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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly 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 a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe to receive regular email updates when we publish new draft items for comment.

Below is a selection of items we are working on as at the time of publication. If you would like a copy of an item please contact us as soon as possible to ensure your views are taken into account. You can get a copy of the draft from **www.ird.govt.nz/public-consultation/** or call the Senior Technical & Liaison Advisor, Office of the Chief Tax Counsel on 04 890 6143.

Ref	Draft type/title	Description/background information	Comment deadline
ED0161	Draft determination – Depreciation rate for tablet computers and electronic media storage devices	The Commissioner has recently been asked to consider what depreciation rate should apply for tablet computers (such as iPads). In considering that matter, we have also taken the opportunity to ensure that other similar devices such as smartphones, MP3 players (iPods and the like) are also clearly provided for in the Commissioner's Table of Depreciation Rates.	28 February 2014

IN SUMMARY

Interpretation statements

IS 13/03: Income tax – Deductibility of expenditure incurred in borrowing money – section DB 5 3

The Interpretation Statement considers the application of s DB 5, which provides for the deductibility of expenditure incurred in borrowing money for use as capital in deriving income. It also considers the relationship between s DB 5 and the financial arrangements (FA) rules, and when borrowing costs may be deductible under s DA 1 (the general deductibility provision).

The types of borrowing-related expenditure that will typically either be deductible under the FA rules or under s DB 5 include legal fees, valuation fees, guarantee fees, lenders mortgage insurance where the cost is directly passed on (ie, as a "recharge"), loan procurement fees, survey fees, mortgage brokers' commissions, costs of arranging overdrafts, and certain expenses relating to debenture issues. Insurance premiums are not deductible under s DB 5.

The Interpretation Statement replaces the item "Deductibility of mortgage repayment insurance taken out to obtain a business loan" *Tax Information Bulletin* Vol 6, No 9 (February 1995). The 1995 item incorrectly states the law in concluding that mortgage repayment insurance would be deductible under the predecessor to s DB 5.

The Commissioner recognises that taxpayers may have incorrectly relied on the 1995 TIB item on mortgage repayment insurance premiums when entering into other insurance contracts. As such, a transitional operational statement was published at the same time as the Interpretation Statement. The transitional approach enables taxpayers who have already entered into certain arrangements, some time to transition into the treatment expected by the Commissioner.

The accompanying statement sets out the Commissioner's transitional operational position.

IS 13/03: Income tax – Deductibility of expenditure incurred in borrowing money – section DB 5 – Transitional operational approach 38

This transitional operational statement relates to the published Interpretation Statement IS 13/03. That Interpretation Statement considers the application of s DB 5, which provides for the deductibility of expenditure incurred in borrowing money for use as capital in deriving income.

One of the conclusions in IS 13/03 is that insurance premiums are not deductible under s DB 5. This is a change from the position in the item "Deductibility of mortgage repayment insurance taken out to obtain a business loan" *Tax Information Bulletin* Vol 6, No 9 (February 1995). The 1995 TIB item concluded that mortgage repayment insurance would be deductible under the predecessor to s DB 5. That is now considered incorrect, and IS 13/03 replaces the 1995 TIB item.

The Commissioner recognises that taxpayers may have incorrectly relied on the 1995 TIB item on mortgage repayment insurance premiums when entering into other insurance contracts. As such, the Commissioner will take the approach set out in the transitional operational statement, to enable taxpayers who have already entered into certain arrangements some time to transition into the treatment expected.

Legislation and determinations

Correction to depreciation determination PROV25 39

This determination published in July 2013 has been amended. Where the straight-line rate of 7.5% appears it is replaced with the straight-line rate of 7% back-dated to the application date of the determination.

Questions we've been asked

QB 13/05: Income tax – deductibility of a companion's travel expenses 40

This Question We've Been Asked considers the deductibility of a companion's travel expenses. It only applies to individuals, sole traders and partners in partnership. It does not apply to companies, where different rules apply (eg, FBT and dividends). It applies from the 2014 income year and subsequent income years.

Legal decisions – case notes

Commissioner's application for strike-out successful 45

The Commissioner of Inland Revenue's application to strike out the remainder of the disputant's claim was granted.

Rule in *Mannix* upheld 46

The judgment upheld the rule established in the Court of Appeal decision *Re GJ Mannix Ltd* [1984] 1 NZLR 309, but waived security for costs where the director of the appellant company provided an undertaking to pay costs.

Resource consent not a stand-alone asset 46

The High Court found that resource consents acquired for the purpose of constructing electricity generation projects were not stand-alone assets separate from the projects to which they related.

Employee indemnity fund a tax avoidance arrangement 49

The arrangement did not meet the requirements of sections DC 5, DA 1 DB 6 or DB 7 of the Income Tax Act 2004. The arrangement was also a tax avoidance arrangement and the shortfall penalty for taking an abusive tax position was appropriately applied by the Commissioner of Inland Revenue. Further, the requirements for a deduction under section DB 33 were not satisfied.

Property rental activities a business and not a passive investment 50

The taxpayer and her husband were found to be carrying on a small, residential property rental business. The scale and volume of the operation, and the commitment of time, effort and finance involved were found to have been considerable and not merely passive investments as the taxpayer maintained. This finding resulted in a consequential re-calculation of their Working for Families Tax Credits entitlements.

Unsuccessful claim for recovery of a statutory debt owing under section 46 of the Goods and Services Tax Act, unsuccessful application for judicial review 51

The taxpayer was unsuccessful in its claim for a statutory debt owing as the Court held the Commissioner of Inland Revenue had not breached her obligations under section 46 of the Goods and Services Tax Act 1985. The grounds for Judicial Review were rejected.

Proceedings struck out for failing to comply with unless orders 53

The proceedings were struck out by the court for failing to comply with unless orders.

Case transfer and consolidation 54

The Commissioner of Inland Revenue was successful in her application to have a number of cases originally filed in the Taxation Review Authority transferred to the High Court and consolidated with other High Court cases concerning the same dispute.

INTERPRETATION STATEMENTS

This section of the *TIB* 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.

IS 13/03: INCOME TAX – DEDUCTIBILITY OF EXPENDITURE INCURRED IN BORROWING MONEY – SECTION DB 5

Summary

1. This item deals with the deductibility of borrowing-related expenditure—that is, the transaction costs incurred in connection with obtaining borrowed funds ("borrowing-related expenditure"). This does not include interest, the deductibility of which is dealt with by specific provisions in the Act (in particular, ss DB 6–DB 10B).

2. Borrowing-related expenditure may be deductible under the financial arrangements rules ("the FA rules"), under s DA 1 (the general deductibility provision), or under s DB 5 (which provides for the deductibility of expenditure incurred in borrowing money for use as capital in deriving income). The deductibility of borrowing-related expenditure may need to be determined under subpart DG, if it relates to a mixed-use asset (see further [57]). This statement is primarily about how s DB 5 applies (from [55]), but it also identifies when borrowing-related expenditure may be deductible under the FA rules or under s DA 1, rather than under s DB 5. It is necessary to consider whether a particular item of expenditure is taken into account under the FA rules before considering deductibility under s DA 1 or s DB 5, because the FA rules generally prevail over any other provision in the Act in relation to the timing and quantifying of income and expenditure under financial arrangements to which the FA rules apply.

3. The types of borrowing-related expenditure that will typically either be deductible under the FA rules or under s DB 5 include legal fees, valuation fees, guarantee fees, lenders mortgage insurance where the cost is directly passed on (ie, as a "recharge"), loan procurement fees, survey fees, mortgage brokers' commissions, costs of arranging overdrafts, and certain expenses relating to debenture issues. Insurance premiums are not deductible under s DB 5.

The financial arrangements rules

4. Where borrowing-related expenditure is consideration that is taken into account in calculating income or expenditure under the FA rules, the amount and timing of the expenditure are determined under those rules. Because expenditure under the FA rules is deemed to be interest, whether a deduction is allowable for such expenditure is determined by s DB 6, s DB 7 or s DA 1 (in conjunction with the limitations in s DA 2).

5. If a taxpayer is not a cash basis person (see [37]) and the FA rules apply to them or if a taxpayer is a cash basis person who is required to use a spreading method because of an election under s EW 61 (see [38]), borrowing-related expenditure that may need to be taken into account and spread under the FA rules includes:

- the cost of any lenders mortgage insurance that is passed on to the borrower by being incorporated into the interest rate;
- loan application fees—unless they are non-contingent fees (see [34]) or non-integral fees (see [35]);
- loan establishment or draw down fees—unless they are non-contingent fees or non-integral fees;
- loan procurement fees or broker's fees—unless they are non-contingent fees or non-integral fees; and
- guarantee fees for a guarantee given as security for borrowed money.

6. Cash basis persons are not required to calculate and spread income or expenditure under the FA rules (s EW 13(3)). Therefore, ss DA 1 (in conjunction with the limitations in s DA 2) and DB 5 are the relevant provisions for determining deductibility of expenditure incurred in borrowing money by a cash basis person, except in the year in which a base price adjustment is required (see [46]).

7. In the year in which a base price adjustment is required (eg, the year in which a loan is repaid), all consideration paid or payable under the financial arrangement comes into the base price adjustment. This includes any expenditure under a loan that has not already been deducted under s DB 5 or s DA 1. This might include, for example, expenditure under a loan incurred in the year of the base price adjustment, and expenditure paid to the lender to discharge a mortgage or to induce a lender to accept early repayment of a loan.
8. A guarantee given for a fee is also a financial arrangement in itself. Therefore, in the final year of the guarantee, a base price adjustment would be required.
9. Any expenditure that is not taken into account and spread under the FA rules or brought into a base price adjustment is potentially deductible under either s DA 1 or s DB 5.

Sections DA 1 and DB 5

10. Where borrowed money is a revenue item (see from [51]), expenditure incurred in borrowing the money will generally be deductible under s DA 1.
11. Where borrowed money is an addition to capital, expenditure incurred in borrowing the money will not be deductible under s DA 1, because of the capital limitation (s DA 2(1)). However, it may be deductible under s DB 5, which overrides the capital limitation. This item sets out the requirements for expenditure to be deductible under s DB 5.
12. Section DB 5 allows a person a deduction for expenditure incurred "in borrowing money that is used as capital in deriving their income". For expenditure to be deductible under s DB 5, the:
    - expenditure must be incurred by the taxpayer;
    - expenditure must be incurred in borrowing money; and
    - the taxpayer must use the borrowed money as capital in the derivation of their income.
13. As noted at [2], the deductibility of borrowing-related expenditure may potentially need to be determined under subpart DG, if it relates to a mixed-use asset (see further [57]).
14. The fact that s DB 5 requires the taxpayer to use the money borrowed as capital in deriving their income means that the taxpayer must actually borrow money for the borrowing-related expenditure to be deductible under s DB 5. Expenditure incurred in unsuccessfully attempting to borrow money is not deductible under s DB 5 (*Case L101* (1989) 11 NZTC 1,533; *Case Q61* (1983) 83 ATC 319).
15. To be incurred "in borrowing money" the expenditure must be incurred in establishing or setting up the loan (*Ure v FCT*, 81 ATC 4,100 (FCA)).
16. The expenditure does not need to be incurred at the time of the borrowing. Expenditure "incurred in borrowing money" could include expenditure that is incurred during the life of the loan. This will be the case only when, at the time of and in the course of establishing the borrowing, the borrower enters into an obligation to incur the expenditure during the life of the loan (*Ure*). This would not extend to expenditure related to bringing the borrowing to an end.
17. Expenditure on items such as interest and the repayment of principal are not deductible under s DB 5 (*Ure*).
18. Costs incurred in refinancing or "rolling over" a loan may be incurred in establishing a **new** loan, but it will be a question of fact in each case. For example, an extension of the term of a loan contract, made under a provision in the contract contemplating such an extension, may be a variation of the contract and not the establishment of a new loan (*In re Goldstone's Mortgage* [1916] NZLR 489; *Nelson Diocesan Trust Board v Hamilton* [1926] NZLR 342 (CA)). Costs incurred in relation to such an extension would not be deductible under s DB 5 because they are not incurred in establishing a loan.
19. Expenditure incurred in repaying borrowed money is not expenditure incurred in borrowing money, so is not deductible under s DB 5 (*Riviera Hotel v MNR* [1972] CTC 157 (FC); *Neonex International Ltd v R*, 78 DTC 6,339 (FCA); *Case 31*, 10 CTBR 92). A payment made to induce a lender to accept early repayment is expenditure incurred in **repaying** borrowed money rather than expenditure incurred in borrowing money, even if it is necessary to incur such expenditure to satisfy a requirement that the replacement lender be given a first charge (*Riviera Hotel* and *Neonex*). However, as noted above, such expenditure may come into the base price adjustment that the FA rules require in respect of the loan that is being brought to an end.
20. Similarly, expenditure incurred in discharging a mortgage is not expenditure incurred in borrowing money, whether or not the discharge of the mortgage is required to give security to a replacement lender. Therefore, expenditure incurred in discharging a mortgage is not deductible under s DB 5 (*Riviera Hotel* and *Neonex*).

21. The premium on a life insurance policy required by the lender as security for a loan is not deductible under s DA 1 (by virtue of s DA 2(1)) because it is capital expenditure (*Case 64*, 10 CTBR 189; *Equitable Acceptance Corp Ltd v MNR* [1964] CTC 74; *Côté-Reco Ltd v MNR* [1980] CTC 2,019; *Case Y21*, 91 ATC 250). Such a premium is also not deductible under s DB 5 because it is expenditure incurred in acquiring an asset or benefit (ie, the rights under the policy) other than the loan. Therefore, it cannot be characterised as being incurred "in borrowing money". This is the case regardless of the type of life insurance (ie, whole of life, term, mortgage repayment insurance, or otherwise) (*Case 19* (1966) 13 CTBR (NS) 124; *Case Y21*; *Equitable Acceptance*; *Antoine Guertin Ltée v R* [1988] 1 CTC 117 (FCA); *Elirpa Construction & Materials Ltd v Canada* [1995] 2 CTC 2,968).

22. The passed on cost of lenders mortgage insurance may be deductible under s DB 5, if it is expenditure the borrower is required to incur to obtain a loan. However, this will not be the case where such costs have to be taken into account and spread under the FA rules or are incorporated into the interest rate. In those cases such costs would be deductible under s DB 6, s DB 7 or, if not under those provisions, potentially under s DA 1.

23. It is not possible to provide a comprehensive list of expenditure that will be deductible under s DB 5. Whether particular expenditure is deductible under s DB 5 depends on whether the expenditure meets the requirements of the section as set out in this statement, whether the expenditure needs to be taken into account and spread under the FA rules, and whether it is expenditure that relates to a mixed-use asset (in which case the deductibility of the expenditure would be determined under subpart DG). However, expenditure that will typically be deductible under s DB 5 (where not required to be taken into account and spread under the FA rules, and where not required to be considered under subpart DG) includes:
    - legal fees in connection with establishing a loan;
    - valuation fees, where the lender requires a valuation;
    - guarantee fees;
    - the passed-on cost of lenders mortgage insurance (where the cost is passed on to the borrower as a "recharge");
    - loan procurement fees;
    - survey fees, where the lender requires the surveying;
    - mortgage brokers' commissions;
    - costs of arranging bank overdrafts; and
    - certain expenses relating to debenture issues (such as drafting, advertising and printing prospectuses).

Statements this Interpretation Statement replaces

24. This Interpretation Statement replaces the item "Deductibility of mortgage repayment insurance taken out to obtain a business loan" *Tax Information Bulletin* Vol 6, No 9 (February 1995). The 1995 item incorrectly states the law in concluding that mortgage repayment insurance would be deductible under the predecessor to s DB 5.

25. It is also noted that there is a PIB item entitled "Life and accident insurance policies" *Public Information Bulletin* No 106 (July 1980) that is still under consideration as part of Inland Revenue's review of PIBs. PIB items still under consideration should be referenced with some care, and should not necessarily be taken as the Commissioner's current view of the law or operational practice. The item "Life and accident insurance policies" considers the deductibility of life and accident insurance premiums in an employment context. The PIB item could potentially be interpreted more generally in relation to the deductibility of insurance premiums. To the extent that interpreting it that way would make it inconsistent with this Interpretation Statement, the PIB item is overtaken by this item.

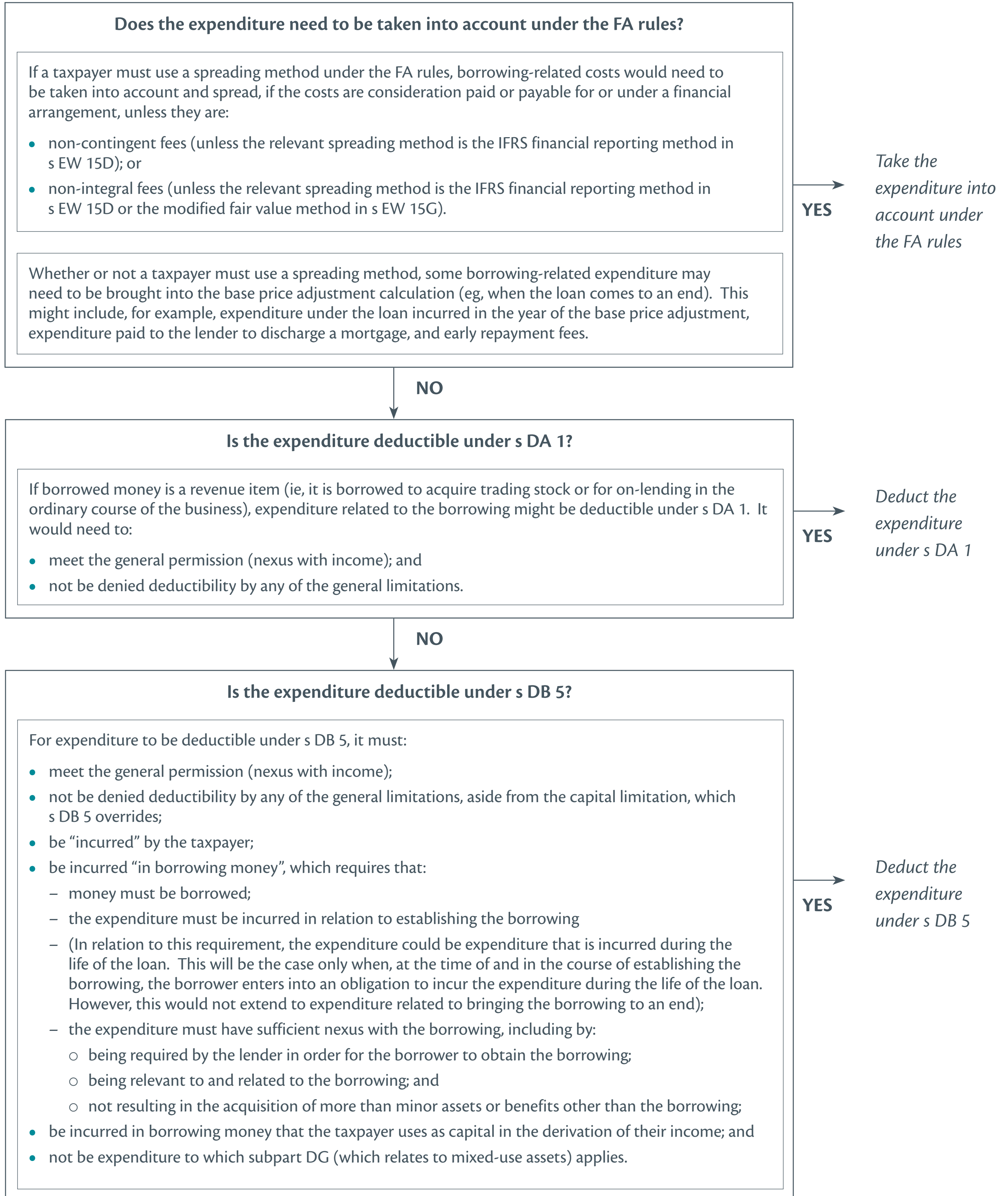
Introduction

26. Borrowing-related expenditure may be deductible under the FA rules, under s DA 1 (the general deductibility provision), or under s DB 5 (which provides for the deductibility of expenditure incurred in borrowing money for use as capital in deriving income). This Interpretation Statement is primarily about the application of s DB 5, but it also identifies when borrowing-related expenditure could be deductible under the FA rules or under s DA 1, rather than under s DB 5. This statement does not consider the application of the FA rules to borrowing-related expenditure that would not otherwise potentially be deductible under s DB 5.

