductible (1)	Deductible (1)
Replanning fees	Deductible (4)	Deductible (1)	Deductible (1)
Switching fees	Deductible (4)	Deductible (1)	Deductible (1)
Fees incurred in earning exempt income or non-assessable income	Non-deductible	Non-deductible	Non-deductible

Key

(1) Deductible in income year incurred, unless

- the fee is "accrual expenditure" (i.e. paid in respect of a future period also).

(2) Deductible in the year incurred, unless

- the fee is "accrual expenditure", or
- the fee is in respect of "preliminary expenses" (ie paid before any such activity has commenced).

(3) Deductible in the year incurred, unless

- the fee is "accrual expenditure", or
- paid in respect of a "financial arrangement"

(4) Deductible in the year incurred, unless

- there is a significant change to the investment structure (eg a change from a rental producing structure to a share investment portfolio resulting in a changed income flow)

Issues

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

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

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

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

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

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

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

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

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

Background

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

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

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

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

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

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

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

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

Legislation

Deductibility

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

An amount is an allowable deduction of a taxpayer -

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

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

(i) incurred by the taxpayer in deriving the taxpayer's gross income, or

(ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or

(iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

Prohibition on deductibility

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

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

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

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

Assessability

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

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

Definition

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

Qualified accruals rules

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

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

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

Definitions

"Accrual expenditure", in section EF 1 and EF 4, in relation to any person, means any amount of expenditure incurred on or after 1 August 1986 by the person that is allowed as a deduction under this Act, ……….., other than expenditure incurred -

(a) In the purchase of trading stock; or

(b) In respect of any financial arrangement; or

(c) In respect of a specified lease, or a lease to which section EO 2 applies, or

"Core acquisition price"

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

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

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

(includes)

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

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

"Financial arrangement" -

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

(i) Any debt or debt instrument; and

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

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

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

(b) …

Trading stock

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

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

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

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

Definition

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

Legislation

Section EE 5(1)

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

Section EE 13

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

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

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

(a) Has no current or likely future market value; and

(b) Has been written off as worthless by the taxpayer.

Section EF 2(1)

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

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

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

Types of investor

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

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

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

When is an investor a passive investor?

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

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

When is an investor a speculative investor?

A speculative investor is someone who either:

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

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

Investors are not speculative investors simply because they would like to see their investment capital increase, or that they may sell their investment if the capital increases. Most passive investors fall within that description. It is the person's dominant purpose that is important in this distinction.

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

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

When is an investor in business?

Section OB 1 defines "business" to include:

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

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

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

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

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

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

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

- the nature of the taxpayer's activities; and
- the period over which the taxpayer engages in the activity; and
- the scope of the taxpayer's operations; and
- the volume of transactions undertaken; and
- the commitment of time, money and effort by the taxpayer; and
- the pattern of activity; and
- the financial results achieved by the activity.

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

- The fact that a taxpayer's activity is sufficient to render his or her returns assessable under section 65(2)(e) (now section CD 4) does not mean that the activity is a business.
- Where the taxpayer's activity is merely a means of supplementing an already adequate income, the taxpayer is unlikely to be in the business from which that supplementary income is derived.
- If the taxpayer is in full-time employment and engages in a spare-time activity, the presumption will be against that spare-time activity being a business.
- If the taxpayer is either unemployed or retired and is only engaged in moderate (investment) activity, the presumption is against that activity being a business.

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

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

Example 1

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

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

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

Example 2

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

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

Example 3

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

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

During this time Taxpayer C purchased and sold many shares. Any shares purchased were only held for as long as he considered he could maximise returns on

each share parcel. He acquired the shares on all occasions for the purpose of selling them at a profit and did not purchase them for dividend income. During this time he received other income in the form of superannuation payments and some consultancy fees from his former employer.

