TAX INFORMATION BULLETIN

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Contents

This TIB has no appendix

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Te Tari Taake

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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 and 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 draft item is available for review/comment this month, having a deadline of 1 October 2001. Please see page 6 for the text of this item:

Ref.	Draft type	Description
DDG00014	Depreciation determination	Dairy farm milking shed building, plant and machinery

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 *Adjudication & Rulings, a 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 download these publications free of charge from our website at **www.ird.govt.nz**

PRODUCT RULING – BR PRD 01/16

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 First Mortgage Managers Limited (FMM).

Taxation Laws

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

This Ruling applies in respect of the definition of "beneficiary income" contained in section OB 1, and sections NF 1 to NF 3.

This ruling expressly does not consider or rule on the potential (if any) for application of section BG 1 to the Arrangement.

The Arrangement to which this Ruling applies

The Arrangement is the establishment and operation of a Group Investment Fund (referred to as "GIF") under the Trustee Companies Act 1967. The GIF is to be known as the First Mortgage Trust Group Investment Fund (referred to as "FMGIF" or "the Fund").

Further details of the Arrangement are set out in the paragraphs below.

1. The initial funds to be invested in the Fund will be derived from a unit trust, First Mortgage Trust, that is currently being managed by the applicants.
2. The Trustees Executors and Agency Company of New Zealand Limited (trading as Tower Trust) will establish FMGIF. First Mortgage Trust will then be wound up following the redemption of the units outstanding at market value. Investors will then invest the funds obtained from the redemption in FMGIF.
3. The Fund will be governed by a trust deed dated 20 February 2001. This trust deed has been drafted in a manner that purports to limit the investment activities of the Fund to the types of investments listed in paragraphs (a) to (j) of section 4 of the Trustee Act 1956 (read and construed as if the Trustee Amendment Act 1988 had not been enacted).
4. In confining its investment activity to those investments listed in paragraphs (a) to (j) of section 4 of the Trustee Act 1956, the proposed GIF will be a "designated GIF" for the purposes of the Income Tax Act 1994.
5. The Fund will be governed by a trust deed. Clause 268 of the deed defines the authorised investments of the Fund as:

   "authorised investments" to the extent to which the trustee is lawfully permitted from time to time to hold such investments for the purposes of the fund, means:

   1. cash, deposits with, loans to, or other debt securities of any bank whether secured or unsecured
   2. loans made upon security of any mortgages or mortgage backed securities
   3. the acquisition of any mortgage backed securities by way of transfer or assignment of the mortgage or chargeholder's interest in the mortgage or security
   4. property which comes into the possession ownership or control of the trustee by virtue of the exercise of the powers authorities and discretions vested in the trustee by any mortgage backed security held by the trustee
   5. public sector securities
   6. derivatives
   7. any trust (including a unit trust under the Unit Trusts Act 1960) which invests primarily or wholly in one or more of the investments referred to in the preceding bullet points

provided that until such time as the manager and the trustee agree to the contrary the fund shall:

- primarily be invested in loans upon the security of mortgages and mortgage backed securities; and
- only be invested in investments in which a group investment fund is permitted to invest in order to fall within the definition of a designated group investment fund as defined in section OBI of the Income Tax Act 1994, with the intent that unless agreed by the parties to the contrary the fund shall always be a designated group investment fund for taxation purposes.

6. The trustee of this GIF will be The Trustees Executors and Agency Company of New Zealand Limited (trading as Tower Trust). Section 29 of the Trustee Companies Act 1967 allows a "Trustee company", as defined in section 2 of that Act, to establish a GIF. The trustee is a Trustee company as defined in section 2.

7. The manager (and also the applicant) of First Mortgage Trust Group Investment Fund is FMM. FMM is a company operating out of Tauranga. This company currently manages a unit trust called the First Mortgage Trust. First Mortgage Trust is an amalgam of investors in the nominee companies of the three founding law firms, Sharp Tudhope, Holland Beckett Maltby, and Cooney Lees & Morgan. Since then it has acquired the activities of a further five law firms' nominee companies in the Bay of Plenty and Waikato. Investments are also directly lodged with First Mortgage Trust by independent investors.