27. This statement considers the deductibility of premiums for insurance required by a lender as security for a borrowing, because there is conflicting case law on this issue. Also, the Commissioner understands that some taxpayers may have treated term life insurance premiums as deductible under s DB 5. The discussion of the deductibility of premiums for insurance required by a lender as security for a borrowing starts from [122]. This statement does not consider the deductibility of premiums for insurance that is not required by a lender as security for a borrowing.

ANALYSIS

28. The following flowchart illustrates the approach set out in this Interpretation Statement to determining the deductibility of borrowing-related expenditure:



Deductibility of borrowing-related expenditure under the financial arrangements rules

29. The FA rules override any other provision relating to the timing or quantification of income or expenditure under a financial arrangement, unless the other provision expressly or by necessary implication requires otherwise (s EW 2). Therefore, in considering the deductibility of borrowing-related expenditure it is necessary to first consider whether the FA rules apply.
30. Neither s DA 1 nor s DB 5 expressly exclude the application of the FA rules, and those provisions do not deal explicitly with the quantification or timing of expenditure incurred in borrowing money. Therefore, ss DA 1 and DB 5 do not by necessary implication exclude the application of the FA rules.
31. Accordingly, where borrowing-related expenditure is consideration taken into account in calculating income or expenditure under the FA rules, the amount and timing of the recognition of any such income or expenditure is determined by the FA rules. Because expenditure under the FA rules is interest as defined, whether a deduction is allowable for such expenditure is determined by s DB 6, s DB 7, or s DA 1 (in conjunction with the limitations in s DA 2).
32. Where a person is required to use a spreading method under the FA rules, s EW 15(1) provides that the calculation and allocation of income and expenditure under the financial arrangement must include:
    - all consideration paid or payable for or under the financial arrangement except for:
        - non-contingent fees (unless the relevant spreading method is the IFRS financial reporting method in s EW 15D); and
        - non-integral fees (unless the relevant spreading method is the IFRS financial reporting method in s EW 15D or the modified fair value method in s EW 15G); and
    - amounts that have been or will be remitted by the person under the financial arrangement; and
    - amounts that would have been payable to the person under the financial arrangement if those amounts had not been remitted by law.
33. Some borrowing-related expenditure that is “for or under” a financial arrangement may be non-contingent or non-integral fees, and therefore not come under the FA rules.
34. A non-contingent fee (defined in s YA 1) is a fee for services provided for a person becoming a party to a financial arrangement, and is payable whether or not the financial arrangement proceeds.
35. A non-integral fee (defined in s YA 1) is a fee or transaction cost that is not an integral part of the effective interest rate of a financial arrangement for the purposes of financial reporting under IFRS.
36. As non-contingent fees and non-integral fees paid or payable for or under a financial arrangement are not taken into account in calculating income or expenditure under the FA rules, whether such fees are deductible is to be determined under s DA 1 (in conjunction with the limitations in s DA 2) or s DB 5.

Non cash basis persons and cash basis persons applying a spreading method

37. A person will be a cash basis person for an income year if the value of financial arrangements to which they are a party does not exceed the prescribed thresholds in s EW 57(1)–(3) (s EW 54). If those thresholds are exceeded, the person will not be a cash basis person. If the FA rules apply to them (s EW 9), they must calculate and spread income or expenditure under the FA rules for any financial arrangement they are a party to.
38. A cash basis person is not required to apply any of the spreading methods under the FA rules to their financial arrangements, but may choose to do so under s EW 61 (ss EW 13(3) and EW 55(1)). If a cash basis person elects to use a spreading method, they must use a spreading method for all financial arrangements they are a party to at the time of making the election, and all financial arrangements they enter into after the income year in which they make the election, until any revocation of their election is effective (s EW 61).
39. A loan is a financial arrangement (s EW 3). Therefore, if a taxpayer is not a cash basis person and the FA rules apply to them, or if they are a cash basis person who has elected to use a spreading method, any consideration for or under the loan would be taken into account and spread under the FA rules. This might include, for example:
    - the cost of any lenders mortgage insurance that the lender passes on to the borrower;
    - loan application fees (unless they are non-contingent fees or non-integral fees);
    - loan establishment or draw down fees (unless they are non-contingent fees or non-integral fees, though they are probably unlikely to be so);
    - Loan procurement fees or broker’s fees (unless they are non-contingent or non-integral fees, though they are probably unlikely to be so).
40. An extension of the term or amount of a loan contract or an alteration to the interest rate that is made under

a provision in the contract contemplating such an extension or alteration may amount to a variation of the contract and not the establishment of a new loan. In this situation, if the taxpayer is required to use a spreading method, *Determination G25: Variations in the Terms of a Financial Arrangement* may need to be applied. If this is the case, any loan variation fees would be included in the adjustment made under that determination in the year of the variation.

41. Other borrowing-related expenditure that would need to be calculated and spread under the FA rules would include any fees for a guarantee that is provided as security for borrowed money. This is because a guarantee given for a fee is a financial arrangement.

42. If the lender requires the borrower to take out insurance as security for the loan, it is unlikely that the loan and insurance contracts would be considered to be together part of a wider or composite financial arrangement. Where the insurance contract is not part of a wider financial arrangement, the premiums payable are not taken into account under the FA rules, because the insurance contract is an excepted financial arrangement (s EW 5(8)).

43. However, there may be circumstances where an insurance contract is part of a wider financial arrangement. Where this is the case, the premium would fall outside the FA rules to the extent that it was solely attributable to the insurance contract (which typically it would be in its entirety).

44. It is unlikely that there would be any other expenditure incurred in borrowing money that would be incurred for or under the loan or for or under another financial arrangement. However, if other expenditure were incurred for or under a financial arrangement, it would need to be taken into account under the FA rules. The deductibility of all other expenditure incurred in borrowing money would be determined under s DA 1 (in conjunction with the limitations in s DA 2) or s DB 5 (which requires that the general permission be satisfied, but overrides the capital limitation).

Cash basis persons not applying a spreading method

45. Cash basis persons (see [37]) are not required to calculate and spread income or expenditure under the FA rules (s EW 13(3)). Therefore, ss DA 1 (in conjunction with the limitations in s DA 2) and DB 5 are the relevant provisions for determining deductibility of expenditure incurred in borrowing money by a cash basis person, except in the year in which a base price adjustment is required (ss EW 28–EW 31).

46. A base price adjustment is a wash-up calculation that a party to a financial arrangement must perform in the year that any of the events specified in s EW 29 occur (unless s EW 30 applies). For example, a base price adjustment is required on the maturity or disposal of a financial arrangement, on the absolute assignment of the party's rights or legal defeasance of the party's obligations under the financial arrangement, or on a party to a financial arrangement ceasing to be a New Zealand resident.

47. In the year in which a base price adjustment is required, all consideration paid or payable under the financial arrangement would be included in the base price adjustment. This would include any consideration for or under the loan that has not already been deductible expenditure under s DA 1 or s DB 5, for example, expenditure incurred under the loan in the year of the base price adjustment, and "break fees" payable on early repayment of the loan if those fees are payable under a financial arrangement.

Deductibility of borrowing-related expenditure under section DA 1

48. Borrowing-related expenditure may be deductible under the general deductibility provision, s DA 1(1). Section DA 1(1) and (2) provide that:

> **DA 1 General permission**
>
> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called the general permission.

49. Provided that none of the general limitations in s DA 2 apply, a deduction is allowed under s DA 1 for an amount of expenditure or loss incurred in the course of deriving assessable income, excluded income or a combination of assessable income and excluded income, or in the course of carrying on a business for

such purposes. One of the limitations in s DA 2 that overrides s DA 1 is the capital limitation (s DA 2(1)). The capital limitation ensures that no deduction is allowable under s DA 1 for expenditure of a capital nature.

50. Generally, borrowed money is regarded as an addition to capital (*Caltex Ltd v FCT* (1960) 106 CLR 205; *Davies v The Shell Company of China Ltd* (1950–1952) 32 TC 133 (CA); *Public Trustee v Commissioner of Taxes* [1938] NZLR 436). Expenditure incurred to obtain borrowed money that is an addition to capital is capital expenditure (*Texas Land & Mortgage Co v Holtam* (1894) 3 TC 255).

51. However, in some circumstances borrowed money is a revenue item (*Scottish North American Trust Ltd v Farm* (1903–1911) 5 TC 693; *Texas Co (Australasia) Ltd v FCT* (1940) 63 CLR 382; *Canada Permanent Mortgage Corp v MNR* [1971] CTC 694; *AVCO Financial Services Ltd v FCT*, 82 ATC 4,246 (HCA); *Coles Myer Finance Ltd v FCT*, 93 ATC 4,214 (HCA)).

52. Whether borrowed money is capital or revenue depends on the purpose for which the money is borrowed. If money is borrowed to acquire trading stock or is borrowed for on-lending in the ordinary course of the business (ie, by a taxpayer who is in the business of lending money), the borrowed money is revenue in nature.

53. Where borrowed money is a revenue item, borrowing-related expenditure may be deductible under s DA 1. Where borrowed money is an addition to capital, borrowing-related expenditure will generally not be deductible under s DA 1, because of the capital limitation (s DA 2(1)).

54. If loan variation fees do not need to be taken into account and spread under the FA rules, they may be deductible under s DA 1. This would be the case, for example, if the fee is payable in order for the borrower to get out of a fixed interest rate early, and so save on interest that would itself have been deductible if incurred.

Deductibility of borrowing-related expenditure under section DB 5

55. Capital expenditure incurred in borrowing money may be deductible under s DB 5, which states:

> **DB 5 Transaction costs: borrowing money for use as capital**
>
> *Deduction*
>
> (1) A person is allowed a deduction for expenditure incurred in borrowing money that is used as capital in deriving their income.
>
> *Relationship with subpart DG*
>
> (1B) Subpart DG (Expenditure related to use of certain assets) overrides this section for expenditure to which that subpart relates.
>
> *Link with subpart DA*
>
> (2) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

56. Section DB 5(2) states that s DB 5 overrides the capital limitation. Therefore, a deduction for expenditure associated with borrowing money that would not otherwise have been allowable because it is capital expenditure may be permitted under s DB 5. However, for a deduction to be allowable under s DB 5, the test in s DA 1 must still be satisfied (ie, a relationship must exist between the borrowing-related expenditure and the income-earning process) (s DB 5(2)). Therefore, s DB 5 modifies the general deductibility rule by permitting a deduction for expenditure incurred in borrowing money that is expenditure of a capital nature, but does not override s DA 1.

57. Where expenditure relates to borrowing used to purchase a mixed-use asset, the deductibility of that expenditure may need to be determined under subpart DG, which overrides s DB 5 for expenditure to which that subpart relates (s DB 5(1B)). Subpart DG sets out the rules for the deductibility and apportionment of expenditure incurred for an income year in relation to an asset when the asset is used partly for income-earning purposes and partly for private purposes, and for a time during the income year, the asset is not in use (s DG 1).

58. For expenditure to be deductible under s DB 5:
- the expenditure must be "incurred" by the taxpayer (see [59]–[60]);
- the expenditure must be incurred "in borrowing money" (see [69]–[171]); and
- the borrowed money must be used by the taxpayer as capital in the derivation of their income (see [172]–[177]).

Expenditure must be "incurred" by the taxpayer

59. Section DB 5 requires that the expenditure be incurred by the taxpayer in borrowing money.

60. The meaning of "incurred" has been considered in the context of an Australian provision equivalent to s DB 5 (in *Ure*), and in the context of the predecessors to s DB 5 (in *Felt and Textiles v CIR* [1969] NZLR 493 and *King v CIR* [1974] 2 NZLR 190).

61. In *Felt*, the objector issued debentures to the public at a discount of 1%. The objector claimed that the discount was deductible under s 121 of the Land and Income Tax Act 1954 (a predecessor to s DB 5) as expenditure incurred in the borrowing of money used by the objector as capital in the production of assessable income.

62. The Supreme Court held that the issuing of debentures at a 1% discount (and therefore the obligation incurred to pay an additional £1 per debenture at maturity, after 15 years) did not involve an expenditure in borrowing money. McGregor J considered there was no expenditure because nothing was actually disbursed, saying at 499:

> I cannot appreciate how the agreement to pay the additional sum on the maturity of the debenture can be regarded as an expenditure incurred by the taxpayer. The words of Kekewich J. in *Re Bristol* [1893] 3 Ch. 161 are somewhat apt: "'Expenditure': What do you expend? You expend that which you have. In common parlance you say that a man has spent more than his income. That is common parlance, but that is not language which you would suppose the Legislature to use. A man cannot spend what he has not got; he can mortgage or pledge, but he cannot actually spend".

63. The reasoning of the court in *Felt* was considered in *King*. In *King*, the Supreme Court considered whether contributions that mortgagors borrowing from the State Advances Corporation were required to make to the General Reserve Fund were deductible when the loan money was used in the production of assessable income.

64. The Commissioner, following the approach taken by McGregor J in *Felt*, denied that these contributions were expenditure incurred by the taxpayers, since the taxpayers had never had the money (the taxpayers elected to have the amount of the contributions added to the loan and secured by the mortgage). However, Wild CJ felt that "expenditure" could not be construed so narrowly, commenting at 195:

> "Expenditure" is defined in the *Shorter Oxford Dictionary* as "the amount expended from time to time", and the meaning of "expend" is given as "to pay away, lay out, spend". In the New Zealand section the word "expenditure" is linked with the word "incurred", as is the phrase "losses or outgoings" in the Australian legislation. For that reason, notwithstanding the citation made by *McGregor J*. from *Kekewich J*., I think the reasoning of the High Court should be applied to the construction of sec. 121. Accordingly I think that a deduction may be allowed under that section in respect of "expenditure incurred" although there has been no actual disbursement if, in the relevant income year, the taxpayer is definitively committed to that expenditure. In this case the objectors were so committed.

65. The court held that a deduction may be allowed under s 121 of the Land and Income Tax Act 1954 in respect of "expenditure incurred" although there has been no actual disbursement, if in the relevant income year (here the year of borrowing) the taxpayer is definitively committed to the expenditure. As support for this proposition the court referred to *New Zealand Flax Investments Ltd v FCT* (1938) 61 CLR 179 and *FCT v James Flood Pty Ltd* (1953) 88 CLR 492.

66. The Court of Appeal in *CIR v Banks* (1978) 3 NZTC 61,236 (CA) approved the approach of the court in *King*. The court in *Banks* considered the issue of when expenditure is incurred in the context of s 104 of the Income Tax Act 1976 (a predecessor to s DA 1). The court cited *King* and *James Flood* as authority for the proposition that expenditure is incurred when the taxpayer is definitively committed to the expenditure for which the deduction is sought.

67. In *Ure*, the majority of the Australian Federal Court took a similar view of the meaning of "incurred" in the context of s 67 of the Income Tax Assessment Act 1936–1976 (Cth), stating at 4,113:

> In our view, it is unlikely that it was the legislative intent that the deductibility of expenditure incurred in borrowing should be governed by reference to whether actual payment was made or due at the time of the loan. It seems to us to be preferable to interpret the reference to expenditure incurred in borrowing as including payment to be made during the life of the loan pursuant to a contractual obligation which was incurred at the time of borrowing as an incident of establishing the loan.

68. The most significant New Zealand authority on the meaning of the term "incurred" is the Privy Council decision of *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351. None of the decisions discussed above are inconsistent with *Mitsubishi*.

Expenditure must be incurred "in borrowing money"

69. To be deductible under s DB 5, the expenditure must be incurred "in borrowing money".

70. For expenditure to be incurred "in borrowing money" for the purposes of s DB 5:
    - money must be borrowed (see [71]–[75]);
    - the expenditure must be incurred in relation to establishing the borrowing (see [76]–[117])

    [In relation to this requirement, the expenditure could be expenditure that is incurred during the life of the loan. This will be the case only when, at the time of and in the course of establishing the

borrowing, the borrower enters into an obligation to incur the expenditure during the life of the loan (eg, the guarantee fees in *Ure*). However this would not extend to expenditure related to bringing the borrowing to an end]; and

- the expenditure must have sufficient nexus with the borrowing (see [118]–[171]), including by:
  - being required by the lender in order for the borrower to obtain the borrowing;
  - being relevant to and related to the borrowing; and
  - not resulting in the acquisition of more than minor assets or benefits other than the borrowing.

Money must be borrowed

71. Section DB 5 requires the taxpayer to use the money borrowed as capital in deriving their income. It is clear from this requirement that the taxpayer must actually borrow money before the borrowing-related expenditure can be deductible under s DB 5. A taxpayer cannot use borrowed money as capital in deriving income unless the taxpayer actually borrows the money.

72. If expenses are incurred in attempting to borrow money, and the borrowing does not proceed, no deduction is allowed. *Case L101* supports this view. In that case, the taxpayer claimed a deduction for travel expenses incurred in travelling to Australia to put in an offer on a commercial property that had been found on a previous trip and to arrange finance for the purchase. The finance was arranged through a finance company, which borrowed money offshore. The offer to purchase the property was unsuccessful.

73. The taxpayer claimed that the expenses of the trip were deductible under s 136 of the Income Tax Act 1976 (a predecessor to s DB 5). One reason for the Taxation Review Authority's finding in *Case L101* that the expenditure was not deductible was that s 136 did not apply because no money was borrowed.

74. The decision in *Case L101* is consistent with the decision in *Case Q61*, in respect of an equivalent Australian legislative provision.

75. The money received must also be "borrowed" money. For example, a company that incurs expenditure in issuing shares to the public will receive money. However, because that money is not "borrowed", the expenditure is not deductible under s DB 5. Money subscribed for shares is not borrowed money. The amount represented by the shares does not represent money lent by the shareholders to the company. Such shares are capital of the company, not a debt between the shareholder and the company (*Case 40* (1958) 8 CTBR (NS) 196).

Expenditure must be incurred in establishing the borrowing

76. The scope of the phrase "in borrowing money" is open to different interpretations. However, in light of the apparent purpose of s DB 5, the Commissioner considers that "in borrowing money" means that the expenditure in question must be incurred in establishing or setting up the loan in order for the expenditure to be deductible under s DB 5.

Section 5 of the Interpretation Act 1999

77. Section 5(1) of the Interpretation Act 1999 provides that the meaning of an enactment must be ascertained from its text and in the light of its purpose (see also *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36; [2007] 3 NZLR 767). Therefore, it is necessary to determine the ordinary meaning or meanings of the words "in borrowing money", and then to cross-check the meaning or meanings against the purpose of s DB 5.

78. The *Concise Oxford English Dictionary* (12th edition, Oxford University Press, New York, 2011) defines the word "in" (relevantly) as:

> **In ▸prep. 1** expressing the situation of being enclosed or surrounded by something. **2** expressing motion that results in being within or surrounded by something. **3 expressing a period of time during which an event happens or a situation remains the case. 4** expressing the length of time before a future event is expected to happen. **5** expressing a state, condition, or quality. **6** expressing inclusion or involvement. …
>
> [Emphasis added]

79. The *Concise Oxford English Dictionary* defines the word "borrow" (relevantly) as:

> **borrow ▸v. 1** take and use (something belonging to someone else) with the intention of returning it. • take and use (money) from a person or bank under agreement to pay it back later. …

80. The text in s DB 5 could be given two different interpretations in terms of the meaning of the phrase "in borrowing money", because "borrowing" has two potential meanings.