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

Deductibility provisions

(a) General deductibility

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

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

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

(b) The capital/revenue distinction

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

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

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

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

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

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

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

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

The Sun Newspapers *tests*

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

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

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

The question is whether the expenditure is incurred to achieve an enduring advantage. This test of capital is not whether expenditure results in a permanent, tangible asset (*Kemball v C of T* [1932] NZLR 1305, *John Fairfax and Sons Pty Ltd v FC of T* (1959) 101 CLR 30), but if the expenditure is incurred to obtain an advantage or something of lasting value. The financial adviser provides an initial plan that becomes the investment framework for the investor. The plan is of continuing benefit to the investor because it forms the investor's strategy. Using the investor's goals, the adviser provides an approach to investment that takes into account those goals, and may identify particular investments that will enable those goals to be achieved. Over time, particular investments may no longer serve the purpose of achieving the investor's goals, and the adviser may recommend new investments. When that happens, the adviser's new advice may relate to bringing into effect a new investment strategy.

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

Fixed or circulating capital

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

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

Accounting treatment

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

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

Benefit obtained and method of payment

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

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

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

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

A. Passive investors–deductibility of fees

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

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

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

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

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

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

Initial planning fees

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

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

Implementation fees

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

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

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

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

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

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

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

Administration fees

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

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

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

Monitoring fees

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

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

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

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

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

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

Evaluation fees

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

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

Replanning fees

Replanning services may be provided as part of the financial adviser's on-going service. Using information received from monitoring or re-evaluating an investor's portfolio, the financial adviser may

recommend changes to the investor's investments. The changes may be made to bring the investor's portfolio into line with the investor's goals and risk profile, to take advantage of better or new opportunities, or to take into account a change in the investor's requirements. Some financial advisers may call a fee for this service a monitoring fee. In this situation the service is better described as a planning fee or a replanning fee, even though some of the original investments may be retained.

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

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

Recent case law

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

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

Case T42 was appealed by the Commissioner (*C of IR v BO and M North,* (1999) 19 NZTC 15,219). The High Court confirmed the TRA's decision and dismissed the appeal. Finding for the taxpayers, Williams J said that the payments of the financial planning fees were revenue in nature and deductible for income tax purposes. The fees had been charged for a change in investment without a change in object ("...though the mix of their investments changed markedly, the object of their investments did not"). In applying the tests in *BP Australia,* the Court ruled that it was not determinative that one of those tests, that the fee was paid "once and for all", was a point in favour of the Commissioner when seen against all the other factors required to be taken into account.

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

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

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

> seems to me that the fee cannot be fairly regarded as incurred in the course of earning income but as incurred in the course of establishing the structure to obtain income. Accordingly, payment of the said consultancy fee represents capital expenditure.

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

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

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

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

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

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

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

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

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

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

> In this case [*Case T42*] Willy DCJ was considering a transposition of investments by an experienced investor without change of object. In *Case T64* Barber CJ was considering a fundamental change from an investment of capital designed to provide employment, salary and associated benefits to the investment of that capital in investments of a very different nature designed to provide income.
>
> … it would be imprudent to go further than the comments already made save to say that *Cases T42* and *T64* clearly indicate the difference in result which is likely to occur between fees charged for a change in investments of a broadly similar nature without change in object by contrast with those charged for fundamental changes in investments where the aim of the objector also alters.

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

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

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

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

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

Another example of a more than significant or a considerable change is where a taxpayer is made redundant from his work and receives a redundancy payment of $100,000. The money is immediately deposited in a three-month fixed-term account at his local bank while he decides what to do with it. He seeks the advice of a financial planner with the view of investing the redundancy proceeds in shares and securities from which he intends to derive interest and dividends to supplement some part-time employment income. On the basis of the definitions contained in this statement, the taxpayer can be described as a passive investor. The planning fees incurred in establishing the taxpayer's portfolio will be on capital account as they are the costs of creating an investment structure (*Case T64).* The simple depositing of the money in the fixed-term account could not be considered to be prior investment activity as there was no "active management" of the investment (*C of IR v North*).

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

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

The ATO determination is consistent with the view of the law taken in BR Pub 95/10, that fees incurred in the creation of, or changes to, an investment plan, are on capital account. Were it not for the recent TRA and High Court cases discussed above, it could be argued that the better view of the law when deciding whether financial planning fees were deductible or not, would be to treat the portfolio as being a collection of individual investments, each investment being a separate asset (unless the taxpayer is a dealer or trader). In applying the capital/revenue deductibility rules on such a basis, the result may be that advice leading to the sale of any such capital asset would be on capital account. Therefore, for passive investors, who sought financial advice that may lead to the sale of one parcel of shares to purchase another parcel, the cost of making those changes (eg switching fees) would be on capital account. However, with the decisions of the High Court (*C of IR v North*) and the TRA *(Case U12),* the Commissioner considers that the matter is now to be determined by the weight of this more recent authority. In these two cases it was held that because the taxpayers had an existing portfolio of

investments, and there was no change to the investors' aims or objects, the fees related to the income earning process (rather than to a collection of capital assets) and were deductible.