8. The rationale behind the establishment of this "designated GIF" as an investment vehicle is to enable each New Zealand resident unitholder to be effectively taxed at source at their marginal rate on any resident withholding income they derive from the Fund as beneficiaries of the trust.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) That the discretion contained in clause 268 will not be exercised to allow investments to be made by FMGIF, which are not investments that a "designated GIF" can invest in as referred to in the definition of "designated group investment fund" contained in section OB 1.

b) That the power to amend as contained in clause 253 will not be exercised in any way so as to affect the "designated GIF" status of the Fund.

c) The beneficiaries will be resident in New Zealand for tax purposes.

How the Taxation Laws apply to the Arrangement

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

- To the extent that any gross income derived during an income year by the trustee vests absolutely in interest in the beneficiary, or is paid or applied by the trustee to or for the benefit of the beneficiary during or within six months after the end of the income year, it will be "beneficiary income" as defined in section OB 1 of the Income Tax Act 1994 and gross income of the beneficiary under section HH 3(1).
- Pursuant to the provisions of sections NF 1, NF 2, and NF 3, if the trustees hold a certificate of exemption and no resident withholding tax has been deducted from resident withholding income, that they receive and distribute as beneficiary income, the trustees will be under an obligation to deduct resident withholding tax at the appropriate rate from the resident withholding income paid to the beneficiary unless the beneficiary provides a certificate of exemption.

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 April 2001 to 31 March 2004.

This Ruling is signed by me on the 31st day of May 2001.

Martin Smith

General Manager (Adjudication & Rulings)

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation, accrual and depreciation determinations, livestock values and changes in FBT and GST interest rates.

DAIRY FARM MILKING SHED BUILDING, PLANT & MACHINERY

DRAFT GENERAL DEPRECIATION DETERMINATION

Please quote reference: DDG00014

In *Tax Information Bulletin* Vol 12, No 2 (February 2000) we published an interpretation statement setting out the Commissioner's view on the deductibility of certain dairy farm expenditure relating to the operation of the dairy shed complex and the various items of plant and equipment found in the dairy shed. That statement did not address depreciation issues and said that depreciation rates for the assets identified in the statement would be set in due course.

The Commissioner proposes to issue a general depreciation determination for the identified assets that will insert new asset classes into the "Agriculture, Horticulture and Aquaculture" industry category and also where applicable into the "Dairy Plant" industry category. The existing asset class for "Milking machinery" in the "Agriculture, Horticulture and Aquaculture" industry category will be deleted. The draft determination therefore proposes to:

- Delete the existing asset class "Milking machinery" and general depreciation rate of 22% diminishing value ("DV") and 15.5% straight-line ("SL") from the "Agriculture, Horticulture and Aquaculture" industry category;
- Insert a new asset class "Milking plant" with a general depreciation rate of 15% DV and 10% SL into the "Agriculture, Horticulture and Aquaculture" industry category. The milking plant consists of all items of the milking line plant and machinery commencing with the cups attached to the cow and ending with the pipe from which the milk flows into the milk storage vat, and includes those items making up the milk extraction and cleansing units. A more detailed description of the items included in this asset class is contained in the interpretation statement in *TIB* Vol 12, No 2;
- Insert a new asset class "Wash down unit " with a general depreciation rate of 18% DV and 12.5% SL into the "Agriculture, Horticulture and Aquaculture" industry category. The wash down unit is used for washing down the dairy shed surfaces and yards and external surfaces of other plant such as the milking plant. The wash down unit comes in two broad types, either a fixed unit, to which the above rates will apply, or a portable wash down unit, the depreciation rates for which are set out below;
- Insert a new asset class "Wash down unit (portable)" with a general depreciation rate of 50% DV and 40% SL into the "Agriculture, Horticulture and Aquaculture" industry category. This asset class refers to the portable water blasters that are used by some farmers for wash down purposes;
- Insert a new asset class "Water heaters" with a general depreciation rate of 15% DV and 10% SL into the "Agriculture, Horticulture and Aquaculture" industry category. This asset class refers to the water heaters or hot water cylinders for heating water for cleaning the milking plant, milk vat, etc;
- Insert new asset classes "Milk storage vat/silo" and "Milk storage vat/silo (on farm)" with a general depreciation rate of 12% DV and 8% SL into the "Agriculture, Horticulture and Aquaculture" and "Dairy plant" industry categories respectively. The milk storage vat/silo is sometimes called a milk storage tank or bulk milk tank and includes colostrum vats. It is the farm milk storage vat/silo together with its integral components such as refrigerant pads (or coils in older units), valves, temperature gauges, stirrers, load cells and any other integral components, but not including the refrigerant compressor which is a separate asset class, the depreciation rates for which are set out below;