81. The first possible interpretation is that because the ordinary meaning of "in" can express a period of time during which **a situation remains the case**, and the ordinary meaning of "borrow" being to take **and use** money under agreement to pay it

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back later, the phrase "in borrowing money" can encompass the entire on-going process or transaction of borrowing money. That is, that the phrase can refer to expenditure incurred in the course of the borrowing of the money, rather than just in the course of establishing the borrowing.

82. The second possible interpretation is that because the ordinary meaning of "in" can express a period of time during which **an event happens**, the phrase "in borrowing money" could refer only to the process of getting or obtaining the loan (ie, establishing the borrowing).

83. As noted above, s 5 of the Interpretation Act 1999 makes it necessary to cross-check the meaning of the legislative text against its purpose (see also *Fonterra*).

84. The history of s DB 5 provides some insight into the intended scope of the provision. The provision was originally enacted as s 15 of the Land and Income Tax Amendment Act 1939 (which was deemed part of the Land and Income Tax Act 1923), which read:

> **15.** Notwithstanding anything to the contrary in section eighty of the principal Act, the Commissioner may, in calculating the assessable income of any taxpayer, allow such deduction as he thinks fit in respect of expenditure incurred by the taxpayer during the income year for the preparation, stamping, and registration of any lease of property used in the production of his assessable income, or of any renewal of any such lease, or in the borrowing of money employed by the taxpayer as capital in the production of assessable income.

85. During the second reading of the Land and Income Tax Amendment Bill 1939, the Minister of Finance, the Hon. Mr Nash, explained the purpose of the provision as follows (see *NZPD* Vol 256, 537):

> Clause 15 gives a taxpayer the right to deduct from assessable income in arriving at his taxable income the legal expenses associated with a mortgage. There has been quite a lot of injustice through the lack of a provision of this nature. A taxpayer might incur in the renewal of a mortgage on property used in the production of the income an expense of from £20 to £30, and yet under the existing law has no right to deduct that expense from the assessable income.

86. These comments arguably suggest that the provision was aimed at providing deductions for expenses in raising money on mortgage (though in relation to borrowing costs it was not limited to the specific establishment costs listed in the provision in relation to leases).

87. The wording of the original provision is slightly different to the current wording of s DB 5. The original provision referred to expenditure incurred "in **the** borrowing of money", whereas s DB 5 refers to expenditure incurred "in borrowing money". It could be suggested that the "the" indicates that the provision was meant to apply in respect of expenditure incurred at any point in the course of the borrowing. However, the Commissioner considers that it is more strongly arguable that the word "the" indicates that the provision was meant to apply in respect of expenditure incurred in the course of the establishment of the borrowing.

88. The provision remained in essentially its original form until the Income Tax Act 2004, when the reference to the preparation, stamping, registration and renewal of leases of property was separated out into a new provision (now s DB 18), and the provision took on its current form.

89. Although the deductibility of expenditure incurred in borrowing money was not restricted to specific items of expenditure (as it was for expenditure relating to leases of property), the Commissioner considers that the scheme of the provision suggests that the intended scope was expenditure associated with the establishment of a lease or borrowing.

90. It is acknowledged that very little can be drawn from the pre-legislative material as to the intended purpose of what is now s DB 5. However the Commissioner considers that the provision appears to have been primarily aimed at allowing for the deductibility of expenses associated with **obtaining** borrowed money, rather than for the deductibility of any borrowing-related expenses.

91. On the basis of the above, the text in s DB 5 could be given two different interpretations in terms of the meaning of the phrase "in borrowing money". Those words could be interpreted as referring to the entire on-going process of borrowing money or as referring only to the process of obtaining a borrowing. When those words are considered in light of what appears to have been the purpose of s DB 5, the Commissioner considers that the words "in borrowing money" in s DB 5 refer to expenditure related to the **process of obtaining the borrowing** (ie, in establishing the loan).

Case law

92. There is little New Zealand case law on s DB 5 or its predecessors. The only New Zealand case that touched on the provision (when it was s 136 of the Income Tax Act 1976) is *Case G50* (1985) 7 NZTC 1,212. In *Case G50* Judge Barber considered that the fees and disbursements in question would fall within either the general deductibility provision or alternatively

the equivalent of s DB 5. However, the Commissioner considers that *Case G50* does not provide any guidance on the meaning of the words "in borrowing money" or the provision more generally[1] (see further from [112]).

93. The Australian Federal Court decision of *Ure* is considered the leading case on a similar provision, namely s 67(1) of the Income Tax Assessment Act 1936–1976 (Cth), which provided that:

> Subject to this section, so much of the expenditure incurred by the taxpayer in borrowing money used by him for the purpose of producing assessable income as bears to the whole of that expenditure the same proportion as the part of the period for which the money was borrowed that is in the year of income bears to the whole of that period shall be an allowable deduction.

94. Section 67(1) of the Income Tax Assessment Act 1936–1976 (Cth) was not identical to s DB 5, as it expressly provided for apportionment. However, the court still had to consider the meaning of the phrase "in borrowing money", and the Commissioner considers that Ure is relevant authority as to the meaning of that phrase in s DB 5.

95. In *Ure*, the Federal Court of Australia drew a distinction between what it called the cost of borrowing money and the cost of the money. The court held that the taxpayer was entitled to a deduction under s 67(1) of the Income Tax Assessment Act 1936–1976 (Cth) for an appropriate proportion of valuation fees and legal costs associated with the borrowing. The majority of the court (Deane and Sheppard JJ) said at 4,112:

> The words "expenditure incurred … in borrowing money" in the context of sec. 67(1) of the Act, refer in our view, to the "cost" of the borrowing as distinct from the "cost" of the money. The expenditure on account of legal expenses and valuation fees was plainly a "cost" of the borrowing: it was incurred in relation to the actual establishment of the relevant loan. On the other hand, interest payable to the lender represented a "cost" of the money: it was the price payable to the lender for the use of the money lent. The legal expenses and valuation fees were, and the interest was not, "expenditure incurred … in borrowing money" for the purposes of sec. 67(1).

96. The court considered that the legislative provision in question (equivalent to s DB 5) allowed a deduction only for expenditure incurred in establishing or setting up the loan (which was the cost of the borrowing), not expenditure arising from the borrowed money itself (which was the cost of the money).

97. Expenditure on items such as interest and the repayment of principal are not deductible under s DB 5. Although the repayment of money is linked to the borrowing of money (borrowing necessarily implies repayment at some time), the expenditure relates to the loan itself, not to the establishment or setting up of the loan.

98. The Commissioner considers that *Ure* is authority for expenditure incurred "in borrowing money" being expenditure incurred in establishing or setting up the loan. However, the expenditure does not need to be incurred at the time of the borrowing. Expenditure "incurred in borrowing money" could include expenditure incurred during the life of the loan. This will be the case only when at the time of and in the course of establishing the borrowing the borrower enters into an obligation to incur the expenditure during the life of the loan. For example, in *Ure* it was held that guarantee fees payable on an annual basis over the term of the loan were deductible, because the contractual obligation to pay them arose at the time of, and as an incident of, establishing the loan. That said, loan-related expenditure that is incurred during the life of the loan under a contractual obligation arising at the time of the establishment of the loan would not be incurred "in borrowing money" if it relates to bringing the borrowing to an end (see from [107]). It is not sufficient that the expenditure arises under the original loan contract; the character of the expenditure must also be considered.

Costs incurred in refinancing or rolling over an existing loan contract

99. Section DB 5 permits deductions for expenditure incurred in establishing a borrowing. Therefore, it may be necessary to consider whether variations or extensions to existing borrowings result in the rescission of the original loan contract and the establishment of a new one or whether they operate simply as variations. If there is a rescission of the original loan and the establishment of a new one, associated expenditure will potentially be deductible under s DB 5. But if there is simply a variation of the existing loan, associated expenditure will not be deductible under s DB 5 as it will not relate to the establishment of the loan.

[1] *Case G50* is discussed from [112]. As noted at [113], in *Case G50*, the Commissioner conceded that the fees and disbursements were revenue expenditure. It is unclear why this concession was made, and the Commissioner considers that the finding in *Case G50* (at least in respect of the general deductibility provision) appears to be based on this concession. Judge Barber's comments on s 136 of the Income Tax Act 1976 were *obiter*, and there is no reasoning in the case to support them. For these reasons, the Commissioner does not consider *Case G50* to be good authority for the deductibility of mortgage discharge fees under s DB 5.

100. Costs incurred in refinancing or rolling over a loan may, effectively, be incurred in establishing a new loan. As a matter of contract law, a variation of a loan may or may not create a new contract. The Court of Appeal discussed this principle in *Goldstone* at 502:

> It may be here observed that to call any such transaction as we have described a variation of the original mortgage would in popular language be correct, but in law and in truth the alteration made by the new instrument is a new contract compounded of the terms of the old and the new instrument.

101. The Court of Appeal applied *Goldstone* in *Nelson* in which the term of a mortgage had been extended by the execution of a memorandum. However, in *Robt Jones Investments Ltd v Instrument Supplies Ltd* (1991) NZ ConvC 190,746 at 190,752, the High Court considered *Nelson* was not relevant where:

> The variation of Lease was to give effect to the rent fixing provisions in the Lease during the term of the Lease and nothing was being done to vary the Lease outside the terms contemplated by the Lease.

102. In *Robt Jones* the court cited *Baker v Merckell* [1960] 1 All ER 668 (CA), one of several English cases concerning leases of land. In *Baker*, a lease had been granted for a term of seven years from 1 November 1946. In 1949, a deed was endorsed on the lease witnessing the parties' agreement that the term should be extended for a further term of four years at the option of the tenant. Pearce LJ, with whom the other members of the court agreed, applied the dictum of Maugham J in *In re Savile Settled Estates* [1931] 2 Ch 210 at 217:

> An alteration of an existing lease, so that it will operate for a term extending beyond the original term, can operate in law only as a surrender of the old lease and a grant of a new one.

103. Pearce LJ said at 672:

> Although the implication of surrender and fresh grant is a fiction based on estoppel, and, as Clauson J said … it is not to be encouraged or extended, it is not easy on the authorities to avoid the implication of a surrender and fresh grant where such a change is made in the term, viz., a variation of a term of seven years to a term of seven years with an option for a further four years.

104. It follows from this Court of Appeal authority (*Goldstone* and *Nelson*) that a new loan contract comes into existence on the refinancing or rolling over of an old loan. Therefore, the costs incurred in the refinancing or rolling over of a loan may be incurred "in borrowing money". This will be the case where the costs relate to the establishment of the new borrowing, but not where the costs relate to bringing the old borrowing to an end (ie, break fees).

105. However, another line of cases may lead to a contrary result. These cases began with *Morris v Baron & Co* [1918] AC 1 (HL). In *Morris*, the House of Lords decided that whether a contract is discharged depends on the extent to which the parties intended to alter their existing contractual relations. The intention may be merely to vary or modify the terms of the prior contract without altering them in substance, or it may be to extinguish the former contract and substitute a new one. The intention to extinguish and substitute may be inferred from the second agreement being inconsistent with the first to an extent that goes to the very root of it.

106. It seems likely that refinancing or rolling over a loan will evidence an intention to extinguish the old contract and substitute a new one, as an extension of the term of a contract goes to the root of the contract (*Baker*). This would mean that expenditure incurred in relation to the refinancing or rollover may be deductible under s DB 5. However, it will be a question of fact in each case. For example, an extension of the term of a loan contract, made pursuant to a provision in the contract contemplating such an extension, is a variation of the contract and is not the establishment of a new loan. Expenditure incurred in relation to a variation would not be deductible under s DB 5.

Expenditure relating to bringing borrowing to an end is not incurred "in borrowing money"

107. Several cases support the view that expenditure incurred in bringing a borrowing to an end is not expenditure incurred in borrowing money (*Riviera Hotel; Neonex; Case 31*).

108. *Riviera Hotel* concerned a company that was required to discharge an existing first mortgage to borrow additional capital. As the existing mortgage did not allow prepayment, the company was required to pay six months' bonus interest under the existing mortgage to secure the discharge of the mortgage. The Canadian Federal Court considered that the bonus interest was not paid for the use of money, so it was not interest. The court held that the bonus interest was an inducement to the existing lender to forego its right to hold the mortgage to maturity and to accept repayment. The bonus interest was an expense incurred in the course of repaying money to the first lender rather than an expense incurred in the course of borrowing money from the second lender. Therefore, the bonus interest was not deductible under the Canadian legislative provision (equivalent to s DB 5(1)). Cattanach J stated at 161:

> Reverting to the facts in this appeal it is significant to recall that there were two different and distinct borrowings. The appellant sought to obtain further funds from the first lender. Under the mortgage held by the first lender principal and interest remained unpaid and the mortgage contained no provision for prepayment to the first lender. The appellant, having made the commercial decision to expand its hotel facilities by which it expected to earn still further money from its business, was compelled to seek the further necessary funds from another source. This the appellant succeeded in doing but subject to the second lender having a first charge on the appellant's premises. To meet this condition required by the second lender the appellant was compelled to pay all arrears of principal and interest and in addition was obliged to pay to the first lender the sum of $13,108.27 as a bonus, computed by the yardstick of the equivalent of interest for six months, for the privilege of discharging the mortgage before maturity.
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> …
>
> **The payment of $13,108.27 by the appellant to the first lender was not a payment for the use of the money obtained from the first lender. This payment was made to the first lender as an inducement or bonus for the first lender to forego its right to hold its first mortgage to maturity and to accord to the appellant the privilege of paying the balance of principal and interest under the mortgage, which it was the appellant's obligation to do ultimately, prior to the due dates. The payment of the sum of $13,108.27 was an expense incurred for this purpose.**
>
> **The payment was not made in the course of borrowing money from the first lender but it was made in the course of repaying that money. This being so it follows that the payment to the first lender cannot be construed as an expense incurred by the appellant in the course of borrowing money from the second lender.**
>
> [Emphasis added]

109. In *Neonex*, a company paid a prepayment bonus to obtain a lender's consent to the early repayment of a loan. The repayment of the existing loan was a condition of a replacement loan from another lender. The Canadian Federal Court of Appeal considered that the payment was not deductible because it was an expense incurred to rid itself of the first lender, rather than an expense incurred in borrowing money from the second lender:

> It seems to me that the facts of this case more closely resemble the factual situation in the *Riviera* case than those in the *Yonge-Eglinton* case. The reasoning of Cattanach J. appears to me to be clearly right on the facts as he found them which facts are, as observed, closely similar to those in this case. In my view, the payment of $105,000 paid by the Appellant, while in a sense necessary for the fulfillment of a condition imposed in respect of a second borrowing is more properly characterized as a bonus paid to induce the first lender, Prudential Insurance Company of America, to forego its right to hold its first mortgage to maturity by permitting the mortgagor, the Appellant herein, to prepay it. Thus, it cannot be construed as an expense incurred by the Appellant in the course of borrowing money from Marine-Midland, the second lender. It was an expense incurred to rid itself of the first lender.

110. However, early repayment fees or "break fees" may come into the base price adjustment calculation required under the FA rules. See *Deductibility of Break Fee Paid by a Landlord to Exit Early from a Fixed Interest Rate Loan (BR Pub 12/01) and Deductibility of Break Fee Paid by a Landlord to Exit Early from a Fixed Interest Rate Loan on Sale of Rental Property* (BR Pub 12/03).

111. In *Case 31*, the Australian Commonwealth Taxation Board of Review considered that a payment made to obtain a mortgagee's agreement to the early repayment of the mortgage was not deductible under s 67 of the Income Tax Assessment Act 1936–1941 (Cth) (equivalent to s DB 5). This was because s 67 did not apply to expenditure incurred in the repayment of borrowed money.

112. In *Case G50* the Commissioner conceded that legal fees and disbursements relating to the discharge of mortgages were revenue expenditure. Judge Barber considered that the fees and disbursements were deductible under ss 104 and 136 of the Income Tax Act 1976 (predecessors to s DA 1 and s DB 5(1) respectively). Judge Barber said at 1,215:

> … The relevant portion of sec 136 gives a discretion to allow a deduction for expenditure incurred by the taxpayer during the income year in question "in the borrowing of money employed by the taxpayer as capital in the production of assessable income" …
>
> I understood Mr McGuire to concede that the said $197, fees and disbursements on the discharge of mortgages to achieve the sale, is deductible as a revenue expense. In any case I find the $197 to be deductible as coming within the words I have quoted from sec 136 of the Act and as generally coming within sec 104. The mortgage loan had provided O with a capital asset, the stud farm, on which to carry out its breeding business. The $197 fee could not come within sec 106(1)(h)(i) because it does not comprise interest.

113. It is unclear why it was conceded that fees and disbursements on the discharge of the mortgages were revenue expenditure, and the Commissioner considers that the finding in *Case G50* (at least in respect of the general deductibility provision) appears to be based on this concession. Judge Barber's comments that the

fees and disbursements would be deductible under s 136 were *obiter*, there is no reasoning in the case to support this view, and *Case G50* is inconsistent with the case law outlined above. The Commissioner does not consider *Case G50* to be correct in this regard, and for the above reasons does not regard it as good authority for the deductibility of mortgage discharge fees under s DB 5.

114. Expenditure incurred in discharging a mortgage is not a cost of obtaining a loan, and is unlikely to be expenditure incurred under a definitive contractual obligation entered into in connection with the establishment of a loan. In any event, even if mortgage discharge costs were incurred under a definitive contractual obligation entered into in connection with the establishment of a loan, having a mortgage discharged is so intrinsically related to bringing a borrowing to an end that the Commissioner considers those costs cannot rightly be characterised as incurred "in borrowing money". Expenditure incurred in discharging a mortgage is incurred to terminate the interest of the mortgagee in the land over which the mortgage is secured. *Laws of New Zealand* Mortgages (online ed, accessed 5 August 2013) at [295] and [296] states:

> A mortgage consists of two parts: the contract and the charge. Strictly speaking, the term "release" refers to the termination of the contract, while "discharge" refers to the termination of the charge. The terms are not synonymous. A debt may be released or repaid but a registered charge still remain on the land, at least until action is taken to remove it; and the charge may be discharged, without the debt being released, in which case the debt becomes unsecured.
>
> …
>
> A registered mortgage is discharged, wholly or partly, by a mortgage discharge instrument executed by the mortgagee, discharging the whole or part of the land or estate or interest from payment of the whole or part of the principal sum. Before it is registered, a mortgage discharge instrument in paper form operates as a deed *inter partes*; but it does not affect the legal title until registered. The form must be modified if it is desired to retain the personal covenant. It is not effective to discharge the security until it is registered. If it is not registered, the security remains for the benefit of the person entitled. The discharge and release of a mortgage, whether registered or unregistered, operates as if it were a deed, and transfers or releases to the current mortgagor the interest of the mortgagee in the mortgaged property to the extent specified in the instrument.

115. A possible argument is that if a discharge of a mortgage is required to enable the taxpayer to provide security for a replacement loan, expenditure in connection with the discharge of a mortgage is incurred in borrowing under the replacement loan. However, in *Riviera Hotel* and *Neonex*, although it was necessary to incur expenditure in repaying an existing lender to satisfy a requirement that the replacement lender be given a first charge, the courts did not accept that the expenditure was incurred in borrowing money from the replacement lender.

116. In the Commissioner's view, expenditure incurred for the discharge of a mortgage is not expenditure incurred in borrowing money, whether or not the discharge of mortgage is required to give security to a replacement lender. Such expenditure is incurred in terminating the interest of the existing mortgagee over the land subject to the mortgage.