Apportionment of global fees

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

Example 4

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

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

Example 5

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

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

Example 6

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

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

B. Speculative investors—deductibility of fees

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

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

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

Preliminary expenditure

Any planning advice received by a speculative investor prior to commencing the speculative activity may not have the necessary nexus between the derivation of income from speculating in investments. For example, in *Case Q18* (1993) 15 NZTC 5,100 the objector intended setting up as a self-employed

architect, but before doing so and while still an employee, he undertook a business diploma course at a university. The Commissioner disallowed the claim. In finding for the Commissioner, Barber J at page 5,103 said:

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

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

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

Cost of revenue account property

As discussed earlier, investments held for the purpose of resale are revenue account property. Under the new trading stock rules revenue account property must be valued at cost. "Cost" is not defined in the Act in relation to investments that are "excepted financial arrangements" (eg shares and options), and therefore cost must take its ordinary meaning. In general terms, the cost of revenue account property will be its purchase price and the cost of acquisition. Implementation, commissions and brokerage fees paid by an investor to acquire or sell investments will be part of the cost of those investments. The effect of treating these fees as part of the cost of revenue account property is that they are not deductible when incurred, but when the investments to which they relate are eventually sold.

Ongoing planning fees

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

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

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

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

Other matters

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

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

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

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

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

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

If an investor is in the business of investing, any difference between the cost of the investment and the amount received on disposal of the investment is

assessable income or a deductible loss. The investments are trading assets and not capital assets of the investor. Therefore, fees do not fail the test of non-deductibility for the reason that they relate to the investor's profit-making process.

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

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

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

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

Example 7

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

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

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

Where the fee is "accrual expenditure"

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

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

Example 8

Investor J pays a monitoring fee of $21,000 to a financial advisor to cover all monitoring services for a period of three years—the services are to be equally spread over the three years. The effect of applying the

accrual expenditure rules is that in the first income year only one-third ($7,000) of the fee is deductible, ie $21,000 is allowed as a deduction. However, $14,000 is added back to income as the unexpired portion of accrual expenditure. The unexpired portion is deducted in the following year and any remaining unexpired portion is added back to income. Effectively this will allow a deduction of $7,000 in each of the three years.

Qualified accruals rules and implementation fees

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

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

- The removal of the references to "issuer" and "holder". The new legislation only refers to a "party" (to a financial arrangement).
- With the removal of the holder/issuer distinction, the cash basis holder exemption from the spreading methods has been extended to all parties to financial arrangements. These exemption thresholds have been amended by:
  (a) increasing from $600,000 to $1,000,000 the threshold in respect of the value of financial arrangements held, and
  (b) increasing the income and expenditure thresholds from financial arrangements from $70,000 to $100,000, and
  (c) increasing the threshold whereby a breach of the cash basis threshold occurs where the investor creates a deferral of income, or an acceleration of expenditure, in excess of $40,000.
- Removal of the 2% threshold for non-contingent fees. Previously, non-contingent fees up to 2% of the core acquisition price did not have to be spread. This threshold has been removed so that all non-contingent fees are not now spread. The treatment of fees is reflected in the definition of "consideration" in section EH 48.
- Non-contingent fee is defined in section OB 1 as a fee for services provided in relation to a person becoming a party to a financial arrangement that is payable whether or not the arrangement proceeds.

The amended accrual rules apply only to financial arrangements entered into on or after the date the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 received the Royal Assent—20 May 1999. Any financial arrangements entered into before this date are still dealt with under the former rules. To accomplish the distinction between the former and the new provisions the accrual rules are set out in two divisions. The rules existing prior to the introduction of the new legislation are contained in Division 1, that is, sections EH A1 to EH 19.

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

Division 1

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

Financial arrangement implementation fees

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

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

- on the maturity, remission, or sale of the financial arrangement for cash basis holders; or
- over the life of the financial arrangement for non-cash basis holders.