- Insert new asset classes "Compressor (refrigerant)" and "Compressor (refrigerant) (on farm)" with a general depreciation rate of 15% DV and 10% SL into the "Agriculture, Horticulture and Aquaculture" and "Dairy plant" industry categories respectively. The refrigerant compressor although linked to the refrigerant pad on the milk vat/silo is a separate asset class;
- Insert a new asset class "Rotary dairy shed milking platforms (turntables)" with a general depreciation rate of 7.5% DV and 5.5% SL into the "Agriculture, Horticulture and Aquaculture" industry category. The rotary dairy shed milking platforms or turntables are currently of two main types, floating platforms and conventional rotary platforms. This asset class consists of the rotary platform together with its attached steel pipe work to enclose and separate the cows, the drive mechanism and associated electric motor. A more detailed description of the items included in this asset class is contained in the interpretation statement in *TIB* Vol 12, No 2;
- Insert a new asset class "Dairy shed and yard (including pipe work bails, railings and gates)" with a general depreciation rate of 6% DV and 4% SL into the "Agriculture, Horticulture and Aquaculture" industry category. This asset class consists of the dairy or milking shed itself together with yard and includes pipe work surrounds, bails, railings, barriers and gates (including the backing gate and its motorised drive unit). A more detailed description of the items included in this asset class is contained in the interpretation statement;
- Insert a new asset class "Teat sprayers (automatic)" with a general depreciation rate of 26% DV and 18% SL into the "Agriculture, Horticulture and Aquaculture" industry category. Automatic teat sprayers consist of a pump and piping, and a spray unit with an automatic activation sensor.

The interpretation statement on the deductibility of dairy shed complex expenditure in *TIB* Vol 12, No 2 also discussed the treatment of the dairy farm electricity reticulation system. As outlined in the statement, the cost of overhead lines is able to be "amortised" (under section DO 4) at 10% DV in line with clause 14 of Part A of the Seventh Schedule.

The draft depreciation determination is reproduced below. The proposed new depreciation rates are based on the estimated useful lives of the assets as set out in the determination and residual values of 13.5% of cost as required by section EG 4(3).

EXPOSURE DRAFT – GENERAL DEPRECIATION DETERMINATION DEP[X]

This determination may be cited as "Determination DEP[x]: Tax Depreciation Rates General Determination Number [x]".

1. Application

This determination applies to taxpayers who own the asset classes listed below.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2001/2002 and subsequent income years.

2. Determination

Pursuant to section EG 4 of the Income Tax Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Deleting from the "Agriculture, Horticulture and Aquaculture" industry category the general asset class, estimated useful life and diminishing value and straight-line depreciation rates listed below:

Agriculture, Horticulture and Aquaculture	**Estimated useful life (years)**	**DV banded dep'n rate (%)**	**SL equiv banded dep'n rate (%)**
Milking machinery	8	22	15.5

- Inserting into the "Agriculture, Horticulture and Aquaculture" industry category the general asset classes, estimated useful lives, and diminishing value and straight-line depreciation rates listed below:

Agriculture, Horticulture and Aquaculture	**Estimated useful life (years)**	**DV banded dep'n rate (%)**	**SL equiv banded dep'n rate (%)**
Milking plant	12.5	15	10
Wash down unit	10	18	12.5
Wash down unit (portable)	3	50	40
Water heaters	12.5	15	10
Milk storage vat/silo	15.5	12	8
Compressor (refrigerant)	12.5	15	10
Rotary dairy shed milking platforms (turntables)	25	7.5	5.5
Dairy shed and yard (including pipe work bails, railings and gates)	33.3	6	4
Teat sprayers (automatic)	6.66	26	18

- Inserting into the "Dairy Plant" industry category the general asset classes, estimated useful lives, and diminishing value and straight-line depreciation rates listed below:

Dairy Plant	**Estimated useful life (years)**	**DV banded dep'n rate (%)**	**SL equiv banded dep'n rate (%)**
Milk storage vat/silo (on farm)	15.5	12	8
Compressor (refrigerant) (on farm)	12.5	15	10

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 1994.