117. On the basis of these cases, the Commissioner considers that:

- Section DB 5 is not limited to expenditure on the preparation and registration of mortgages or other security documents. Expenditure incurred in borrowing money means costs that are incurred to obtain borrowed money. Interest, which is the price paid for the use of money, is not expenditure incurred in borrowing money.
- Expenditure does not need to be paid out at the time of the borrowing to be incurred in borrowing money. Expenditure "incurred in borrowing money" includes expenditure the borrower is contractually obliged to pay during the life of the loan (even if the expenditure has not been incurred at the time of the borrowing), but only where a definitive contractual obligation to make the payment was incurred at the time of the borrowing (and as an incident of establishing the loan). However, expenditure that relates to bringing a borrowing to an end is not expenditure incurred in borrowing money.
- A payment made to induce a lender to accept early repayment is expenditure incurred in repaying borrowed money rather than expenditure incurred in borrowing money, even if it is necessary to incur the expenditure to satisfy a requirement that the replacement lender be given a first charge. (However, such expenditure may potentially be brought into the base price adjustment required under the FA rules, see [29]–[47].)

- Expenditure incurred for the discharge of a mortgage is not expenditure incurred in borrowing money. Such expenditure is related to bringing a borrowing to an end, because it is incurred in terminating the interest of the existing mortgagee over the land subject to the mortgage. This is the case whether or not it is necessary to incur costs in discharging an existing mortgage to give security for a new loan.

Nexus between the expenditure and the borrowing of money

118. Section DB 5 does not permit a deduction for all expenditure incurred as part of the process of obtaining a loan. A sufficient connection must exist between the expenditure and the borrowing of money for the expenditure to be "incurred in borrowing money".

119. Provided that none of the general limitations in s DA 2 apply, an amount of expenditure is deductible under s DA 1 to the extent to which the taxpayer incurs it:

    - in deriving their assessable income, excluded income or a combination of the two; or
    - in the course of carrying on a business for the purpose of deriving their assessable income, excluded income or a combination of the two.

    The courts have held that a sufficient connection must exist between the expenditure and the deriving of the taxpayer's assessable income (ie, the expenditure must be incurred in deriving the taxpayer's assessable income).

120. The Commissioner considers that generally, expenditure will have sufficient nexus with a borrowing if it is required by the lender in order for the borrower to obtain the borrowing, is relevant to and related to the borrowing, and does not result in the acquisition of more than minor assets or benefits other than the borrowing. Typically, expenditure such as legal expenses, valuation fees, guarantee fees (unless the taxpayer is required to use a spreading method under the FA rules) and other similar expenditure that relates to a loan transaction itself will have a sufficient nexus with the borrowing of the money to be deductible under s DB 5.

Expenditure resulting in the acquisition of assets or benefits other than the borrowing

121. A connection between expenditure being incurred and a borrowing being obtained will not necessarily be enough for the expenditure to be correctly characterised as incurred "in borrowing money". As noted, a sufficient nexus must exist between the expenditure and the borrowing, and the Commissioner considers that this will not be the case if the expenditure results in the acquisition of more than minor assets or benefits other than the borrowing.

Insurance premiums

122. The issue of whether expenditure has a sufficient nexus with a borrowing to be characterised as being incurred "in borrowing money" has arisen in the context of life insurance required by a lender as security for a borrowing. The deductibility of life insurance premiums is specifically considered in this Interpretation Statement because there is conflicting case law on this issue. Also, the Commissioner understands that some taxpayers may have treated term life insurance premiums as deductible under s DB 5 on the basis of the conclusion in the item "Deductibility of mortgage repayment insurance taken out to obtain a business loan" *Tax Information Bulletin* Vol 6, No 9 (February 1995). That item stated that mortgage repayment insurance would be deductible under the predecessor to s DB 5. The Commissioner understands that mortgage repayment insurance is no longer used in a business context. However, in any event, as noted at [24], this Interpretation Statement replaces that item.

123. A financial institution may require life insurance (eg, over the lives of the directors of a company) as security for a loan. The following description of various types of life insurance policy is set out in *New Zealand Business Law Guide* (looseleaf ed, CCH New Zealand, 1985, updated to 28 August 2013) at [80-060]:

    > ***Whole of life***
    >
    > The sum assured is payable in full on the death of the life assured. However, it is common for the payment of premiums to be required for only a limited term, which may be until age 60 or 65. Such a policy is almost invariably a "participating" policy, which means that the insurer adds a portion of its profits to the amount payable in the form of annual bonuses so that the longer the life assured lives the greater will be the sum payable on death. If the policy is surrendered after it has been in force for a minimum number of years, it has a cash value which is payable to the insured by the insurer.
    >
    > ***Term or temporary insurance***
    >
    > The sum assured will be payable only if the life assured dies during a specified period, and if death does not occur during that time then nothing is payable. These are commonly converted to a whole of life policy or renewed for a further term.

Endowment insurance

This provides for the payment of a lump sum if the life assured survives until the end of the term of the policy or if the life assured dies during that period. These are generally participating policies which means that annual bonuses are added to the sum payable. They usually have a surrender value.

Investment insurance or insurance bonds

This type of insurance provides a comparatively nominal death cover of whatever amount the policyholder requires. Its most important aspect is that the premiums paid, apart from the amount needed to purchase whatever death cover is required, are invested by the insurer and returns paid to the insured. Generally, a specified minimum sum must be paid for the first few years after the policy is taken out, but after that the payments become optional. Returns are based on the amount paid. The manner in which the returns are to be paid is also flexible, in that it may be by lump sum or by instalments. To some extent the insurer is acting as an investment broker for the insured, rather than only as an insurer.

Annuities

These provide for the payment of a lump sum by way of premium, in return for which the insurer agrees to pay specified amounts, either annually, quarterly or monthly, until the annuitant dies or for a fixed term. These are rare in New Zealand, except as part of a superannuation fund.

Mortgage repayment insurance

This form of life insurance is common in New Zealand and is frequently required by lending institutions. It is a single premium policy for an amount which is sufficient to repay whatever is owing on a mortgage. It is payable on the death of the life assured, who is the mortgagor. This means that it is for a restricted term and also for a decreasing amount, assuming that the liability under the mortgage is decreasing.

124. The following analysis looks at whether premiums on life insurance required by a lender as security for a loan are deductible under s DA 1 or s DB 5. The analysis is set out under the headings:

- (i) Deductibility of life insurance premiums for policies required by a lender as security for a loan—section DA 1: discussed from [125].
- (ii) Deductibility of life insurance premiums for policies required by a lender as security for a loan—section DB 5: discussed from [131].
  - Case law on whether premiums on life insurance policies required as security are expenditure incurred in borrowing money: discussed from [135].
  - Assignment of life insurance policies: discussed from [163].
- (iii) Lenders mortgage insurance: discussed from [165].

(i) Deductibility of life insurance premiums for policies required by a lender as security for a loan – section DA 1

125. There are no relevant New Zealand cases on whether premiums for life insurance required by a lender as security for a loan are deductible under the general deductibility provision (s DA 1). However, the deductibility of such premiums under general deductibility provisions has been considered in Australia and Canada in *Case 64*, *Equitable Acceptance*, *Côté-Reco* and *Case Y21*. In each of these cases, it was considered that the premium on a life insurance policy was capital expenditure, and so not deductible under the relevant general deductibility provision. In *Equitable Acceptance* and *Côté-Reco* the Exchequer Court of Canada and the Canadian Tax Review Board, respectively, considered that any payments for the purpose of obtaining capital (ie, the loans) would be capital outlays, and so not deductible under the general provision. In *Case 64* and *Case Y21* the Australian Commonwealth Taxation Board of Review and Administrative Appeals Tribunal, respectively, considered that the insurance policies in those cases were capital assets, and so the premiums were not deductible under the general provision.

126. In *Case 64* a company borrowed money to purchase a business. A condition of the loan was that the managing director of the company would insure his life and assign the policy to the lender as collateral security. The Commonwealth Taxation Board of Review considered that the premiums brought into existence an asset or advantage for the enduring benefit of the company's business, and were effective to build up a substantial asset under the insurance policy. The board concluded that the premiums were capital expenditure, being consideration for a capital asset (the policy), saying at 191:

> In this case the premium payments are bringing into existence an asset or advantage for the enduring benefit of the taxpayer's business. They are, as we have already said, building up a substantial asset under an insurance policy which, if it matures by the death of the Managing Director at any time before the debt of £3,250 is fully discharged, will provide the taxpayer with more than sufficient funds for that purpose. The Mortgagee insisted upon taking out this policy and evidently looks upon it as valuable collateral security. The capital character of the premiums appears in the fact that they are paid as consideration for – in substance they are the purchase price of – a capital asset, the hypothecation of which provided the funds for the purchase of the business by the taxpayer.

127. In *Equitable Acceptance*, Cattanach J considered that the premiums were incurred for the purpose of obtaining additional capital, so they were capital expenditure. That being the case, a deduction was allowable only if the premiums fell within the Canadian equivalent of s DB 5 (s 11(1)(cb)(ii) of the Income Tax Act RSC 1952). The court considered at [23]–[25] that:

> 23 The evidence clearly established that the money borrowed by the appellant from Triarch was forthwith deposited in the appellant's bank account and was used in the operation of the appellant's business. The loan was not comparable to mere temporary accommodation from the appellant's bankers, but was rather an addition to the capital of the appellant.
>
> 24 Any payments for the purpose of obtaining capital are outlays of capital within the meaning of Section 12(1)(b) [of the Income Tax Act RSC 1952].
>
> 25 Therefore, it is quite clear the payment of premiums on the life insurance policies is not deductible unless it falls within the express terms of Section 11(1)(cb)(ii) of the Act [the Canadian equivalent of s DB 5] and the issue for determination is whether the said payment of the life insurance premiums constituted an expense incurred in the year in the course of borrowing money.

128. In *Côté-Reco*, the Tax Review Board considered that the premium on a life insurance policy was capital expenditure, being a payment made to obtain additional capital. Therefore, a deduction was not allowable under s 18(1)(a) of the Canadian Income Tax Act RSC 1952 (the equivalent of s DA 1). A deduction was precluded by s 18(1)(b) of the Income Tax Act RSC 1952, which prohibited the deduction of capital expenditure. The board noted at [21] and [22] that:

> 21 The evidence showed that the increase in the line of credit was necessary primarily to construct a building and purchase a computer. The increased line of credit used for these purposes constituted an increase in the capital of the company. Any payment made in order to obtain capital is covered by paragraph 18(1)(b) [of the Income Tax Act RSC 1952], not paragraph 18(1)(a) [of the Income Tax Act RSC 1952].
>
> 22 Consequently, the expenditure made to pay an insurance premium guaranteeing the increase in the said line of credit cannot be deducted under paragraph 18(1)(a).

129. In *Case Y21*, the taxpayer had purchased a rental property using money provided by a family trust. The taxpayer then took out an endowment life insurance policy that was used as security for a loan from a finance company. The taxpayer claimed that the purpose of the loan was to repay the family trust. However, the Administrative Appeals Tribunal did not accept that there was a loan between the trust and the taxpayer. Therefore, the tribunal did not consider that the finance company loan was borrowed to repay a loan obtained to acquire the rental property. On that basis, the tribunal considered that the premiums were not deductible under the equivalent of s DA 1. The tribunal considered that even if the loan from the finance company had been borrowed to refinance a loan from the family trust to purchase the rental property, the premiums would not have been deductible. This was because the premiums were expenditure of a capital nature as they brought into existence an asset (the insurance policy) that was an enduring benefit. The tribunal noted at [24] that:

> 24. In the circumstances of these references, the Tribunal is of the opinion that the enduring benefit test, which takes its origin from the judgment of Viscount Cave L.C., in *British Insulated and Helsby Cables Limited v Atherton* (1926) AC 205, is relevant. His Lordship's opinion as to the characteristics of capital expenditure was expressed in the following terms:
>
> "But when an expenditure is made not only once and for all, with a view to bringing into existence an asset or an advantage for the enduring benefits of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."
>
> In the Tribunal's view the paying of premiums on a yearly basis rather than once and for all is, in the circumstances, of no consequence and does not alter the finding that the payment under consideration brought into existence an asset which was bound to come home in due course, subject only to continued payment of premiums during the life of the policy. The conclusion is inescapable that the transaction is an affair of capital.

130. The above cases confirm that a premium on a life insurance policy required by a lender as security for a loan is capital expenditure, either on the basis that it is incurred to obtain additional capital or on the basis that it is incurred to obtain a capital asset in the form of the policy.

(ii) Deductibility of life insurance premiums for policies required by a lender as security for a loan – section DB 5

131. The Commissioner considers that to be deductible under s DB 5, the expenditure in question must be able to be characterised as being about establishing the loan, and must not be consideration for valuable benefits other than the loan.

132. It is a question of fact and judgement whether a particular expense is expenditure incurred in borrowing money or whether it is expenditure for something else. The necessary enquiry involves consideration of what the borrower acquires by making the payment. The acquisition of minor assets or benefits will not indicate a lack of sufficient nexus between the expenditure and the loan. For example, receipt of a valuation report would not mean that valuation fees were not expenditure incurred in borrowing money. However, where the assets or benefits acquired are more than minor, there will be an insufficient nexus between the expenditure and the loan. No precise lines can be drawn here—it is a matter of fact and judgement to determine whether the real nature of the transaction is that the borrower has incurred expenditure in order to obtain borrowed money (rather than to acquire some other asset or benefit) and so whether there is a sufficient nexus between the expenditure and the borrowing of money for the expenditure to be regarded as incurred "in borrowing money".

133. The Commissioner considers that the benefit obtained in relation to expenditure on life insurance premiums colours the character of the expenditure such that the required nexus between the expenditure and the borrowing of money is not met. Therefore, it is considered that expenditure on insurance premiums cannot be regarded as incurred "in borrowing money", even if the lender requires the insurance as security for the loan.

134. There is no New Zealand case law on this issue. However, a body of Australian and Canadian case law supports the above view.

Case law on whether premiums on life insurance policies required as security are expenditure incurred in borrowing money

135. In *Case 19* (1966) 13 CTBR (NS) 124, the taxpayer was one of a group of trusts that had borrowed money to purchase an income-producing property. The lender required two life insurance policies over the life of the trustee. One of these policies was in existence at the time the money was borrowed and the other was taken out specifically to provide the required security. Annual bonuses were paid under the policies, and the policies had a surrender value. The trusts paid the premium in respect of the second policy. The taxpayer claimed a deduction for its share of the premiums.

136. The Australian Commonwealth Taxation Board of Review held that the premiums were not expenditure incurred in borrowing money. The premiums were expenditure on insurance, which was an asset that was separate and distinct from the loan itself, and the premiums were paid for valuable benefits (insurance over the life of the trustee, annual bonuses and a surrender value). The board noted at [4] that:

> 4. For several reasons, the expenditure with which we are concerned seems to fall outside the provisions of s. 67 [of the Income Tax and Social Services Contribution Assessment Act 1936–1963 (Cth)]. The outgoing had the character of expenditure on insurance, rather than expenditure in borrowing. The premiums under the policy, of the first of which the deduction claimed was part, are payable as consideration for valuable benefits, namely a continuing insurance on the life of the trustee, annual bonuses and a surrender value in the event of the policy being cashed before maturity. They lack entirely the character of a cost of borrowing and, though they are outgoings, are not expenses in the nature of costs at all. They are outgoings which will, in due course, result in a payment under the policy which may well be far in excess of the amount paid. Yet s. 67 speaks of expenditure rather than outgoings. … In our opinion, therefore, the subject expenditure, rather than having the character of "expenditure incurred … in borrowing", was an outgoing incurred on insurance, which, though it qualified the trustee to obtain the loan and provided collateral security for the repayment thereof, was, nevertheless, a thing distinct from, and independent of, the loan itself.

137. In *Case Y21*, the tribunal adopted the reasoning in *Case 19* and held that the premium on an endowment policy was not expenditure incurred in borrowing money. This was because the expenditure brought into existence an asset (the policy) from which the taxpayer or the taxpayer's family stood to gain, either on death or at maturity of the policy. The tribunal noted at [23] and [26] that:

> 23. Court decisions over the years demonstrate that in a determination of this kind, there is no one test capable of universal application. What does become clear, is that the character of the outgoing must be considered in the context of all the circumstances. There is no doubt that **the payment of the premium brought into existence an asset of some significance** i.e. the policy of assurance, **and that at some time in the future, either upon death or at maturity, the applicant and/or members of his family stood to gain financially**. In simple terms, **the policy is an investment and the premiums paid represent its cost**. That the policy was used as security alters nothing, in fact it supports such a conclusion.
>
> 26. … the Tribunal is of the view that it would be wrong to describe the payment of a premium on a policy of life assurance, as an expense incurred in borrowing money. The same view was expressed by

> the Taxation Board of Review No 2 in 13 CTBR (NS) 124 *Case 19*. …
>
> [Emphasis added]

138. In *Equitable Acceptance* the court held that premiums on whole of life insurance policies were not an expense incurred in the course of borrowing money. The court considered that although the purchase (and assignment) of the policies was a condition of the loan, the true nature of the transaction was that in return for the payment of the premiums the borrower obtained an asset that could be used as security for the borrowing of money. The court noted at [27] that:

> 27 … the cost of the purchase of the two life insurance policies and the maintenance in force thereof by the payment of premiums is not an expense incurred in the year in the course of borrowing money used by the taxpayer for the purpose of earning income from a business. **While it is true that the purchase of these life insurance policies and their assignment to Triarch [Triarch Corporation Limited] was a condition imposed by Triarch before making the loan to the appellant, nevertheless the true nature of the transaction was that the appellant acquired an asset which could be used, and was in fact used, as a collateral security necessary to borrow money to be used in its business. In short, the appellant, by the purchase of the two insurance policies, merely enhanced its position as a reliable lending risk.**
>
> [Emphasis added]

139. The court also noted that if the insured had died during the term of the loan while the policies were in force, the taxpayer's net position would have improved because the loan would have been repaid in full without any corresponding debit entry. Further, if the proceeds of the policy had exceeded the amount required to repay the loan, the taxpayer would have been entitled to receive the excess. Also, once the loan was repaid, the policy was available to provide security for another loan:

> 28 If the insured, Emil E. Schlesinger, had died while the policies were in force and before the repayment of the loan, the appellant would then be in the position of the loan being fully paid from the proceeds of the insurance policies and the amount of the loan received by the appellant would become part of the appellant's assets without any corresponding debit entry. Again if the proceeds were in excess of the amount required to repay the loan, then any such excess would have accrued to the appellant's assets. Further when the loan was repaid, as it was, there was nothing to prevent the appellant from securing another loan from the same or a different source on the strength of the security of the two life insurance policies, if the necessity arose.