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

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

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

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

Category 1: cash basis holders
A cash basis holder is a natural person for whom either the total value of all financial arrangements held by that person will not exceed $600,000, or the income derived in the year by the person from financial arrangements will not exceed $70,000. A further requirement is that the difference between the income that would be returned under the accruals rules, and the income returned as a cash basis holder, does not exceed $20,000.

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

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

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

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

Category 2: non-cash basis holders
If an investor is not a cash basis holder, he or she must return income and expenditure according to the rules set out in section EH 1. Section EH 1(1) requires that for the purposes of calculating income and expenditure under sections EH 1(2) to (6), regard must be had to the amount of consideration provided by the person. The accruals rules spread the difference between amounts received by the person and amounts provided by the person over the life of the financial arrangement. Where implementation fees are part of the acquisition price of the arrangement, they will be one of the amounts provided by the person that is spread over the life of the arrangement.

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

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

- If the non-contingent fees are no more than two percent (2%) of the core acquisition price, they are excluded from the accruals rules calculations and their deductibility is tested under normal income tax rules.
- If the non-contingent fees are greater than two percent (2%) of the core acquisition price, they are included within the accruals rules calculations to the extent that they exceed 2% of the core acquisition price. The remaining amount of fees (that is equal to 2% of the core acquisition price) is deductible or otherwise under normal income tax rules.

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

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

Example 9

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

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

If the fee charged was a non-contingent fee, then, to the extent that it was no more than 2% of the core acquisition price of the financial arrangement, it would be excluded from the accruals rules and tested according to normal principles. As such it would be non-deductible, as Investor K is a passive investor.

Division 2

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

Contingent fees – Cash basis person concession

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

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

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

Non-contingent fees

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

Transitional adjustments

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

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

TAPE-RECORDING INLAND REVENUE INTERVIEWS INV-330

Introduction

In keeping with its efforts to streamline its activities by using technology, Inland Revenue has been conducting some of its interviews using audio recording rather than the traditional method of taking hand written notes. This Standard Practice Statement (SPS) outlines Inland Revenue's standard practice when audio taping an interview.

Interviews can range from general information exchanges where Inland Revenue will gather information to enable resolution of queries, through to formal interview situations where a line of enquiry has potential for litigation.

Generally, interviewees will be advised of the intention to tape-record interviews by Inland Revenue when arranging interviews. Occasions may arise where, after having arranged an interview, Inland Revenue may seek to tape-record and interviewees will be advised prior to the commencement of the interview. Where interviews are voluntary, Inland Revenue will respect interviewees' decisions to decline tape-recording of discussion.

Statements made during recorded interviews may be admissible as evidence, and in this respect it is important that the interviews are carried out fairly to the person being interviewed. Admissibility will however, be subject to the normal rules of evidence applicable to the presiding Court.

Before going into the general detail of Inland Revenue practice when taping interviews, it is opportune to reflect on why the SPS has been developed.

Over recent years, Inland Revenue has used tape recorders at various interviews simply for ease of providing a complete record of discussion between parties. This has ranged from the use of Dictaphones through to the use of triple deck recorders, depending on the needs of the parties and the types of interviews.

It now seems appropriate to establish a standard practice which is able to be applied across a variety of interview situations where tape recorders might reasonably be used. The simple use of technology to record (generally by consensus) interview situations does not result in any significant change to current Inland Revenue practice.

Application

This Standard Practice Statement applies from 1 June 2000.

This SPS will not apply to an independent contractor who is conducting an interview on behalf of Inland Revenue, for example a research company contracted to carry out a customer satisfaction survey or an external solicitor under contract to carry out a Child Support review.

Advantages

Recording interviews in audio format is now a common practice by investigative agencies and there are advantages for both Inland Revenue staff and the person being interviewed in audio recording.

- The interview will take less time than is the case when hand written notes are taken.
- There is an exact record of what was said at the interview by both the interviewee and the Inland Revenue Officer conducting the interview.
- Tape-recording provides far greater clarity of content of what is said and the inferences from it.
- The Inland Revenue staff member and the interviewee can concentrate fully on the interview instead of there being a delay in taking full notes.
- There will be a copy of the taped interview available to the interviewee.
- If Inland Revenue transcribes the tape a full copy is available for the interviewee after transcription.