If you wish to make a submission on these proposed new depreciation rates, please write to:

Assistant General Manager (Adjudication & Rulings)
Adjudication & Rulings
National Office
Inland Revenue Department
PO Box 2198
WELLINGTON

We need to receive your submission by 1 October 2001 if we are to take it into account in finalising the determination.

Draft items produced by the Adjudication & Rulings Business Group represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

QUESTIONS WE'VE BEEN ASKED

This section of the TIB 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.

FUNERAL EXPENSES PAID BY FUNERAL DIRECTORS IN CONNECTION WITH FUNERAL ARRANGEMENTS

Goods and Services Tax Act 1985 – section 60(2) – supply to an agent

The service provided by funeral directors to their clients is the making of arrangements for funerals. That service would necessarily include arrangements for the burial or cremation. Funeral directors may also enter into contracts with third parties for goods or services (including arrangements for newspaper advertisements, flowers, the printing of the order of service, purchase of burial plots, the minister or organist's services) but normally these arrangements would be made only at the request of the clients. Funeral directors generally make payments to the third parties (who may in some cases be non-registered persons) and recover the costs from their clients. We have been asked whether funeral directors act as agents of their clients in respect of the supply of goods or services such as:

- advertising of funeral notices
- flowers for the funeral service
- printing of the order of service
- purchase of burial plots, and
- minister or organist's services

and what is the correct GST treatment of such transactions.

Are funeral directors agents?

The same criteria apply in all situations where it is necessary to decide whether a person has acted as an agent on behalf of another person for GST purposes. Unless there are specific arrangements to the contrary, such goods or services would be acquired from third parties by funeral directors as agents for their clients as:

- the goods or services would not be supplied unless requested by the clients, and
- the clients would be aware that the goods or services will be supplied by third parties, and
- the funeral directors would be authorised (expressly or implicitly) to acquire the goods or services on behalf of the clients.

What is the correct GST treatment?

Section 60(2) deems a supply of goods or services to an agent on behalf of a principal to be made to the principal. The effect of section 60(2) is that the agent "drops out" of the transaction. For GST purposes the supply of goods or services by a third party to a funeral director as agent for a client would be treated as a supply to the client and not to the funeral director. The correct GST treatment of the transactions would be:

- The funeral director would not add GST to the disbursement paid on behalf of a client as the disbursement would not be paid for a supply made by the funeral director: Section 8(1).

  However, if a funeral director required payment of an amount exceeding the disbursement paid on behalf of the client, the amount charged in excess of the costs paid (however described in the invoice) would normally be considered to be part of the fee for services supplied by the funeral director. This presumption would be subject to the terms of the agreement between the funeral director and the client so that if the agreed fee is a specific amount, GST would be chargeable by the funeral director on that amount. A written quotation accepted by the client would be evidence of the agreed fee for the funeral director's services.

- The funeral director would not be entitled to an input tax credit on the supply of goods or services acquired on behalf of a client as the supply would not be made to the funeral director and would not relate to goods or services "acquired" by the funeral director: Sections 3A and 20(3).

  Even if funeral directors acquired services as principals, input tax credits are not allowable on services supplied by non-registered persons. An input tax credit may be allowable on the sale of "secondhand goods" by non-registered persons to funeral directors as principals. "Secondhand goods" are goods which have been previously owned and used for their intrinsic purpose by a previous owner: *Case N16* (1991) 13 NZTC 3,142; *L R McLean & Co Ltd v CIR* (1994) 16 NZTC 11,211. For example, flowers would not be "secondhand goods" for GST purposes since their previous use for their intrinsic purpose would normally result in their no longer being regarded as new. Therefore, an input tax credit would not be allowable to funeral directors on flowers acquired from a non-registered person, whether acquired by funeral directors as a principal or agent.