140. *Obiter* comments in *Irwin v MNR* [1978] CTC 3,247 also confirm that premiums on a life insurance policy used as security for a loan are not deductible. In *Irwin*, the taxpayer had purchased his father's shares in a company. A condition of the purchase agreement was that the taxpayer was to purchase term life insurance on his father's life and pay the premiums on the policy. If the father died, the proceeds of the policy would be applied to the balance owing on the purchase of the shares. The Canadian Tax Review Board considered that the relationship between the taxpayer and his father was a debtor–creditor relationship rather than a borrower–lender relationship. On that basis, the premiums were not deductible. However, even if there had been a borrower–lender relationship, the board considered that, on the authority of *Equitable Acceptance*, the premiums would not be deductible:

> 30 The facts however in the *Equitable Acceptance* case are distinguishable from those in the instant appeal in that the appellant actually borrowed and received monies which were used in the operation of its business. The purchase of the insurance policies which was also a condition of the loan was only collateral security for the loan and it was held that the premiums paid thereon had nothing to do with expenses incurred in the borrowing of money used by the taxpayer for the purpose of earning income.
>
> 32 In the instant appeal, although the purchase of a $50,000 life insurance policy was a condition of the purchase of share agreement, the subject transaction was basically the purchase and sale of a capital asset giving rise to a debtor-creditor relationship in which part of the appellant's debt was secured by a life insurance on his father's life and payable on his death to his father's estate, if the balance of the selling price had not been paid. No evidence was produced, not even a promissory note as in the *McCool* case (*supra*), which might be interpreted as the appellant having borrowed money from his father and even less that the borrowed monies had been used by the appellant for the purpose of earning income from the business.
>
> 33 **If the facts in the *Equitable Acceptance* case (*supra*) led the Court to conclude that the life insurance premiums paid by the appellant did not constitute an expense in the course of borrowing money then *a fortiori* do the facts in the instant appeal justify the same conclusion.**
>
> [Emphasis added]

141. In the 1988 case of *Guertin*, the company had borrowed to purchase land and construct buildings to expand its operations. Whole of life insurance policies on the life of the president of the company were transferred to the lender as security for the loan. The company claimed a deduction of an amount equal to

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the premiums that would have been payable had it purchased term policies on the president's life, instead of whole of life policies. Marceau J in the Canadian Federal Court of Appeal noted that as the court must deal with what the taxpayer actually did, not what the taxpayer could have done, it was not strictly necessary to determine whether there was a distinction between permanent and temporary insurance. Therefore, even if there were a distinction, because the company had obtained permanent insurance, the premiums were not deductible. However, the court considered whether such a distinction existed, because it was the focus of the parties' submissions.

142. The court considered that the basis of the decision in *Equitable Acceptance* was that the true nature of the transaction was that the taxpayer had acquired an asset. The right of an insured under a term life insurance policy was considered to be as much an asset as a whole of life policy, and could be used as security in the same way. Therefore, the court considered that the reasoning in *Equitable Acceptance* was equally applicable to term life policies, whether or not the term of the insurance policy correlated with the term of the loan. The court considered that to be expenditure incurred in the course of a loan, the expenditure must result in a diminution of the borrower's property. As the right under a term life policy was of equivalent value to the premium, the court considered that payment of the premium under a term life policy did not result in diminution of the borrower's property. The court stated at [5]–[7] that:

> 5. I should say first that **I have some difficulty understanding how the scope of the judgment in *Equitable Acceptance Corporation* can be limited to cases in which the life insurance obtained and transferred is whole life insurance.** In my opinion, Cattanach J.'s reasoning is entirely contained in this paragraph from his reasons:
>
> > In my view the cost of the purchase of the two life insurance policies and the maintenance in force thereof by the payment of premiums is not an expense incurred in the year in the course of borrowing money used by the taxpayer for the purpose of earning income from a business. While it is true that the purchase of these life insurance policies and their assignment to Triarch was a condition imposed by Triarch before making the loan to the appellant, nevertheless the true nature of the transaction was that the appellant acquired an asset which could be used, and was in fact used, as a collateral security necessary to borrow money to be used in its business. In short, the appellant, by the purchase of the two insurance policies, merely enhanced its position as a reliable lending risk.
>
> 6. **It seems to me that this reasoning applies just as much to the case of temporary insurance as to that of whole life insurance. The right of the insured under a temporary life insurance contract is an "asset" in the sense in which the word is used by Cattanach, J., that is, a usable security from which a benefit can be obtained, or valuable property, in the same way as the right conferred on an insured by a "permanent" life insurance contract, even though the asset is of a lower value and its transformation into cash is of course only a contingency. Cattanach J.'s judgment has often been treated as based simply on an interpretation of the phrase "in the course of" contained in the wording of the applicable provision, the judge being of the view that the expense was prior to the loan and not "in the course of borrowing" (cf *Côté-Reco Inc. v. Minister of National Revenue*, [1980] CTC 2019, 80 DTC 1012). On the contrary, the reasoning appears to me to go much further than that. I understand it to mean that, in order to speak strictly and accurately of an *expense* incurred in the course of a loan, the expenditure must as such have had no consideration other than the loan, or in other words, it must be an expenditure resulting in a diminution of the borrower's property. The property right represented by temporary insurance is the premium paid in another form with an equivalent value, and no diminution could possibly result in the property of the insured.**
>
> 7 It is true that, in his reasons, Cattanach, J. went on to say, in a paragraph subsequent to the one just cited, the following:
>
> > If the insured, Emil E. Schlesinger, had died while the policies were in force and before the repayment of the loan, the appellant would then be in the position of the loan being fully paid from the proceeds of the insurance policies and the amount of the loan received by the appellant would become part of the appellant's assets without any corresponding debit entry. Again if the proceeds were in excess of the amount required to repay the loan, then any such excess would have accrued to the appellant's assets. Further when the loan was repaid, as it was, there was nothing to prevent the appellant from securing another loan from the same or a different source on the strength of the security of the two life insurance policies, if the necessity arose.

> In my view, however, in so doing the judge added nothing to his reasoning and merely elucidated the various aspects of the "asset" represented by the policies at issue in the case before him …. **In my view the reasoning underlying *Equitable Acceptance Corporation* applies just as much to temporary insurance for the duration of the loan as to insurance which will continue beyond it, and it is a reasoning which appears to me to be unimpeachable.**
>
> [Emphases added]

143. In *Elirpa Construction & Materials Ltd v Canada* [1995] 2 CTC 2,968, which concerned a whole of life policy, the taxpayer argued that there was a distinction between whole of life insurance and term life insurance, and that the only issue was the amount of the deduction. The Tax Court of Canada considered that on the authority of *Guertin*, no deduction was allowable. However, a different approach had been taken in the earlier cases of *Côté-Reco* and *Economy Carriers Ltd v MNR* [1984] CTC 2,210, which concerned term life policies. As noted at [150], in *Guertin* the court considered that in *Côté-Reco* the board had misunderstood the decision in *Equitable Acceptance*. The court in Elirpa cited that aspect of the judgment in *Guertin* with approval.

144. In the 1980 case of *Côté-Reco*, the company was required to assign term life or temporary life insurance policies as security for the extension of a line of credit. The Tax Review Board of Canada disagreed with the reasoning in *Equitable Acceptance*, and considered that it was not bound to follow that case given the conclusion in *MNR v Yonge-Eglinton Building Ltd* [1974] CTC 209. In *Yonge-Eglinton*, it was held that to be deductible as an expense incurred in the course of borrowing money, expenditure must be incurred "in connection with", "incidental to" or "arising from" the process of borrowing money. In *Côté-Reco*, the board considered that the company had purchased the policies "in the course of borrowing money" (ie, "in connection with", "incidental to" or "arising from" the process of borrowing money), stating at [41]–[44]:

> 41 In the Board's opinion, the payment of insurance policy premiums complies word for word with the condition specified by subparagraph 20(1)(e)(ii), namely that the expense was incurred "dans l'année à l'occasion d'un emprunt contracté par le contribuable et utilisé en vue de tirer un revenu d'une entreprise ou de bien …"
>
> 42 It is worth citing the English wording:
>
> (e) an expense incurred in the year,
>
> (ii) in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property …
>
> 43 The phrase "in the course of" may appear at first sight to have a more limited meaning than "à l'occasion de". In 1974, however, ten years after the *Equitable Acceptance Corp Ltd* judgment [*supra*], in *Yonge-Eglinton Building Ltd v Minister of National Revenue*, [1974] CTC 209, 74 DTC 6180, the Federal Court of Appeal, per Thurlow, J, explained the meaning of "in the course of", and appeared to give it a rather broad meaning, at least as broad as "à l'occasion de":
>
> > It may not always be easy to decide whether an expense has so arisen but it seems to me that the words "in the course of" in section 11(1)(cb) are not a reference to the time when the expenses are incurred but are used in the sense of "in connection with" or "incidental to" or "arising from" and refer to the process of carrying out or the things which must be undertaken to carry out the issuing or selling or borrowing for or in connection with which the expenses are incurred.
>
> 44 Although the Court made this comment in a discussion of time, the broad meaning given to the phrase "in the course of", is still valid. When the appellant purchased its two insurance policies to guarantee the loan (a condition required by the lender), it did so "in the course of borrowing money" although, as Cattanach, J observed, in doing so the appellant "merely enhanced its position as a reliable lending risk".

145. The board considered that this conclusion was not altered by the fact that the company, by taking out life insurance, had enhanced its position as a reliable lending risk. The board also considered the possibility that the insured could have died while the loan was outstanding and the proceeds of the insurance may have exceeded the amount required to repay the loan. The board considered that it was irrelevant that in this scenario the company would have had a sum of money left over from the proceeds after repaying the loan. The board stated at [45] that:

> 45 The Board considers that even if the insured died and the appellant, after receiving the indemnity and paying the balance owed the lender, still had a substantial amount in its bank account, that does not alter the fact that the payment of the premiums, at least in the earlier years, was made "in the course of borrowing money". It appears to the Board that once the situation falls word for word within the Act, particularly in an exempting section, there is no need to look for hypothetical consequences which might be more favourable to the taxpayer, and then if any are found, disallow

the exemption. The phrases "à l'occasion de" or "in the course of", in the broad meaning given them by the Federal Court of Appeal, do not allow of such a restrictive interpretation.

146. In the 1984 case of *Economy Carriers*, the taxpayer's bank had granted a line of credit for operating capital, the purchase of equipment, and the purchase of a terminal and land. Term insurance policies on the lives of key employees of the taxpayer were assigned to the bank as a condition of the provision of the loan. The Tax Court of Canada considered that if the insurance policies had been whole of life policies, the premiums would not have been deductible. The court applied *Côté-Reco* and held that the premiums were deductible, because the payment of the premiums was necessary to obtain the loan, under which the taxpayer obtained a lower rate of interest on borrowing for the purpose of gaining or producing income. The court stated at [8–11] that:

> 8. … Trucking companies, basically their equipment, are under conditional sales contracts, the terms of which are rather onerous considering the interest charged by the truck manufacturers. It was certainly open to the Company to obtain a line of credit for operating capital, the purchase of equipment, the purchase of a terminal in Edmonton and land. This was a reasonable and viable approach by the company to effect the purpose of gaining or producing income from its business or property. T**he insurance was term insurance. Otherwise, if it had been permanent insurance, it would readily be disallowed. See *Antoine Guertin Ltée v The Queen*, [1981] C.T.C. 351, 81 D.T.C. 5268.** With respect to the respondent's allegations that the insurance premiums were not expenses incurred in the year in the course of borrowing money, I would refer to the case of *MNR v Yonge-Eglinton Building Ltd*, [1974] C.T.C. 209, 74 D.T.C. 6180, a decision of Thurlow, J of the Federal Court of Appeal, and in particular I refer to what he says at 214 and 6183 respectively:
>
>> It would be untenable if it meant that the expense must be incurred in the taxation year of the issuing or selling or borrowing and since it is impossible to know what is included in "around the time" it seems to me to be untenable on that basis as well. What appears to me to be the test is whether the expense, in whatever taxation year it occurs, arose from the issuing or selling or borrowing. It may not always be easy to decide whether an expense has so arisen but it seems to me that the words "in the course of" in section 11(1)(cb) [of the Income Tax Act RSC 1952] are not a reference to the time when the expenses are incurred but are used in the sense of "in connection with" or "incidental to" or "arising from" and refer to the process of carrying out or the things which must be undertaken to carry out the issuing or selling or borrowing for or in connection with which the expenses are incurred. In my opinion therefore since the amounts here in question arose from and were incidental to the borrowing of money required to finance the construction of the respondent's building they fall within section 11(1)(cb)(ii) as expenses incurred in the year in the course of borrowing money etc …
>
> This case clearly illustrates the deductibility of premiums on insurance during the course of the operations of the taxpayer's business.
>
> 9 I particularly rely on the decision of my learned colleague Tremblay, J in the case of *Côté-Reco Inc v Minister of National Revenue*, [1980] C.T.C. 2019, 80 D.T.C. 1012, at 2024 and 1016 respectively:
>
>> The phrase "in the course of" may appear at first sight to have a more limited meaning than "à l'occasion de". In 1974, however, ten years after the *Equitable Acceptance Corp Ltd*, judgment, in *Yonge-Eglinton Building Ltd v Minister of National Revenue*, [1974] CTC 209, 74 DTC 6180, the Federal Court of Appeal, per Thurlow, J, explained the meaning of "in the course of", and appeared to give it a rather broad meaning as [sic] least as broad as "à l'occasion de":
>>
>> "It may not always be easy to decide whether an expense has so arisen but it seems to me that the words 'in the course of' in section 11(1)(cb) are not a reference to the time when the expenses are incurred but are used in the sense of 'in connection with' or 'incidental to' or 'arising from' and refer to the process of carrying out or the things which must be undertaken to carry out the issuing or selling or borrowing for or in connection with which the expenses are incurred."
>
> 10 Being acutely aware of the vicissitudes of the "trucking business", and the very high cost of commercial financing for the purchase of trucking equipment, the course of action of the appellant was completely reasonable and prudent having regard to the demands of the company's bank. The appellant did what it had to do to increase its business and its outlays for insurance premiums were a condition prerequisite for the purpose of gaining or producing income from its business or property.
>
> 11 I therefore find that the premiums paid on term insurance as collateral for a line of credit with the

> Royal Bank of Canada were properly deductible in the course of the appellant's business and the said premiums were outlays for the purpose of gaining or producing income.
>
> [Emphasis added]

147. In *Côté-Reco* and *Economy Carriers*, the Tax Review Board and Tax Court considered that, because the taking out of the policies was a condition of the loans, the premiums were an expense incurred "in the course of" borrowing money. Therefore, premiums on term life insurance policies were held to be deductible. The courts considered that their approach was supported by *Yonge-Eglinton*, which was decided after *Equitable Acceptance*. However, *Yonge-Eglinton* considered a timing issue, rather than the nature of the expenditure. This is apparent from the judgment of Thurlow J at [9] and [10]:

> 9 This provision has been considered in a number of cases [see footnote (FN) 4 below] and has received in general a strict and in one case what might be regarded as a narrow construction. In none of them, however, has a point comparable to the present arisen.
>
> 10 The Minister's position, as I understand it, is not that the amounts were not expenses of borrowing money but that in order to qualify for deduction the expense must be one that is incurred at or around the time the borrowing takes place and that here the liability to pay the amounts was not incurred in the course of the borrowing but in years after the borrowing took place upon profits being earned from the operation of the building. Counsel for the Minister further contended that the amounts were bonuses within the meaning of subparagraph (iii).
>
> FN4 *Equitable Acceptance Corporation Ltd v Minister of National Revenue*, [1964] C.T.C. 74, 64 D.T.C. 5045; *The Consumers' Gas Company v Minister of National Revenue*, [1965] C.T.C. 225, 65 D.T.C. 5138; *Sherritt Gordon Mines, Ltd v Minister of National Revenue*, [1968] C.T.C. 262 at 290, 68 D.T.C. 5180 at 5196-7; *Canada Permanent Mortgage Corporation v Minister of National Revenue*, [1971] C.T.C. 694, 71 D.T.C. 5409; *Riviera Hotel Co Ltd v Minister of National Revenue*, [1972] C.T.C. 157, 72 D.T.C. 6142.

148. In *Equitable Acceptance*, the issue for consideration was the nature of life insurance premiums (ie, what the premiums were paid for). The court considered that the true nature of the transaction was that the taxpayer acquired an asset that could be used as security for borrowing money. The fact the purchase (and assignment) of the policies was a condition of the loan did not alter the nature of the transaction. Similar views were expressed in *Case 19* and *Case Y21*. *Obiter* comments made by the court in *Guertin* indicate that that reasoning is equally applicable to term life policies.

149. With the exception of *Côté-Reco* and *Economy Carriers*, premiums on life insurance policies have been regarded as expenditure to acquire an "asset" (the right to be paid under the policy) able to be used as security for the borrowing of money rather than expenditure incurred in borrowing money.

150. In *Côté-Reco*, the court expressed doubt as to the correctness of the reasoning in *Equitable Acceptance*. The implication is that the board considered that whole of life insurance was not distinguishable from term life insurance, and that premiums on both whole of life and term insurance policies were deductible under the equivalent of s DB 5. However, in *Guertin* the court considered that in *Côté-Reco* the board had misunderstood the decision in *Equitable Acceptance*.

151. The Commissioner acknowledges that the discussion of *Equitable Acceptance* in *Guertin* is *obiter*. However, the *Guertin* decision came after *Côté-Reco*, and is a Canadian Federal Court of Appeal decision, which is of higher authority to both *Côté-Reco* (Canadian Tax Review Board) and *Economy Carriers* (Tax Court of Canada). It is also noted that *Guertin* was applied in a subsequent Tax Court of Canada case, *Elirpa*. The court in *Elirpa* stated at [4]:

> in order to speak strictly and accurately of an expense incurred in the course of a loan, the expenditure must as such have had no consideration other than the loan, or in other words, it must be an expenditure resulting in a diminution of the borrower's property.

152. Although in *Côté-Reco* and *Economy Carriers* deductions were allowed for premiums on term life policies, the Commissioner considers that subsequent higher level authority should be preferred. Further, the Commissioner considers that the reasoning in *Guertin* is more persuasive than that in *Côté-Reco* or *Economy Carriers*.

153. To determine the character of expenditure, it is necessary to consider the legal arrangements entered into and carried out under which expenditure is incurred (*Buckley & Young v CIR* (1978) 3 NZTC 61,271). In *Marac Life Assurance Co Ltd v CIR* (1986) 8 NZTC 5,086, the Court of Appeal adopted the definition of life insurance in *Bunyon on the Law of Life Assurance* (5th ed, C & E Layton, London, 1914 at 1):

> The contract of insurance has been defined by Tindal CJ to be that in which a sum of money "as a premium is paid in consideration of the insurer's incurring the risk of paying a larger sum upon a given contingency". … The contract of life insurance may be further defined

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> to be that in which one party agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another. This consideration in money is termed the premium or premiums, and is paid either in one sum, when it is termed a single premium, or by a succession of periodical instalments. …

154. The essence of any life insurance contract is that in consideration for the payment of the premium or premiums, the policy holder acquires the right to be paid a specific sum upon the death of the person insured. In *The National Mutual Life Association of Australasia Ltd v FCT* (1959) 102 CLR 29 (HCA), Windeyer J considered that this description applied to all forms of life insurance. Therefore, under any life insurance contract (regardless of the type of policy), the advantages obtained from the payment of premiums include the right to a specific sum under the policy upon the happening of the insured event (the death of the person insured).

155. Although the right to payment of the sum insured is contingent on the happening of the insured event, the contractual rights held by the owner of the policy are themselves an asset or benefit (a chose in action—see, for example *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 at [212]). In *Marac*, Cooke P considered that although the right to be paid under a life insurance policy is contingent, all life insurance can be regarded as an investment, stating at 5,090 that:

> In the general sense all life insurance is investment. What distinguishes it from other kinds of investment is that the gain or yield, if there is one, depends on the contingencies of human life.

156. In *Marac*, McMullin J commented at 5,103 that:

> Most holders of life insurance would look on their policies as investments, even though the benefits of these policies are more likely to be enjoyed by persons other than themselves.

157. As suggested in *Case Y21*, the fact a life insurance policy is used as security for a loan supports the view that premiums under life insurance policies are paid for an asset. *New Zealand Business Law Guide* (looseleaf ed, CCH New Zealand, 1985, updated to 28 August 2013) states at [80-080] that:

> A life insurance policy is a piece of property with some value because the insurer has to pay the sum assured at some time. It is therefore common for life insurance policies to be transferred or to be used as security.

If term life insurance were not an asset, it would not be possible to use it as security for a loan.

158. The contingent rights under a life insurance policy are certainly, as Marceau J observed in *Guertin*, "an "asset" in the sense in which the word is used by Cattanach, J. [in *Equitable Acceptance*], that is, a usable security from which a benefit can be obtained, or valuable property".