Standard Practice

When to tape interviews

Tape recording may be deemed necessary if:

- The tax affairs to which the interview relates are complex.
- There are numerous facts to be gathered.
- There are inconsistencies in the interviewee's explanations to date.
- The relationship between the interviewee and Inland Revenue has deteriorated and objectivity needs to be restored.
- Inland Revenue has reasonable grounds for considering legal proceedings may be taken involving the interviewee or some other taxpayer.
- Inland Revenue has reasonable grounds for considering that the interviewee may provide important information in circumstances where the interviewee's or another taxpayer's purpose or intention is relevant, eg in relation to avoidance.
- The interviewee requests that the interview be recorded.

However, these are examples only and the decision by Inland Revenue staff to tape-record an interview is not limited to these situations.

An interviewee may request that an interview be recorded using the audio monitor equipment. Such requests must be made prior to the interview and will be subject to the availability of Inland Revenue's recording equipment.

In most cases, the interviewee will be advised prior to attending the interview that the intention is to record the interview.

Consent

Where an interviewee is attending an interview voluntarily the interview will only be recorded with the consent and co-operation of the interviewee.

Attendance at an inquiry by the Commissioner under section 19 of the Tax Administration Act 1994 is compulsory. All interviews carried out under this section will be tape-recorded. The interviewee can not decline the tape-recording of interviews carried out under this section.

There will not be any secret tape-recording of interviews. To minimise the possibility of accusations of secret recording the interviewee's acknowledgement that the interview is being taped will also be recorded during the interview.

Equipment

When Inland Revenue intends to record interviews, Inland Revenue will provide the audio equipment; this will be general practice whether interviews are held at an Inland Revenue office or elsewhere. New tape cassettes should be used for each interview.

The audio monitoring equipment used to record interviews may vary between Inland Revenue offices. Interviews may be taped on any equipment as long as the recording equipment records the interview clearly and all the participants can be heard and are distinguishable on the tape.

Inland Revenue may use equipment that produces one, two or three copies of the taped interview.

1. *Master Copy*

Where Inland Revenue uses recording equipment that produces three copies of the taped interview one copy will become the master tape. This cassette will be removed from the recorder and sealed at the conclusion of the interview while the interviewee is still present.

It will be stored in a secure place in the Inland Revenue office. It will remain sealed until such time as it may be required for evidential purposes.

2. *Interviewee's Copy*

If a two or three tape cassette recorder is used the interviewee will be given one of the cassettes immediately after the interview to keep for his/her own purposes.

If a single deck recorder is used and the interviewee requests a copy of the interview then Inland Revenue will make another copy as soon as possible after the interview and give it to the interviewee.

3. *Working Copy*

The working copy of the tape becomes part of the investigation records and is used for any other purposes as required. Inland Revenue will usually copy the working copy and use this version to work with. If it should get lost or destroyed another copy can be made from the original working copy.

Labelling of cassettes

Each cassette and its cover (where no cover is available, a sealed bag or envelope will be used) will have an adhesive label affixed on which should be written:

- Interviewee's name
- Interviewer's name
- Date of interview

This Standard Practice Statement was signed by me on 11 May 2000.

Margaret Cotton

National Manager Technical Standards

QUESTIONS WE'VE BEEN ASKED

This section of the *Tax Information Bulletin* sets out the answers to some day-to-day questions that people have asked.

We have published these as they may be of general interest to readers.

These items are based on letters we've received. A general similarity to items in this package will not necessarily lead to the same tax result. Each case will depend on its own facts.

TAX RESIDENCE AND ELIGIBILITY OF MIGRANTS FOR RETURNING RESIDENTS' VISAS

Tax Information Bulletin Vol 11, No 11 (December 1999) contained a "Question We've Been Asked" explaining the criteria used by the New Zealand Immigration Service for determining eligibility for Returning Residents Visas (RRVs), and the relevance of tax residence to those criteria. It was noted in the article that tax residence would no longer be a relevant factor for RRV eligibility from June 2000. This was based on a decision made by the previous Government last year.

It has now come to our attention that the new Government has put that decision on hold pending further review. Until a final decision is made, tax residence will continue to be used as a factor in determining RRV eligibility.