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, the Court of Appeal and the Privy Council.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision. Where possible, we have indicated if an appeal will be forthcoming.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

WHETHER PAYMENT IN SETTLEMENT OF A CLAIM WAS CAPITAL OR REVENUE

Case: *TRA022/00 Decision Number: 006/01*

Decision date: 11 July 2001

Act: Income Tax Act 1994, Goods & Services Tax Act 1985

Summary

The Taxation Review Authority found for the Commissioner.

Facts

The Disputant operated a kiwifruit packhouse and storage facility. In 1987 the Disputant purchased an AWA links grading machine ("the fruit processing machine") from F Limited for $380,500 plus GST.

The Disputant alleged that the fruit processing machine did not perform to the standards set out in its purchase contract and accordingly, in March 1993, filed a Statement of Claim against F Ltd as supplier and A Ltd as manufacturer. The Statement of Claim pleaded breach of contract against F Ltd and A Ltd, misrepresentation against F Ltd and negligence against A Ltd. The Disputant (as Plaintiff) claimed that its resulting loss or damage was $1,050,561.25.

Before the matter reached court the parties entered into a mediation. This led to an out of court settlement with a denial of liability, whereby the Disputant received $170,000 from A Ltd and $100,000 from F Ltd.

The Disputant treated this receipt as a non-taxable capital receipt in its accounts to 31 December 1995. However the Commissioner assessed the settlement payment as income.

Decision

Judge Barber found that the character of the settlement payment in this case must be ascertained by an examination of the legal documents and circumstances surrounding the payment, in other words, from an examination of the Statement of Claim and the Mediation Agreement with its attached Settlement Agreement.

His Honour examined the purpose of the mediation as stated in the recitals to the Mediation Agreement and found that the recitals accurately reflected what happened, namely, that the resolution sought was of the matters covered in the Statement of Claim. His Honour held that the Settlement Agreement expressly provided that the settlement payment was to settle disputes in connection with the Statement of Claim. His Honour also held that the Disputant could not now seek to go behind its own documents.

For Judge Barber the determining factor was the purpose of the payment. His Honour found that where the Settlement Agreement represented the entire agreement between the parties, their individual and uncommunicated reasons for entering the agreement were irrelevant. His Honour held that the purpose of the payment was to settle the claim.

Judge Barber then examined whether the settlement payment was income or capital and held that that question depended upon whether it was paid to compensate for a loss of capital or revenue. His Honour found that the payment was made to compensate the Disputant for the items in the Statement of Claim and so the payment attracted the same character as those items. His Honour found that the items in this case were clearly revenue in character. In reaching this decision Judge Barber compared the facts in this case to the similar case of *Omihi Lime Company v CIR* [1964] NZLR 731 (SC).

Judge Barber found that there was no evidence of a permanent loss of capital which could be said to be replaced by the settlement payment, and even if there had been, the evidence disclosed that this was not what the settlement payment was for. The Disputant sought damages for loss of profit and repair costs for the non-performance of the fruit processing machine and that was a claim for lost revenue.

The Disputant argued *inter alia* that:

- The comparatively low level of the payment (as compared to the original claim) was proof that the payment was not for the claims within the Statement of Claim.
- The settlement did not compensate for the claims in the Statement of Claim because the settlement agreement was made with a denial of liability on the part of each Defendant.
- The settlement payment was made to purchase the Disputant's right to sue.

His Honour held that to view the settlement payment as a purchase of the right to sue ignored the terms of the Settlement Agreement and focused only upon the legal rights necessarily extinguished in the process of a settlement.

Judge Barber held that the relatively low level of payment was not proof that the payment was not for the claims in the Statement of Claim, only that other factors were taken into account by the Disputant in accepting the payment—such as costs and risks of litigation.

His Honour held that to attribute significance to the fact that the settlement was made with a denial of liability was to ignore the commercial reality of the situation and that it was unlikely that a Defendant in any proceedings would accept liability. If a Defendant did not deny liability then there would be no incentive for a claimant to compromise its claim and settle for less than claimed.