159. In any event, it seems clear from the above cases that the obtaining of a benefit (whether or not it can be described as an asset, or would be recorded as an asset for accounting purposes) will colour the nature of the expenditure such that it cannot accurately be said to be incurred in borrowing money, but rather for the asset or benefit obtained.

160. The Commissioner considers that the weight of authority establishes that premiums on life insurance, including term life insurance, are not deductible under s DB 5(1). In the Commissioner's view, it is not possible to distinguish between term life insurance and other types of life insurance. Regardless of whether the term and sum insured under the policy correlate with the term and amount of the loan, or whether the policy has a surrender value, the right to payment under a life insurance policy is an asset or a benefit.

161. The Commissioner also considers that it is not possible to distinguish mortgage repayment insurance from other types of life insurance. Mortgage repayment insurance is a type of term life insurance (though it may also cover other contingencies) under which a single premium is paid on the commencement of the policy, the term of the policy coincides with the term of the loan, and the sum insured reduces as the balance of the loan reduces. As with other life insurance policies, the payment of a premium under mortgage repayment insurance is paid for the right to be paid under the policy. (In any event, mortgage repayment insurance is usually obtained in respect of loans for private or domestic purposes. Premiums on such insurance taken out in connection with a loan for private purposes would not be deductible under s DB 5 as the loan would not be capital employed in deriving income.)

162. For the reasons outlined above, it is the Commissioner's view that the premiums under any life insurance policy are correctly characterised as being for a benefit other than the loan (being the right to be paid the sum insured under the policy). Therefore, the Commissioner considers that it is not possible to distinguish between insurance policies according to whether the term and amount of the policy correlate with that of the loan, whether the policy has a surrender value, or whether bonuses are paid.

Assignment of life insurance policies

163. A borrower may be required to give an assignment of a life insurance policy as security for a loan. The assignee of a life insurance policy becomes the legal owner of the policy (s 43(1) of the Life Insurance Act 1908). Alternatively, a borrower could give a mortgage over a life insurance policy in favour of the lender. In *Craven v Commissioner of Stamp Duties* [1948] NZLR 550 (where a son had granted a mortgage over a life insurance policy in favour of his father) Blair J considered that until the date of the mortgage the son was the legal and beneficial owner of the policy and that after the mortgage was granted, the father was the legal owner of the policy subject to the son's equity of redemption. An implied term of every mortgage of a life insurance policy (unless that term is negatived, modified or altered in the mortgage) is that on repayment of the principal and interest secured by the mortgage and on performance of all other obligations under the mortgage, the mortgagee will execute a discharge of the mortgage (s 45 and schedule 14 of the Life Insurance Act 1908).

164. In the Commissioner's view, the fact that during the term of a loan the lender is the legal owner of a life insurance policy given as security for the loan, so that the proceeds of the policy are payable to the lender, is irrelevant. In *Equitable Acceptance*, no weight was given to the fact that there was such an assignment. The court considered that the true nature of the transaction was that in consideration for the premiums, the borrower obtained an asset that could be used as security for a loan. A borrower could not give an assignment or mortgage of a life insurance policy unless the policy was initially the property of the borrower. Even if the proceeds of the policy were payable to the lender, the proceeds of the policy would be applied to repay the amount owing by the borrower. Therefore, the Commissioner considers that premiums on a life insurance policy given as security for a loan (whether by way of assignment or by way of mortgage or in any other way) should be characterised as expenditure incurred by the borrower to acquire an asset or benefit (the rights under the policy).

(iii) Lenders mortgage insurance

165. Lenders mortgage insurance (insurance to protect the lender from loss in the event that the borrower defaults on the loan) is always an asset of the lender, rather than of the borrower.

166. Under lenders mortgage insurance, the lender is the insured. If an insurance company makes a payment to the lender under lenders mortgage insurance, the insurance company is entitled to step into the shoes of the lender. *Laws of New Zealand* Insurance (online ed, accessed 5 August 2013) at [441] states that:

> Subrogation is where one person is substituted for another so that he or she takes on the rights of the other. As applied to the field of insurance, the insurer's right of subrogation means the right to be placed in the position of the insured so that the insurer has the benefit of the insured's rights against third parties.

167. Therefore, a pay-out under a lenders mortgage insurance policy would not release the borrower from liability in connection with the loan. On that basis, lenders mortgage insurance is distinguishable from life insurance. The passed on cost of lenders mortgage insurance may be deductible under s DB 5, if it is expenditure that the borrower is required to incur to obtain a loan. This may be the case if the cost of such premiums is passed on to the borrower by way of a "recharge". However such costs would not be deductible under s DB 5 where they have to be taken into account and spread under the FA rules or where they are incorporated into the interest rate. In those circumstances, such costs would be deductible under s DB 6, s DB 7 or, if not under those provisions, potentially under s DA 1.

168. For similar reasons, nothing can be taken from the fact that guarantee fees are deductible (see, for example, *Ure*). If a guarantor makes a payment to the lender, as between the lender and the borrower, the debt is repaid; but the guarantor is entitled to be indemnified by the borrower (s 85 of the Judicature Act 1908). For that reason, a guarantee cannot be regarded as an asset of the borrower or as providing a benefit to the borrower. As with lenders mortgage insurance, a guarantee is for the benefit of the lender.

Summary – deductibility of insurance premiums

169. On the basis of the above discussion, the Commissioner's view is that:

- Premiums on life insurance policies (regardless of the type of life insurance) is expenditure incurred in acquiring an asset or benefit (the right to be paid under the policy) rather than expenditure incurred in borrowing money. It follows that a deduction is not allowable under s DB 5 for premiums on any life insurance policy.
- Even if the lender is the legal owner of the life insurance policy that they require as security for the loan, the borrower's expenditure on the premium is incurred in the obtaining of an asset or benefit (that can be used as security), rather than in borrowing money, so is not deductible under s DB 5.

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- The passed on cost of lenders mortgage insurance may be deductible under s DB 5, if it is expenditure that the borrower is required to incur to obtain a loan. This may be the case if the cost of such premiums is passed on to the borrower by way of a "recharge". This is because the lender is the insured, and any payment under the policy would not release the borrower from liability in connection with the loan. (However, this will not be the case where such costs have to be taken into account and spread under the FA rules or are incorporated into the interest rate. In those circumstances, such costs would be deductible under s DB 6, s DB 7 or, if not under those provisions, potentially under s DA 1.

Types of expenditure incurred "in borrowing money"

170. It is not possible to provide a comprehensive list of expenditure deductible under s DB 5. Whether particular expenditure is deductible under s DB 5 depends on whether the expenditure meets the requirements of the section as set out in this statement, whether the expenditure needs to be taken into account and spread under the FA rules, and whether it is expenditure that relates to a mixed-use asset (in which case the deductibility of the expenditure would be determined under subpart DG). However, expenditure that will typically be deductible under s DB 5 (where not required to be taken into account and spread under the FA rules and where not required to be considered under subpart DG) includes:
    - legal fees in connection with establishing a loan;
    - valuation fees, where the lender requires the valuation;
    - guarantee fees;
    - the passed on cost of lenders mortgage insurance (where the cost is passed on to the borrower as a "recharge");
    - loan procurement fees;
    - survey fees, where the lender requires the surveying;
    - mortgage brokers' commissions;
    - costs of arranging bank overdrafts; and
    - certain expenses relating to debenture issues (such as drafting, advertising and printing prospectuses).

171. The expenditure listed above is expenditure that taxpayers commonly incur when establishing or setting up a loan. For example, if the taxpayer is obtaining a mortgage, the lending institution will often require a valuation of the property and valuation fees will be incurred. The expenditure listed above will usually relate solely to the loan. As the sole reason for the expenditure is to obtain the loan, it is unlikely that the expenditure will give rise to benefits distinct from and independent of the loan, and the expenditure is likely to have a sufficient nexus with the borrowing of the money.

Taxpayer must use borrowed money as capital in the derivation of their income

172. Section DB 5 requires that the money borrowed be "used as capital in deriving [the taxpayer's] income".

173. As noted at [50], generally borrowed money is regarded as an addition to capital (*Caltex; The Shell Company of China; Public Trustee*). Where this is the case, and where the use of the money meets the nexus with the taxpayer's income derivation, the requirement in s DB 5 for the borrowed money to be used as capital in deriving income will be satisfied.

174. However, as noted at [51], in some circumstances borrowed money is a revenue item (*Scottish North American Trust; Texas Co (Australasia); Canada Permanent Mortgage Corp; AVCO Financial Services; Coles Myer Finance*). For instance, borrowed money is a revenue item where a taxpayer is in the business of borrowing and lending money and the money is borrowed for on-lending in the ordinary course of the taxpayer's business, or where a taxpayer borrows money to purchase trading stock. Expenditure incurred to secure circulating capital is revenue expenditure and may be deductible under s DA 1.

175. The words "used as capital in deriving income" in s DB 5 focus on how the taxpayer who borrowed the money uses that money. If the taxpayer uses the borrowed money as capital in deriving their income, this requirement of the section has been satisfied.

176. This view is supported by the decision in *Ure*. As discussed above, in *Ure* the Australian Federal Court considered the meaning of the word "used" in the context of s 67(1) of the Income Tax Assessment Act 1936–1976 (Cth) (equivalent to s DB 5). The court was unanimous in its decision that s 67 does not refer to the use made by persons other than the taxpayer of the money borrowed by the taxpayer. It refers to the use made of that money by the taxpayer. In *Ure*, the only use the taxpayer had made of the money was to lend it to his wife or the trust at an interest rate of 1%. Therefore, the money was held to be used by the taxpayer for the purpose of earning assessable income.

177. Apportionment of expenditure incurred in borrowing money is not required where there is a capital aspect to the use of the funds as well as an income-earning use (*Pacific Rendezvous v CIR* (1986) 8 NZTC 5,146).

Alternative arguments

Preference for following Côté-Reco *and* Economy Carriers

178. The Commissioner acknowledges there are alternative views on some aspects of this Interpretation Statement. In relation to the cases on the deductibility of insurance premiums (discussed from [135]–[162]), it has been argued that the Commissioner should follow the ratio in *Côté-Reco* and *Economy Carriers* in relation to term life insurance premiums, rather than the *obiter* comments in *Guertin*. It has further been argued that the court in *Guertin* may have been influenced by the substantial nature of the benefits arising under the whole of life policies at issue in that case.

179. Following the *ratio* in *Côté-Reco* and *Economy Carriers* in relation to term life insurance premiums would not alter what the Commissioner considers the test under s DB 5 to be. Rather, it would lead to a conclusion that, at least in some circumstances, term life insurance premiums may be able to be characterised as incurred "in borrowing money".

180. The Commissioner acknowledges that the discussion of *Equitable Acceptance* in *Guertin* is *obiter*. However, as noted at [151], the *Guertin* decision came after *Côté-Reco* and is a Canadian Federal Court of Appeal decision, which is of higher authority than both *Côté-Reco* and *Economy Carriers*. It is also noted that *Guertin* was applied in a subsequent Tax Court of Canada case, *Elirpa*. Although in *Côté-Reco* and *Economy Carriers* deductions were allowed for premiums on term life policies, the Commissioner considers that subsequent higher level authority should be preferred. Further, the Commissioner considers that the reasoning in *Guertin* is more persuasive than that in *Côté-Reco* or *Economy Carriers*.

Relevance of Pacific Rendezvous

181. It could be argued that "mixed purpose" in terms of the expenditure (as opposed to the use to which the borrowed money is put) would not prevent a deduction. That is, it could be suggested that the fact that the taxpayer obtains a benefit other than satisfying the lending criteria (and so being able to establish the borrowing) does not preclude deductibility under s DB 5 because the nexus test can still be met.

182. For the purposes of s DB 5, expenditure a taxpayer incurs in borrowing money will be deductible if the taxpayer uses the money as capital in deriving their income. As noted at [177], apportionment of expenditure incurred in borrowing money is not required where there is a capital aspect to the use of the funds as well as an income-earning use (*Pacific Rendezvous*).

183. However, the insurance cases relied on in support of the Commissioner's view that insurance premiums are not deductible under s DB 5 concern the character of the expenditure. This was not the issue in *Pacific Rendezvous*, where the expenditure was clearly interest, and the question was whether it was paid on capital employed in the production of assessable income. The Commissioner considers that it is necessary to determine the true character of the expenditure for s DB 5 purposes to determine whether a sufficient nexus exists between the expenditure and the borrowing of money. This is what the various insurance cases relied on are concerned with. It is not a question of mixed use of the borrowed money, but one of characterisation of the expenditure as either having a sufficient nexus with the borrowing to be regarded as incurred "in borrowing money" or not.

Examples

184. The following examples show how the Commissioner considers that the requirements discussed above apply to determine whether expenditure is deductible under s DB 5. These examples are illustrative only and do not cover the wide variety of factual situations that may arise. Each case must be considered on its own facts. The examples proceed on the basis that the deductibility of the expenditure in question does not need to be considered under subpart DG because it is not incurred in relation to a mixed-use asset.

Example 1

185. A farmer wishes to buy additional land to expand his farm. He applies for a loan to purchase the land and cover the costs of fencing the land. As a condition of the loan approval, the bank requires the farmer to obtain an independent valuation of the land and to get the land surveyed before fencing starts. The farmer is also required to pay a loan establishment fee. The farmer is not a cash basis person.

186. The farmer can deduct the costs of the valuation and the surveying under s DB 5 (those costs would not come under the FA rules, because they are

non-contingent fees—being payable whether or not the loan proceeds). The farmer is required to use a spreading method under the FA rules, so must take the loan establishment fee into account and spread it under those rules. This is because it is consideration for a financial arrangement (and is payable only if the loan is actually established, so is not a non-contingent fee).

Example 2

187. Company A has arranged for a bank loan to expand its hotel business. However, the bank requires that the funds it advances be secured by a first charge on Company A's premises. Company A has an existing mortgage over the property, securing a loan that has only a small amount owing. To be able to provide the new bank with the first charge it requires, Company A repays the small amount owing on its current loan, and the original lender discharges the mortgage in its favour. The mortgage agreement provides that a mortgage discharge fee is payable for this. The original loan contract stipulates a fee payable in the event of early repayment of the loan, which fee Company A incurs.

188. Neither the early repayment fee nor the mortgage discharge fee is deductible under s DB 5, because neither is expenditure incurred in borrowing money (either the first borrowing or the new borrowing). These fees are related to bringing the first borrowing to an end, because they are incurred in relation to repaying the loan early and terminating the first lender's interest in the property subject to the mortgage. Even though it is necessary for Company A to incur the mortgage discharge fee to provide security for the new loan, the expenditure is rightly characterised as being about bringing the first borrowing to an end.

189. If the fees are consideration for or under a financial arrangement they would be taken into account under the FA rules.

Example 3

190. Company B wants to expand its business and needs a loan of $150,000. Company B secures the required finance through a mortgage broker. Two of the directors of Company B guarantee the loan, and are paid guarantee fees for providing these guarantees. As a condition of the borrowing, the lender requires Company B to take out a term life insurance policy on the life of the managing director and assign the policy to the lender. The term of the life insurance policy matches the term of the borrowing, and the amount of insurance cover matches the amount outstanding on the loan. The insurance premiums are arm's length amounts, based on such things as the amount and period of the cover, the contingencies covered, and the risk profile of the insured. Company B uses the borrowed money to purchase new equipment for its plant. Company B is not a cash basis person.

191. Company B seeks to deduct under s DB 5:
   - legal fees incurred in arranging the loan;
   - the mortgage broker's commission;
   - the guarantee fees paid to the two directors for acting as guarantors; and
   - the life insurance premiums paid for the life insurance policy taken out on the life of the managing director.

192. The legal fees are deductible under s DB 5. A sufficient nexus exists between this expenditure and establishing the borrowing.

193. Company B is not a cash basis person, and is required to use a spreading method under the FA rules. The guarantee fees would be taken into account and spread under the FA rules. This is because a guarantee for a fee is a financial arrangement. The mortgage broker's commission needs to be taken into account and spread under the FA rules, because it is consideration for a financial arrangement (the loan). This commission is payable only if the loan is actually established, so is not a non-contingent fee.

194. The life insurance premiums Company B paid for the life insurance policy taken out on the life of the managing director are not deductible under s DB 5. There is not sufficient nexus between the expenditure on the insurance policy and the obtaining of the loan. The premiums are consideration for a benefit other than the loan (ie, the rights under the policy, which will ensure the repayment of the loan should the managing director die). Therefore, expenditure on the premiums cannot be considered to be incurred "in borrowing money". The premiums are not taken into account under the FA rules, being amounts solely attributable to an excepted financial arrangement.

Example 4

195. Company C applies for a bank loan to purchase new machinery. As part of the loan agreement, the bank

passes on the cost of its lenders mortgage insurance to Company C as a "recharge".

196. The passed on cost of the lenders mortgage insurance is deductible to Company C under s DB 5 (unless it has to be taken into account and spread under the FA rules), because it is expenditure incurred in borrowing money used as capital in deriving income.

197. The lenders mortgage insurance policy is an asset of the bank, and does not release Company C from liability in connection with the loan. In the event of payment being made under the policy, the insurance company could pursue Company C for the amount paid out.

References

Related rulings/statements
Deductibility of Break Fee Paid by a Landlord to Exit Early from a Fixed Interest Rate Loan (BR Pub 12/01)
Deductibility of Break Fee Paid by a Landlord to Exit Early from a Fixed Interest Rate Loan on Sale of Rental Property (BR Pub 12/03)
"Deductibility of mortgage repayment insurance taken out to obtain a business loan" *Tax Information Bulletin* Vol 6, No 9 (February 1995)
Determination G25: Variations in the Terms of a Financial Arrangement
"Life and accident insurance policies" *Public Information Bulletin* No 106 (July 1980)
Subject references
Income tax; deduction; expenditure incurred in borrowing money used as capital in deriving income
Legislative references
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APPENDIX – LEGISLATION

Income Tax Act 2007

A1. Section DA 1 provides:

DA 1 General permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

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

Avoidance arrangements

(3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

A2. Section DA 2 provides:

DA 2 General limitations

Capital limitation

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

Private limitation

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

Exempt income limitation

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

Employment limitation

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

Withholding tax limitation

(5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the withholding tax limitation.

Non-residents' foreign-sourced income limitation

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

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

A3. Section DA 3 provides:

DA 3 Effect of specific rules on general rules

Supplements to general permission

(1) A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.

Express reference needed to supplement

(2) A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.

Relationship of general limitations to supplements to general permission

(3) Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.

Relationship between other specific provisions and general permission or general limitations

(4) A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.

Express reference needed to override

(5) A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states that—

(a) it overrides the general permission or the relevant limitation; or

(b) the general permission or the relevant limitation does not apply.

Part E

(6) No provision in Part E (Timing and quantifying rules) supplements the general permission or overrides the general permission or a general limitation.

A4. Section DB 5 provides:

DB 5 Transaction costs: borrowing money for use as capital

Deduction

(1) A person is allowed a deduction for expenditure incurred in borrowing money that is used as capital in deriving their income.

Relationship with subpart DG

(1B) Subpart DG (Expenditure related to use of certain assets) overrides this section for expenditure to which that subpart relates.

Link with subpart DA

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

A5. Section DB 6 provides:

DB 6 Interest: not capital expenditure

Deduction

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

Exclusion

(2) Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

Link with subpart DA

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

A6. Section DB 7 provides:

DB 7 Interest: most companies need no nexus with income

Deduction

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

Exclusion: qualifying company

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

Exclusion: exempt income

(3) If a company (company A) derives exempt income or another company (company B) that is part of the same wholly-owned group of companies derives exempt income, subsection (1) applies to company A only if all the exempt income is 1 or more of the following:

(a) dividends; or

(b) income exempted under section CW 58 (Disposal of companies' own shares); or

(c) income exempted under section CW 60 (Stake money) and ancillary to the company's business of breeding.