SHORTFALL PENALTIES FOR FAILURE TO DEDUCT OR ACCOUNT FOR PAYE

Sections 3, 4A(4) and 141A-141E of the Tax Administration Act 1994

We have been asked what shortfall penalties may be imposed if an employer fails to deduct or account for PAYE.

Any or none of the five types of shortfall penalty (lack of reasonable care, gross carelessness, unacceptable interpretation, abusive tax position and evasion) may be imposed, depending on the culpability of the taxpayer. In each case the circumstances surrounding the failure to account or deduct are considered individually and a decision made about whether a shortfall penalty is to be imposed. As far as possible the examples in this item indicate Inland Revenue's approach in similar or identical circumstances.

Where a PAYE shortfall occurs, a number of factors will be considered to establish whether shortfall penalties should be imposed, including;

- The employer's knowledge of the trust money status of PAYE.
- The processes the employer has in place to ensure that returns are correct, filed on time and PAYE accounted for on time.
- Who is responsible for drawing up deduction details and forwarding payment by the due date.
- The length of time the taxpayer has been employing staff, and their awareness of the obligation to deduct PAYE and make payments by the due date.
- Whether the taxpayer was aware that PAYE had not been accounted for by the due date and that an offence was being committed.
- Whether steps were taken to rectify the situation after the taxpayer became aware that payment had not been made.
- Reasons why the deductions were not paid by the due date and who is responsible to ensure payment is made.
- For what purpose(s) the deductions were used when not paid by the due date.

Below are some examples of cases where PAYE was not deducted or accounted for:

Lack of Reasonable Care

The reasonable care test requires a taxpayer to exercise the level of care that a reasonable person would be likely to exercise to fulfil their tax obligations.

Example one

A company employed a new accounts person who was responsible for the calculation of wages and returning PAYE. The previous accounts person left without leaving instructions or giving training and the employer was aware the new person had little experience in dealing with PAYE. Although PAYE for the month was deducted, the PAYE was not accounted for by the due date. The shortfall became apparent to Inland Revenue when the employer filed the *employer monthly schedule* (*IR 348*).

In the above scenario, contact with the taxpayer established that the shortfall was due to a new, untrained staff member. This employer should have foreseen the risks when a new staff member joins the business, and ensured that the staff member had sufficient training to do the job, and that systems were in place to ensure the PAYE was paid on time. The failure to do so implies a lack of care. A shortfall penalty of 20% of the shortfall would be imposed for "not taking reasonable care".

Example two

An employer deducted PAYE from all employees correctly, and placed the envelope with the PAYE return and payment in her briefcase, along with several other letters to be posted. When she got to the Post Office and took the letters out of her briefcase, the PAYE envelope had fallen inside a book in the briefcase, was overlooked and not posted. The employer posted the return and payment several days later, as soon as she discovered that the envelope had not been posted.

In this case the employer had taken reasonable care to meet her obligations to deduct and account for PAYE. The failure to post the return and payment was a genuine accident. No shortfall penalty would be imposed. The taxpayer would be able to apply for remission of late payment penalties.

Gross carelessness

Gross carelessness is doing or not doing something in a way that suggests or implies a high level of disregard for the consequences.

Example three

An employee sought information from Inland Revenue after their employer refused to provide income details when requested. The employer is registered for PAYE but does not keep any proper records or deductions so that each month when he puts in his IR 345 and employer monthly schedule he makes estimates of the amounts deducted. He was audited and it was found that each month there was a substantial tax shortfall.

The shortfall penalty for evasion could be considered, but in this case it could not be proved "on balance of probability" that the employer had never intended to return the PAYE. The shortfall penalty for gross carelessness is the appropriate shortfall penalty because the employer did intend to account for the deductions, but he did not keep adequate records to correctly account for PAYE. This indicates that the employer was reckless and knew that there was a high chance of a tax shortfall occurring.

In this scenario prosecution action for failure to account will also be considered

Example four

A company employs eight people. The business is registered as an employer and has received an advisory visit from a Business Tax Information Officer during which tax and employer obligations, and the distinction between employees and contractors were discussed. As staff have joined the company after the initial setting up stage they have been treated as self-employed, despite working under essentially the same conditions as the existing employees. PAYE is deducted from five employees' wages, the three newer staff provide an invoice and no tax is deducted from payments to them. These additional staff have to take care of their own tax and ACC obligations.