WHETHER INTEREST ON MORTGAGE PAYMENTS DEDUCTIBLE

Case: *Borlase v CIR*

Decision date: 17 July 2001

Act: Income Tax Act 1976

Summary

The appellants were unsuccessful in their appeal from the Taxation Review Authority.

Facts

This case concerns the deductibility of interest payments on a mortgage. The appellants, husband and wife, acquired a home in Dunedin in the 1970s. On account of the husband's work, they lived away from Dunedin for long periods. After the husband experienced a downturn in available work in Dunedin, the appellants shifted to Invercargill in 1991. Their Dunedin house was let and rental accommodation was obtained in Invercargill. There were problems with such accommodation and on two occasions the family had to shift home. After about two years, in February 1993, the appellants purchased a residential property in Invercargill for $185,000. They had no surplus funds to apply to the cost, so a total of $208,000 was borrowed on mortgage from a bank. The Dunedin property was already subject to a mortgage, under which $23,326 was outstanding. Accordingly, the new mortgage for $208,000 represented a sum sufficient to pay the purchase price of the new property, and cover the existing mortgage. The new mortgage was secured against both properties, as required by the bank.

In the tax year to 31 March 1994 the appellants each claimed an interest deduction of half the total interest expenditure. In the following tax year similar deductions were claimed. The Commissioner disallowed them in each year.

Taxation Review Authority

Judge Barber in the TRA set out the factual background, referred to the statutory scheme, and then reviewed the relevant principles (*Pacific Rendezvous; Brierly; Eggers; Public Trustee; Buckley and Young*). Against the background of this review His Honour first considered the deductibility of interest incurred in relation to the core mortgage figure of $23,326. His Honour concluded that this portion of the interest was deductible.

The Authority's conclusion with reference to interest on the increased amount of mortgage was that the $185,000 was used to purchase the residence as a family home, and, therefore, was expenditure of a private nature and not deductible. It made no difference that the loan was secured over both properties.

Decision

Counsel for the appellants accepted that interest on the additional $185,000 was not fully deductible, but submitted three grounds in support of a "fairer" basis of apportionment. These were that the facts of the present case were distinguishable from any other decision of the TRA, that the Authority was too rigid in its application of *Pacific Rendezvous* and that it erroneously applied *Public Trustee*, and that the amendment to section 106(1)(h)(i) effected by the Income Tax Amendment Act (No. 2) 1987 was not "properly considered or considered at all" by the Authority.

Distinguishability

On the first line of argument, counsel for the appellant placed some reliance on *Case S17*. However, Panckhurst J noted that this case was perhaps "better viewed as one decided on its particular facts and where the issue of apportionment was complicated on that account."

Application of Established Principles

With regard to *Public Trustee* His Honour noted that not only is the case now of long-standing, but also that in his view it is well-settled that "the involuntary nature of the expenditure … is pivotal to the outcome." Justice Panckhurst continued, saying:

> "I do not consider that the Authority erred by not placing the present case within the *Public Trustee* principle. To the contrary I agree that the expenditure on the Invercargill house purchase was discretionary, rather than involuntary. In both the *Public Trustee* and *Williams* the requirement to pay, and the quantum of the payment at issue was truly external to and beyond the control of the taxpayer …"

The further line of argument concerning *Pacific Rendezvous* was also swiftly dismissed by His Honour, stating:

> "If anything it seems to me that *Pacific Rendezvous* is against the appellants in the present case. Its emphasis is upon the use to which the funds have been put and, in particular, whether that use is in producing assessable income.

> … In the present case the use to which the $185,000 was put was the acquisition of a domestic dwelling. Every dollar was so employed during the relevant tax years. I am not persuaded that *Pacific Rendezvous* was misunderstood by the Authority or applied with undue rigidity."

Changed wording of section 106(1)(h)(i)

Until 1987 the prohibition on the deductibility of interest applied except so far as the Commissioner was satisfied that:

> "(i) It is payable on capital employed in the production of the assessable income;"

Since the amendment the relevant wording is:

> "(i) It is payable in gaining or producing the assessable income for any income year; or
>
> (ia) It is necessarily payable in carrying on a business for the purpose of gaining or producing the assessable income for any income year;"

The thrust of the appellant's argument was that the inclusion of the word "necessarily" in sub-paragraph (ia) indicated a more expansive approach to deductibility. With reference to the facts, where the taxpayers were intent upon retaining their rental activity in Dunedin, at least part of the additional borrowing was necessarily incurred in order to preserve or retain the income-producing activity. Hence the interest on that part was "necessarily payable in carrying on a business for the purpose of gaining or producing the assessable income for [an] income year".