Exclusion: non-resident company

(4) If a company is a non-resident company, subsection (1) applies only to the extent to which the company incurs interest in the course of carrying on a business through a fixed establishment in New Zealand.

Exclusion: interest related to tax

(5) Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

Consolidated groups

(6) Section FM 12 (Expenditure when deduction would be denied to consolidated group) may apply to allow a deduction under this section to a company that is part of a consolidated group.

Relationship with subpart DG

(6B) Subpart DG (Expenditure related to use of certain assets) overrides this section for expenditure to which that subpart relates.

Link with subpart DA

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

A7. Section EW 2(1) provides:

EW 2 Relationship of financial arrangements rules with other provisions

Financial arrangements rules override other provisions

(1) The financial arrangements rules prevail over any other provision in relation to the timing and quantifying of income and expenditure under a financial arrangement to which the financial arrangements rules apply, unless the other provision expressly or by necessary implication requires otherwise.

A8. Section EW 3(1)–(3) provides:

EW 3 What is a financial arrangement?

Meaning

(1) **Financial arrangement** means an arrangement described in any of subsections (2) to (4).

Money received for money provided

(2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—

(a) at a future time; or

(b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

Examples of money received for money provided

(3) Without limiting subsection (2), each of the following is a financial arrangement:

(a) a debt, including a debt that arises by law:

(b) a debt instrument:

(c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:

(d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

A9. Section EW 5(1)(a) and (b) and (8) provide:

EW 5 What is an excepted financial arrangement?

Meaning

(1) **Excepted financial arrangement** means an arrangement described in any of subsections (2) to (25). However,—

(a) an arrangement described in any of subsections (18) to (20) may cease to be an excepted financial arrangement through the operation of section EW 7:

(b) an arrangement described in any of subsections (21) to (25) may cease to be an excepted financial arrangement for a party who makes an election under section EW 8.

…

Insurance contract

(8) An insurance contract to the extent to which it is not life financial reinsurance is an excepted financial arrangement.

A10. Section EW 9 provides:

EW 9 Persons to whom financial arrangements rules apply

Residents

(1) A person who is a party to a financial arrangement must calculate and allocate income or expenditure under the arrangement for an income year under the financial arrangements rules, if the arrangement is one to which the rules apply under section EW 10. This subsection is overridden by subsection (2).

Non-residents

(2) Subsection (1) applies to a person who is not resident in New Zealand only if subsection (3) or (4) applies.

Non-resident with New Zealand fixed establishment

(3) Subsection (1) applies to a person who is not resident in New Zealand to the extent to which the person is a party to a financial arrangement for the purpose of a business carried on by the person through a fixed establishment in New Zealand.

Non-resident trustee for New Zealand settlor

(4) Subsection (1) applies to a person who is not resident in New Zealand if—

(a) the person is a trustee for a settlor who is resident in New Zealand; and

(b) the trustee is not a person to whom section HC 25 (Foreign-sourced amounts: non-resident trustees) apply.

A11. Section EW 13 provides:

EW 13 When use of spreading method not required

Base price adjustment year

(1) A person does not use any of the spreading methods for a financial arrangement in the income year in which section EW 29 requires them to calculate a base price adjustment for it.

Trustee of personal injury compensation trust

(2) A trustee who holds a financial arrangement in trust to manage compensation paid for personal injury under the Accident Compensation Act 2001, the Accident Insurance Act 1988, any of the former Acts as defined in section 13 of the Accident Insurance Act 1998, the Workers' Compensation Act 1956, or a court order does not use any of the spreading methods for the financial arrangement if the trustee is a cash basis person.

Cash basis person

(3) A cash basis person is not required to use any of the spreading methods, but may choose to do so under section EW 61.

A12. Section EW 15(1) provides:

EW 15 What is included when spreading methods used

Consideration and amounts

(1) A person using a spreading method must include, for the purpose of calculating and allocating income and expenditure under the financial arrangement,—

(a) all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, ignoring—

(i) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D:

(ii) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D or the modified fair value method in section EW 15G; and

(b) all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement, ignoring—

(i) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D:

(ii) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D or the modified fair value method in section EW 15G; and

(c) all amounts that have been remitted, and all amounts that are to be remitted, by the person under the financial arrangement; and

(d) all amounts that would have been payable to the person under the financial arrangement if the amounts had not been remitted by law.

A13. Section EW 28 provides:

EW 28 How base price adjustment calculated

A party to a financial arrangement who must calculate a base price adjustment, as described in sections EW 29 and EW 30, calculates it using the formula in section EW 31.

A14. Section EW 29 provides:

EW 29 When calculation of base price adjustment required

Ceasing to be New Zealand resident

(1) A party to a financial arrangement who ceases to be a New Zealand resident must calculate a base price adjustment as at the date of the party's ceasing to be a New Zealand resident. This subsection is overridden by section EW 30(1) and (2).

Ceasing to be party for purpose of New Zealand business

(2) A person who is not a New Zealand resident and who is a party to a financial arrangement for the purpose of a business the party carries on through a fixed establishment in New Zealand must calculate a base price adjustment as at the date of the party's ceasing to be a party to the arrangement for that purpose.

Maturity

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

Treated as maturity

(4) A financial arrangement that has not matured because an amount has not been paid is treated as if it had matured if—

(a) the amount not paid is immaterial; and

(b) the arrangement has been structured to avoid the application of section EW 31.

Disposal

(5) A party to a financial arrangement who disposes of the arrangement must calculate a base price adjustment as at the date of the disposal.

Absolute assignment

(6) A party to a financial arrangement who makes an absolute assignment of all the party's rights under the arrangement must calculate a base price adjustment as at the date of the absolute assignment.

Defeasance

(7) A party to a financial arrangement who makes a legal defeasance of all the party's obligations under the arrangement must calculate a base price adjustment as at the date of the legal defeasance.

Sale at discount to associated person

(8) A party to a financial arrangement that is a debt must calculate a base price adjustment as at the date on which the creditor sells the debt to a person associated with the debtor and at a discount in the circumstances described in section EW 43.

Discharge without consideration

(9) A party to a financial arrangement must calculate a base price adjustment as at the date on which a party to the arrangement is discharged from making all remaining payments under the arrangement without fully adequate consideration.

Operation of law

(10) A party to a financial arrangement must calculate a base price adjustment as at the date on which a party to the arrangement is released from making all remaining payments under the arrangement under the Insolvency Act 2006 or the Companies Act 1993 or the laws of a country or territory other than New Zealand.

Composition with creditors

(11) A party to a financial arrangement must calculate a base price adjustment as at the date on which a party to the arrangement is released from making all remaining payments under the arrangement by a deed or agreement of composition with the party's creditors.

Lapse of time

(12) A party to a financial arrangement must calculate a base price adjustment as at the date on which all remaining payments under the arrangement become irrecoverable or unenforceable through the lapse of time.

Changing from fair value method

(13) A party to a financial arrangement must calculate a base price adjustment, for the first income year for which a changed method is used for the financial arrangement, where the change in method is—

(a) from the fair value method and the financial arrangement is not subject to a creditor workout:

(b) from the market value method to a method for IFRS under section EW 15B.

A15. Section EW 30 provides:

EW 30 When calculation of base price adjustment not required

Cash basis person who ceases to be temporary New Zealand resident

(1) A cash basis person who ceases to be a New Zealand resident before the first day of the fourth income year following the income year in which they first became a New Zealand resident does not calculate a base price adjustment for a financial arrangement to which they—

(a) were a party before first becoming a New Zealand resident; and

(b) are a party on the date on which they cease to be a New Zealand resident.

Other party who ceases to be New Zealand resident

(2) A party to a financial arrangement who ceases to be a New Zealand resident does not calculate a base price adjustment to the extent to which the arrangement relates to a business the party carries on through a fixed establishment in New Zealand.

Creditor when legal defeasance occurs

(3) A party who has a right to receive money under a financial arrangement the obligations of which are the subject of a legal defeasance does not calculate a base price adjustment on the date of the defeasance if the defeasance requires another person to meet the remaining obligations of the arrangement.

Debtor when legal defeasance occurs

(4) A party to a financial arrangement does not calculate a base price adjustment if—

(a) their obligations under the arrangement are the subject of an absolute legal defeasance; and

(b) some or all of the consideration for the defeasance is deferred.

Creditor when assignment occurs

(5) A party to a financial arrangement does not calculate a base price adjustment if—

(a) their rights under the arrangement are the subject of an absolute assignment; and

(b) some or all of the consideration for the assignment is deferred.

A16. Section EW 31 provides:

EW 31 Base price adjustment formula

Calculation of base price adjustment

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

When formula applies

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

Positive base price adjustment

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

Negative base price adjustment

(4) A base price adjustment, if negative, is expenditure incurred by the person in the income year for which the calculation is made. The person is allowed a deduction for the expenditure under sections DB 6 to DB 8 (which relate to deductions for interest) or, if none of those sections applies, under section DB 11 (Negative base price adjustment).

Formula

(5) The formula is—

consideration − income + expenditure + amount remitted.

Definition of items in formula

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

Consideration

(7) **Consideration** is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. For the purposes of this subsection, the following are ignored:

(a) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D:

(b) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D.

Consideration in particular cases

(8) If any of sections EW 32 to EW 48, or EZ 52D applies, the consideration referred to in subsection (7) is adjusted under the relevant section.

Income

(9) **Income** is—

(a) income derived by the person under the financial arrangement in earlier income years; and

(b) dividends derived by the person from the release of the obligation to repay the amount lent; and

(c) income derived under section CF 2(2) and (3) (Remission of specified suspensory loans).

Expenditure

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

Amount remitted

(11) **Amount remitted** is an amount that is not included in the consideration paid or payable to the person because it has been remitted—

(a) by the person; or

(b) by law.

A17. Section EW 54 provides:

EW 54 Meaning of cash basis person

Who is cash basis person

(1) A person is a **cash basis person** for an income year if—

(a) 1 of the following applies in the person's case for the income year:

(i) section EW 57(1); or

(ii) section EW 57(2); and

(b) section EW 57(3) applies in the person's case for the income year.

Persons excluded by Commissioner

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

A18. Section EW 55 provides:

EW 55 Effect of being cash basis person

Use of spreading method

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

Calculation of base price adjustment

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

A19. Section EW 57 provides:

EW 57 Thresholds

Income and expenditure threshold

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

Absolute value threshold

(2) For the purposes of section EW 54(1)(a)(ii), this subsection applies if, on every day in the income year, the absolute value of all financial arrangements to which the person is a party added together is $1,000,000 or less. The value of each arrangement is,—

(a) for a fixed principal financial arrangement, its face value:

(b) for a variable principal debt instrument, the amount owing by or to the person under the financial arrangement:

(c) for a financial arrangement to which the old financial arrangements rules apply, the value determined under those rules.

Deferral threshold

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

Formula

(4) The formula is—

(accrual income − cash basis income) + (cash basis expenditure − accrual expenditure).

Definition of items in formula

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

Accrual income

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

(a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(c) an alternative method approved by the Commissioner.

Cash basis income

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

Cash basis expenditure

(8) **Cash basis expenditure** is the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the

arrangement and ending on the last day of the income year for which the calculation is made.

Accrual expenditure

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

(a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(c) an alternative method approved by the Commissioner.

Increase in specified sums

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

A20. Section EW 61 provides:

EW 61 Election to use spreading method

Election of spreading method

(1) A cash basis person may choose to use a spreading method, unless subsection (2) applies.

Election not allowed

(2) A cash basis person may not choose to use a spreading method for a financial arrangement in the income year in which section EW 29 requires them to calculate a base price adjustment for the arrangement.

How election made

(3) The person makes the election by calculating a cash basis adjustment under section EW 62(1).

Effect of election

(4) The person must use a spreading method for—

(a) all financial arrangements to which the person is a party at the time of making the election; and

(b) all financial arrangements the person enters into after the income year in which they make the election.

How election revoked

(5) The person revokes the election by giving notice to the Commissioner with a return of income and within the time that the return must be filed under section 37 of the Tax Administration Act 1994.

Effect of revocation

(6) The revocation applies to all financial arrangements the person enters into after the income year in which the notice is given.

A21. Section YA 1 provides (relevantly):

YA 1 Definitions

In this Act, unless the context requires otherwise,—

…

cash basis person is defined in section EW 54 (Meaning of cash basis person)

…

non-contingent fee means a fee that—

(a) is for services provided for a person becoming a party to a financial arrangement; and

(b) is payable whether or not the financial arrangement proceeds

…

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

IS 13/03 – DEDUCTIBILITY OF INSURANCE PREMIUMS UNDER S DB 5 – TRANSITIONAL OPERATIONAL APPROACH

The Interpretation Statement IS 13/03 replaces the item "Deductibility of mortgage repayment insurance taken out to obtain a business loan", *Tax Information Bulletin* Vol 6, No 9 (February 1995). It is now considered that that earlier item incorrectly states the law in concluding that mortgage repayment insurance would be deductible under the predecessor to s DB 5. Some taxpayers may have relied on the 1995 TIB item as supporting the deductibility of other insurance premiums (such as term life insurance premiums) under s DB 5.

The Commissioner recognises that taxpayers may have incorrectly relied on the 1995 TIB item on mortgage repayment insurance premiums when entering into other insurance contracts. Therefore, the Commissioner will not actively apply her resources to seek to disallow certain deductions claimed for insurance premiums prior to the beginning of a taxpayer's 2015 income year.

This approach applies only to term life insurance contracts entered into prior to the publication of the Interpretation Statement in circumstances where: (i) the policy was required by the lender, and (ii) the taxpayer has, prior to finalisation of the Interpretation Statement, been treating those premiums as deductible under s DB 5.

To the extent that an insurance contract relates to any period subsequent to the commencement of the taxpayer's 2015 income year, this approach will not apply.

LEGISLATION AND DETERMINATIONS

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

CORRECTION TO DEPRECIATION DETERMINATION PROV25

LTS Technical Standards issued a provisional depreciation determination *Determination PROV25: Tax Depreciation Rates Provisional Determination Number PROV25* on 5 June 2013. It was published in the *Tax Information Bulletin* Vol 25, No 6 (July 2013), page 49. The determination covered a number of components that make up a "Stabilised turf system".

Certain amendments are now required to correct an error in the determination. These amendments involve replacing the straight-line rate of 7.5% where it appears with the straight-line rate of 7%. The amendments are back-dated to the application date of the determination, ie, from the 2011–12 and subsequent income years.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 13/05: INCOME TAX – DEDUCTIBILITY OF A COMPANION'S TRAVEL EXPENSES

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

This Question We've Been Asked (QWBA) is about ss DA 1(1) and DA 2(2). It applies for the 2014 income year and subsequent income years.

During a review of the *Public Information Bulletin* and *Tax Information Bulletin* series published before 1996, parts of the items "Deduction for Wife's Expenses – Professional People Attending Overseas Conferences" *Public Information Bulletin* No 74, p 10 (June 1973) and "Overseas Travel Expense Claims" *Tax Information Bulletin* Vol 7, No 2 (August 1995) were identified as no longer reflecting the Commissioner's interpretation of the law as it relates to the deductibility of a companion's travel expenses. The Public Information Bulletin review has now been completed, see "Update on Public Information Bulletin review" *Tax Information Bulletin* Vol 25, No 10 (November 2013).

This QWBA updates and replaces the *Public Information Bulletin* item. This QWBA also updates and replaces the part of the *Tax Information Bulletin* item dealing with claims for a companion's or a family member's overseas travel expenses. The Commissioner considers that the other two parts of the *Tax Information Bulletin* item dealing with the information that a taxpayer should supply when asked by Inland Revenue to support a claim for overseas travel expenses and the apportionment of private expenses are still correct and relevant.

Question

1. In the course of carrying on a business, a taxpayer takes a business trip. A companion accompanies the taxpayer on that business trip. Can the taxpayer deduct the companion's travel expenses?

Answer

2. In most cases, the companion's travel expenses will not be deductible. If the companion is accompanying the taxpayer simply for companionship or to attend social functions, then this expenditure will not have a sufficient nexus with the taxpayer's business or income-earning activity.

3. However, a deduction may be permitted where the companion supports the taxpayer, to a reasonably substantial degree, in the business being undertaken. The companion does not need to be an expert in the affairs of the business, but they do need some knowledge of the business being undertaken or they must possess some special skill or expertise to be able to provide support in a material way. If these qualities are present, then the Commissioner considers a sufficient nexus will exist between the companion's travel expenses and the taxpayer's business or income-earning activity.

4. This answer applies to travel expenses incurred overseas and in New Zealand. Deductions for travel expenses incurred in New Zealand may be restricted by the entertainment rules (ss DD 1–DD 11). Employers may also need to consider fringe benefit tax (FBT) if travel expenses confer a private benefit on their employees or associated persons of the employees. This QWBA does not consider the implications of the entertainment rules or the FBT rules on a companion's travel expenses.

Explanation

Deductibility

5. The travel expenses of a taxpayer's companion will be deductible if the expenses satisfy the requirements of s DA 1(1), known as the general permission, and s DA 2 does not deny their deduction. Section DA 1(1) is satisfied where a sufficient nexus or relationship exists between the expenses incurred and the deriving of the taxpayer's assessable income or the carrying on of a business by the taxpayer for the purpose of deriving assessable income. To determine whether there is a sufficient nexus, the character of the expenditure and its relevance to the taxpayer's business must be considered.

6. Some types of expenditure will not be deductible. Section DA 2(2) prohibits a deduction for expenditure of a private or domestic nature.

7. In *CIR v Haenga* [1986] 1 NZLR 119 (CA), Richardson J noted that certain kinds of expenditure have some

relationship with the earning of income in that they are necessary prerequisites (eg, travel to a place of work and childcare costs). However, Richardson J, at 127 to 128, concluded that they are not deductible:

> It is a matter of degree and so a question of fact to determine whether there is a "sufficient" nexus between the expenditure and what it provided or sought to provide on the one hand and the income earning process on the other so as to fall within the words of the section. That the inquiry involves a value judgment of sufficiency is implicit in the statutory scheme.
>
> The legal answer is complicated where as here the asset or advantage in respect of which expenses are incurred may serve private and income earning purposes. Thus expenses of travelling between home and work and expenses of child care have conventionally been regarded by the Courts as a private matter, a form of consumption. In as much as they are a prerequisite to the earning of income it is arguable that they are incurred in the gaining of the assessable income. But depending on one's perspective a similar argument could even be advanced to justify deduction of outlays on such basic items as essential food, clothing and shelter which may be said to maintain and enhance the physical and psychological wellbeing of the individual, and in turn his or her ability to perform his employment. In one sense then any such expenditure has a relation to the purpose of earning income, even if it is described as an ordinary living expense. But it is not to be expected that the legislature ever contemplated such an erosion of the income tax base in respect of employment income; and with careful emphasis on the character of the expenditure incurred the Courts have denied the notion that an expense properly characterised as consumption is incidental and relevant to the derivation of income merely because it is necessary in that sense (*Lodge v Federal Commissioner of Taxation* (1972) 128 CLR 171, 175; *Lunney v Commissioner of Taxation* (1958) 100 CLR 478).

Travel expenses

8. The deductibility of a companion's travel expenses was the subject of two New Zealand tax cases: *Case 16* (1964) 2 NZTBR 119 and *Case K75* (1988) 10 NZTC 602. These cases illustrate how the nexus requirement works in practice.

9. *Case 16* and *Case K75* both concern the deductibility of a companion's overseas travel expenses. In the Commissioner's opinion, the same reasoning would apply to travel expenses incurred within New Zealand. It is the character of the expenses that is important, not whether they were incurred in New Zealand or overseas. (However, deductions for some travel expenses incurred in New Zealand may be restricted under the entertainment rules (ss DD 1–DD 11).)