As the result of an audit it was disclosed that tax should have been deducted from the earnings of the three contractors as they were engaged full time and under similar conditions to the employees.

The employer was reckless regarding his tax obligations—acting as he did meant there was a high risk of a tax shortfall occurring. The employer showed a complete disregard for the consequences of his actions; therefore a shortfall penalty for gross carelessness would be imposed.

Evasion or similar act

All offences in this category require the person to have knowledge, that is, the taxpayer must have knowingly failed to account for or make deductions.

Example five

An employer returns PAYE twice monthly, and had failed to account by the due date. An Inland Revenue officer interviewed the employer and discussed the importance of compliance. The employer stated that although he knew that he was required to pay the deductions to Inland Revenue, he had to choose between paying creditors to keep the business going or paying Inland Revenue. He had decided to pay the creditors.

Numerous court decisions have held that liquidity or cash flow problems are not a cause beyond the taxpayer's control, and therefore are not a defence. Shortfall penalties for evasion would be imposed in this instance. The taxpayer had knowingly failed to account for the deductions by the due date.

Further information

Further discussion of the Commissioner's practice for imposing shortfall penalties may be found in the following Standard Practice Statements:

INV-200: Not taking reasonable care (*Tax Information Bulletin* Vol 10, No 3 (March 1998))

INV-205: Unacceptable interpretation (*Tax Information Bulletin* Vol 10, No 3 (March 1998))

INV-206: Unacceptable interpretation – non application of a tax law (*Tax Information Bulletin* Vol 10, No 5 (May 1998))

INV-210: Gross carelessness (*Tax Information Bulletin* Vol 10, No 3 (March 1998))

INV-215: Abusive tax position (*Tax Information Bulletin* Vol 10, No 3 (March 1998))

INV-220: Evasion or similar act (*Tax Information Bulletin* Vol 10, No 3 (March 1998))

REGULAR FEATURES

DUE DATES REMINDER

June 2000

6 Employer monthly schedule: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *IR 348 Employer monthly schedule* due

Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *IR 345* or *IR 346 Employer deductions* form and payment due

20 Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *IR 345* or *IR 346 Employer deductions* form and payment due

Employer deductions and Employer monthly schedule: **small employers** (less than $100,000 PAYE and SSCWT deductions per annum)

- *IR 345* or *IR 346 Employer deductions* form and payment due
- *IR 348 Employer monthly schedule* due

30 GST return and payment due

July 2000

5 Employer monthly schedule: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *IR 348 Employer monthly schedule* due

Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *IR 345* or *IR 346 Employer deductions* form and payment due

7 Provisional tax instalments due for people and organisations with a March balance date

20 Employer deductions: **large employers** ($100,000 or more PAYE and SSCWT deductions per annum)

- *IR 345* or *IR 346 Employer deductions* form and payment due

Employer deductions and Employer monthly schedule: **small employers** (less than $100,000 PAYE and SSCWT deductions per annum)

- *IR 345* or *IR 346 Employer deductions* form and payment due
- IR 348 *Employer monthly schedule* due

FBT return and payment due

31 GST return and payment due

These dates are taken from Inland Revenue's Smart business tax due date calendar 2000—2001

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

This page shows the draft public binding rulings, interpretation statements, standard practice statements, and other items that we now have available for your review. You can get a copy and give us your comments in these ways:

By post: Tick the drafts you want below, fill in your name and address, and return this page to the address below. We'll send you the drafts by return post. Please send any comments *in writing, to the address below*. We don't have facilities to deal with your comments by phone or at our other offices.

By Internet: Visit **www.ird.govt.nz/rulings/**
Under the Adjudication & Rulings heading, click on "Drafts out for comment" to get to "The Consultation Process". Below that heading, click on the drafts that interest you. You can return your comments via the Internet.

Name ______________________________

Address ______________________________

____

	Draft standard practice statement	***Comment deadline***
☐	**ED 0014:** Offsetting and transferring refunds	30 June 2000

Items are not generally available once the comment deadline has passed

No envelope needed—simply fold, tape shut, stamp and post.

Affix
Stamp
Here

The Manager (Field Liaison)
Adjudication & Rulings
National Office
Inland Revenue Department
P O Box 2198
WELLINGTON