His Honour commented that this submission was simply a variant of the previous ones, and found himself unable to accept that the appellants were obliged to incur, or necessarily incurred, the expenditure of $185,000 in order to produce assessable income or to carry on a business to that end.

In conclusion, His Honour stated that the case was a "conventional one where taxpayers expended borrowed funds for a private or domestic purpose, albeit security was taken over properties one of which was used to gain assessable income."

TAX AVOIDANCE ARRANGEMENT – COMMISSIONER'S ASSESSMENT VALID

Case: *CIR v Dandelion Investments Ltd*

Decision date: 3 August 2001

Act: Income Tax Act 1976

Summary

The High Court found in favour of the Commissioner and the taxpayers' cross appeal was dismissed.

Facts

This was an appeal *from Case U11* (1999) 19 NZTC 9,068.

In 1986 the objector (Dandelion) entered into an arrangement the effect of which was to avoid tax. Deductible interest was paid on a loan to purchase a subsidiary but, via a series of steps involving the Cook Islands, most of that interest paid was returned to Dandelion as a dividend from the subsidiary purchased. The only expense to Dandelion was the fees paid to the companies involved.

The Commissioner formed the view this was avoidance and reassessed. Dandelion objected and then retained Mr J G Russell as its agent. The objection was disallowed.

Dandelion, through Mr Russell sought a case at the Taxation Review Authority alleging misconduct by the Commissioner's staff (in their dealings with Mr Russell), invalidity of the assessment (due to time bar and the Commissioner's Policy Statement on section 99: "the CPS") as well as the incorrectness of the assessment.

At the TRA the allegations of misconduct and invalidity were considered made out and the assessment was invalid. It was also considered the assessment, if it had been valid, was correct.

The CIR appealed the issues of misconduct and invalidity. Dandelion appealed the finding there was tax avoidance.

Decision

Tompkins J considered the assessment was valid. He accepted that the giving of notice of assessment was not part of the assessment process and failure to give notice could not invalidate an assessment.

After reviewing the facts he concluded that the assessment could not be considered "tentative or provisional" in the *Canterbury Frozen Meats* sense.

He noted that a report made after the approval to use section 99 had been given by a properly delegated officer and after the assessment was made, could not make that assessment invalid.

He was not prepared to disturb the TRA's finding that there had been some improper conduct by the Commissioner's staff in their dealings with Mr Russell but concluded that this could not invalidate an assessment properly made some 18 months before Mr Russell's involvement.

Further he considered that the hearing before the TRA was *de novo* (allowing the matter to be reconsidered afresh) and cured any procedural defects that might arise as a result of the CIR's staff conduct. He relied upon *Dandelion Investments* (1996) 16 NZTC 12,689; *Russell v TRA* (2000) 19 NZTC 15,924 and *Miller v CIR* (1998) 18 NZTC. Given the five weeks' hearing before the TRA, Tompkins J considered there was no possible basis to conclude the taxpayer had not had an adequate hearing.

On the cross appeal, Tompkins J considered the TRA was right to conclude there was a tax avoidance arrangement. He could see no reason for the transaction's "elaborate framework" and that the whole purpose of the arrangement was to reduce tax.

His Honour considered *CIR v BNZI* (2001) 20 NZTC 17,103 did not help the taxpayer as there was ample evidence that there was a meeting of minds and consensus as required by *BNZI*.

REGULAR FEATURES

DUE DATES REMINDER

September 2001

5 **Employer deductions and Employer monthly schedule**

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

20 **Employer deductions**

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

Employer deductions and Employer monthly schedule

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

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

28 **GST return and payment due**

October 2001

5 **Employer deductions and Employer monthly schedule**

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

23 **Employer deductions**

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

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

Employer deductions and Employer monthly schedule

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* 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 2001–2002