10. In *Case 16* the taxpayer company carried on business as a wholesale wine and spirits merchant. A was a shareholder and the managing director of the taxpayer. A's wife B was also a shareholder and director, but not an employee. Because of B's personal standing and business interests in Great Britain, she was able to materially assist the company to obtain a whiskey distributorship. However, in 1958 restrictions were placed on import licences, which resulted in poor sales for the taxpayer. The Great Britain whiskey distributor became dissatisfied. To try to preserve the distributorship, A and B visited the distributor. A confirmed that B's presence was essential to the visit. She was present at every meeting, took part in every business discussion and assisted in making decisions. The company sought a deduction for the travel expenditure. The Commissioner allowed a deduction for A's travel expenses, but not for B's.

11. The Taxation Board of Review (the board) held that B's travel expenses had a sufficient nexus with the assessable income of the business, so were deductible. The board found that B actively and competently carried out the duties of a director. Her standing within the licensed trade in Great Britain was of particular value to the company. B was not an employee of the company, but her intimate knowledge of the business meant she was able to contribute in a material way to the business being undertaken on the trip.

12. *Case K75* concerned the deductibility of travel expenditure incurred by a group of executives' wives. The executives had undertaken several business trips accompanied by their wives. The trips involved attending various local and international conferences and seminars. The purpose of the trips was networking and information gathering (to keep up to date with new developments in the publishing world). The wives assisted their husbands with these tasks by meeting and assessing the integrity and competence of the delegates, hosting dinners for delegates and participating in discussions about the business.

13. The company sought a deduction for the wives' travel expenses. The Commissioner refused to allow a deduction on the grounds that the travel expenses lacked sufficient nexus.

14. Judge Barber held that the expenditure was deductible. However, he considered that such expenditure would not easily satisfy the nexus test. He stated at 612:

> I record that I commenced this exercise from the point of view that it must be quite difficult for an objector to prove a sufficiently strong link, on the balance of

> probabilities, between travel expenditure for wives and an income earning process. ... wives would not usually have a sufficient knowledge or interest in the business of their husband's employer to warrant deductibility by the employer of a wife's travel expenses when accompanying her husband.

15. Judge Barber considered, at 612, that a sufficient nexus would exist where:

> ... the wife is travelling with the employee-executive husband to provide him with support, to a reasonably substantial degree, in undertaking the business of the employer; or, in other words, if the wife is adding in a reasonably substantial manner to the contribution which the husband would otherwise make to the business of the employer ...

16. In finding that this test was satisfied, Judge Barber noted that the wives were able to recall names of business contacts, they "ate, drank and talked" the business of the company, and they had a wide knowledge of their husbands' goals and the issues facing the company. Judge Barber considered that the expenditure benefited the company, observing with regards to one wife in particular, at 611:

> True, Mrs G might not be an "expert" in the affairs of the Company; but I am satisfied that her presence overseas accompanying Mr G, was of substantial benefit to the Company, and similarly with regard to the other two wives.

17. Judge Barber noted that deductibility is not available where the presence of the wife has no connection with the business activities undertaken by the employee husband. A deduction is not allowed if the companion is travelling as part of a "junket or joy-ride" (at 613).

18. In the Commissioner's opinion, for a companion to provide support to a "reasonably substantial degree, in undertaking the business of the employer" the companion (whether a spouse or otherwise) must have some knowledge of the business or some special skill or expertise to provide this support in a material way. Simply being supportive is not enough; that support must relate to the business being undertaken for a sufficient nexus to exist.

Travelling with a companion because of ill-health

19. "Overseas travel expense claims" *Tax Information Bulletin* Vol 7, No 2 (August 1995) outlined situations where a taxpayer may be able to claim a companion's travel expenses. One situation is where a taxpayer travelling on business must be accompanied because of ill-health.

20. The Commissioner no longer considers that a companion's travel expenses would be deductible where the companion is travelling with the taxpayer because of ill-health. In such cases there is likely to be an insufficient nexus with the taxpayer's business or income-earning activity and the expenses would likely be of a private or domestic nature. The companion might arguably be providing the taxpayer with support to a reasonably substantial degree, but that support relates to the taxpayer's personal circumstances and not to the business being undertaken.

21. Expenses relating to a health condition are generally not deductible as business expenses. This is the position taken by the New Zealand courts in the following cases: *Case E87* (1982) 5 NZTC 59,455, *Case F69* (1983) 6 NZTC 59,904, *Case F133* (1984) 6 NZTC 60,210, *Case F117* (1984) 6 NZTC 60,125, *Case F158* (1984) 6 NZTC 60,354 and *Haenga*. (See also "Self-employed person's medical costs not deductible" *Tax Information Bulletin* Vol 7, No 1, (July 1995).) In *Case F158* a taxpayer claimed a deduction for the cost of private medical treatment. The taxpayer underwent private treatment so that he was able to more quickly resume his professional work. In denying the deduction, Judge Barber noted:

> In a number of cases over the past year I have covered the view that, generally, expenditure required to remedy diseases or disabilities of the human body is expenditure of a private type – even though a reason for the expenditure is to enable the taxpayer to better earn income or resume the earning of income by remedying his health.
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> ...
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> However, not only is such expenditure not incurred in the course of gaining or producing income, in terms of sec 104 of the Act because it is incurred prior to the income earning process in order to enable the taxpayer to resume that process; but also, quite apart from the legal authorities, common sense tells us that such expenditure for surgery on parts of the human body cannot be regarded as business expenditure because it has the character or nature of private expenditure and hence is not deductible under our law by virtue of sec 106(1)(j) of the Act. The expenditure is not an overhead or functioning cost of O's legal practice; it is a health maintenance cost for O as a human being.

Examples

22. The following examples explain the application of the law. In both examples, the purpose of the trip is business. If a business trip also contains a private element such as a holiday, then it may be necessary to apportion some of the costs associated with the trip. See "Overseas Travel Expense Claims" *Tax Information Bulletin* Vol 7, No 2 (August 1995) for information about apportioning travel expenses.

23. Some of the travel expenses discussed below may also be a fringe benefit and be subject to fringe benefit tax (FBT). These examples do not consider FBT.

Example 1: Spouse accompanying husband to overseas conference

24. Andrew is a barrister. He attends an international law conference in Japan. The purpose of the conference is to discuss new developments in the law and to network with prospective clients and colleagues. The conference is directly relevant to Andrew's practice.

25. The organisation presenting the conference expects that attendees will bring their partners. Andrew's wife Mary accompanies him. She meets with the other attendees' partners and accompanies Andrew to dinners and cocktail functions held as part of the conference.

An overseas organisation expects Andrew to be accompanied – are Mary's travel expenses deductible?

26. Mary's travel expenses need to have a nexus with Andrew's business or income-earning activity. In the Commissioner's opinion, it is unlikely that there will be a sufficient nexus simply because an organisation expects that attendees will bring their partners. The onus will be on the taxpayer to show that this expectation has created a sufficient nexus.

27. If all Mary did was attend dinners and cocktail functions and provide companionship to Andrew, then her travel expenses would not be deductible because there would be an insufficient nexus with Andrew's business or income-earning activity. *Case K75* confirms that travel expenses will not be deductible if the person is travelling as a mere companion.

Would it make a difference if Andrew was also presenting a paper at the conference, the leader of a delegation or the only accredited delegate?

28. The role Andrew takes at the conference has no bearing on the deductibility of Mary's travel expenses. There must be a nexus between Mary's travel expenses and Andrew's business or income-earning activity. Mary is at the conference as a mere companion, so her travel expenses are not deductible.

29. It is also not significant that Andrew is a member of a profession. Deductibility is not related to a taxpayer's status as a professional; it is tied to the taxpayer's business.

30. Andrew could argue that Mary's travel expenses are deductible because he is presenting a paper at the conference to raise his business profile and he is expected to take a partner. In such circumstances Mary's travel expenses would be unlikely to have a sufficient nexus with Andrew's business. It is Mary's role and the contribution she makes, and the connection with Andrew's business that is important.

What if Andrew was the head of the international legal organisation running the conference and asked Mary to run the registration process and organise the various cocktail functions?

31. In this scenario, Mary's travel expenses may have a sufficient nexus with Andrew's business and be deductible. Mary is providing support to Andrew to a reasonably substantial degree with the business being undertaken. She is assisting with the conference and facilitating networking opportunities for the conference attendees, who would include potential clients for Andrew's business. This case is analogous to *Case K75*, where the executives' wives had a wide knowledge of what their husbands were trying to achieve and the wives understood and were concerned with furthering the company's business.

Would it make a difference if Andrew employed Mary full time as his bookkeeper?

32. Even if Mary were employed full time as Andrew's bookkeeper, her travel expenses are unlikely to be deductible. Employment status alone is not enough to create a sufficient nexus. Mary's job as a bookkeeper is an administrative one; she does not undertake legal work. The purpose of the conference is to discuss developments in the law and to network with clients and colleagues.

33. Mary may have knowledge of Andrew's business, but she is not providing support to Andrew to a reasonably substantial degree in the business being undertaken. She is attending the conference as Andrew's wife.

What if Mary is a lawyer employed by Andrew as a legal researcher and attended the conference seminars with him?

34. If Mary is a lawyer employed by Andrew as a legal researcher and attends the conference seminars with him, then her travel expenses are likely to be deductible. Her travel expenses will likely have a sufficient nexus with Andrew's business

or income-earning activity. It is not Mary's job title that determines deductibility—it is the role that Mary performs in Andrew's business. Mary generates assessable income for Andrew's business by undertaking legal research that Andrew uses when providing legal services to his clients. The conference that Mary is attending is about developments in the law that relate directly to Andrew's area of practice. Mary's attendance will be likely to assist her in her work for Andrew.

Example 2: Niece accompanying aunt to overseas trade fair

35. Lucy owns a furniture-importing business. Once a year she travels to a furniture trade fair in Beijing, China. The trade fair is where she sees new designs, inspects items for quality, places orders and makes business contacts. Business is typically conducted in Mandarin. As Lucy cannot speak Mandarin she often hires an interpreter to help her conduct business. This year, Lucy decides to take her niece Alice. Alice speaks fluent Mandarin.

Are Alice's travel expenses deductible?

36. Alice's travel expenses are likely to have a sufficient nexus with Lucy's business or income-earning activity so would be deductible.

37. Alice is providing support to a reasonably substantial degree with the business being undertaken. Without Alice, Lucy cannot engage with her suppliers and place orders. Alice is not an expert in Lucy's business, but she does possess a special skill or expertise (speaking fluent Mandarin) and that special skill or expertise is used to provide support to Lucy in undertaking her business.

References

Subject references
Deductibility; Income tax; Travel expenses
Legislative references
Income Tax Act 2007, s DA 1(1), s DA 2(2)
Case references
Case 16 (1964) 2 NZTBR 119
Case E87 (1982) 5 NZTC 59,455
Case F69 (1983) 6 NZTC 59,904
Case F117 (1984) 6 NZTC 60,125
Case F133 (1984) 6 NZTC 60,210
Case F158 (1984) 6 NZTC 60,354
Case K75 (1988) 10 NZTC 602
CIR v Haenga [1986] 1 NZLR 119 (CA)
Other references
"Deduction for Wife's Expenses – Professional People Attending Overseas Conferences" *Public Information Bulletin* No 74, p 10 (June 1973)
"Overseas Travel Expense Claims" *Tax Information Bulletin* Vol 7, No 2 (August 1995)
"Self-employed person's medical costs not deductible" *Tax Information Bulletin* Vol 7, No 1 (July 1995)

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, Court of Appeal, Privy Council and the Supreme Court.

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.

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.

COMMISSIONER'S APPLICATION FOR STRIKE-OUT SUCCESSFUL

Case	TRA 40/10
Decision date	25 October 2013
Act(s)	Income Tax Act 2004, Tax Administration Act 1994
Keywords	Strike out, Māori sovereignty, PAYE, evasion shortfall penalties

Summary

The Commissioner of Inland Revenue's ("the Commissioner") application to strike out the remainder of the disputant's claim was granted.

Impact of decision

This decision confirms the principle that Māori sovereignty does not relieve taxpayers of their obligations under the Revenue Acts.

Facts

The disputant employed shearers and shed-hands. Until January 2005, the disputant had accounted for PAYE to the Commissioner. Following an investigation, the statutory disputes process was entered into and assessments were made for PAYE for the 2005–07 years. Shortfall penalties for evasion were imposed.

The disputant challenged those assessments and the shortfall penalties imposed, primarily on the basis that it was not liable to account for PAYE due to Māori sovereignty.

The Commissioner applied to strike out the proceedings on 7 March 2011 and again on 15 June 2012. In a judgment dated 19 September 2012 (reported as *Case 9* (2012) 25 NZTC), Judge Barber struck out the pleadings on the basis that they disclosed no reasonably arguable cause of action and were an abuse of the court's process.

However, His Honour granted leave for the disputant to pursue two issues:

1. whether the shearers and shed-hands were independent contractors rather than employees; and
2. whether the disputant held a genuine belief that Māori sovereignty relieved it of its obligations to account for PAYE and so a lower shortfall penalty (than evasion) would be appropriate.

The disputant did not pursue the matter within the timeframe given and so the Commissioner applied to strike out the remainder of the case. Judge Barber gave the disputant two further opportunities to advance their case on the grounds as set out in his judgment of 19 September 2012.

In May 2013, the Commissioner again applied for strike-out and/or summary judgment on the grounds that the disputant had failed to advance its case on the issues open to it, and had advanced arguments beyond the scope of the leave granted.

The disputant failed to respond to the Commissioner's application for strike-out but instead filed numerous affidavits that appeared to evidence the Māori sovereignty arguments. At the hearing, the disputants sought to argue a third type of arrangement existed between the disputants and the shearers and shed-hands (so that the shearers and shed-hands were neither its employees nor independent contractors), known as "Whanau Kaitono".

Decision

The Commissioner submitted that the disputant's claims were "hopeless and entirely without merit". She further submitted that the disputant's claim was an abuse of process since leave was given to advance a case on only two narrow issues. The Commissioner also argued that the principle of *res judicata* applied since the Māori sovereignty arguments had already been heard and decided upon at the previous hearing. Finally, the Commissioner submitted that section 138G of the Tax Administration Act 1994 prohibited the disputant from bringing a proceeding in relation to matters not raised in statements of position without leave of the court.

The disputant's submissions and the briefs of evidence filed in the proceedings appeared to support the Māori sovereignty arguments. In essence, the disputant claimed it was exempt from New Zealand Revenue laws and not liable for PAYE due to Māori sovereignty.

The Commissioner's application for strike-out and/or summary judgment was granted. His Honour held that it was an abuse of process to bring the proceeding outside of the scope of leave granted. His Honour held *res judicata* applied and that the proceedings were an abuse of the Court's process.

RULE IN *MANNIX* UPHELD

Case	EngineerOnline Limited v Commissioner of Inland Revenue
Decision date	31 October 2013 (oral decision)
Act(s)	High Court Rules
Keywords	*Mannix*, security for costs, representation, exceptional circumstances

Summary

The judgment upheld the rule established in the Court of Appeal decision *Re GJ Mannix Ltd* [1984] 1 NZLR 309, but waived security for costs where the director of the appellant company provided an undertaking to pay costs.

Impact of decision

The rule in *Mannix* will only be departed from in exceptional circumstances. Security for costs may be waived where an undertaking is given.

Facts

The appellant company, EngineerOnline Limited, lost a challenge in the Taxation Review Authority ("TRA") in respect of the Commissioner's assessment to disallow the zero-rating, for goods and services tax ("GST") purposes, of supplies manufactured by the company.

The company appealed to the High Court. Preliminary to the substantive appeal, the Court was asked to decide the company's applications to be represented by its director, Mr MJ Elmes, and to have security for costs waived.

Decision

Representation

The Court found that there were no exceptional circumstances justifying the departure from the *Mannix* rule. In fact the Court was persuaded that it was in the appellant company's own interests, as well as those of the Court and the respondent, that it should be represented by a lawyer. The Court found this on the basis that:

- Mr Elmes had failed to put into evidence financial statements the appellant wished to rely upon to show impecuniosity;
- Mr Elmes' oral submissions ranged well beyond the relevant issues;
- Mr Elmes himself acknowledged that he required guidance on matters of procedure, this was not something the Court could provide;
- While Mr Elmes had submitted that he should represent the company because of his knowledge of the factual background, this knowledge was not relevant in relation to the *Mannix* rule.

Security for costs

The Court found that the particular circumstances of the case merited waiving security for costs, for two reasons:

1. The Court noted the financial burden imposed on the company to engage a lawyer and that if security was waived, that money could be applied to obtaining legal advice or representation.
2. Mr Elmes gave a personal undertaking to the Court to meet an order for costs made against the appellant in the event that it was ordered to pay the respondent's costs, if an appeal was unsuccessful.

Costs

Costs were reserved.

RESOURCE CONSENT NOT A STAND-ALONE ASSET

Case	TrustPower Limited v Commissioner of Inland Revenue
Decision date	12 November 2013
Act(s)	Income Tax Act 2004
Keywords	Capital, revenue, resource consent, feasibility expenditure, asset

Summary

The High Court found that resource consents acquired for the purpose of constructing electricity generation projects were not stand-alone assets separate from the projects to which they related.

Impact of decision

Resource consents obtained as part of a project, while possibly valuable as a bundle of rights, will not be stand-alone assets separable from the projects to which they relate.

While the Court found that the Commissioner of Inland Revenue ("the Commissioner") could not raise the land

improvement point procedurally, it indicated that the Commissioner would have been unsuccessful on this point.

Facts

TrustPower is an electricity generator and retailer. It generates (by hydro or wind) approximately one-half of the electricity that it sells and buys the remainder.

TrustPower's approach to its generation is centred around the notion of the development pipeline, which has been set up by the company to give it flexibility in deciding which project it wishes to pursue at any given time. A project is developed along the pipeline, with a final commitment to go ahead with the construction of the project/power plant being made only when TrustPower deems the economic circumstances to be acceptable.

In the period between July 2005 and November 2007, TrustPower applied for, and obtained, consents ("the resource consents") in respect of four projects.

TrustPower refers to the resource consents obtained for the projects in the development pipeline as "Type 2" consents, to distinguish them from consents relating to existing property or plant (which are "Type 1" consents).

Each of the applications for the resource consents included an extensive "Assessment of Effects on the Environment" ("AEE"), pursuant to section 88(2) (b) and Schedule 4 of the Resource Management Act 1991.

TrustPower incurred approximately $17.7 million in expenditure in applying for and obtaining "Type 2" resource consents in the tax years ended 31 March 2006, 2007 and 2008.

Decision

Are the resource consents obtained by TrustPower, on a stand-alone basis, assets?

Andrews J referred to the relevant case law (*Case T53* (1998) 18 NZTC 8,404 (TRA), *Milburn New Zealand Limited v CIR* (2001) 20 NZTC 17,017 (HC), and *ECC Quarries Limited v Watkis (Inspector of Quarries)* [1977] 1WLR 1386 (ChD)) ("*ECC Quarries*"), which discussed as obiter the nature of resource consents and licences, and distinguished all three on the basis that the taxpayer in each scenario was committed to undertaking the operation for which the consents were required. Andrews J decided that these cases are ones involving what TrustPower described as "functional capital assets", and are akin to "Type 1" consents for existing operations. Further, as each of these cases found their respective consents to be inseparable from the business or land to which they relate, case law supported the conclusion that the resource consents in this case cannot be seen as separate assets.

Andrews J also accepted TrustPower's evidence that the resource consents provided no independent value to TrustPower.

Andrews J concluded that the resource consents obtained by TrustPower with respect to the four projects were not stand-alone assets, separate from the projects to which they relate. The expenditure incurred in obtaining them must, therefore, be treated in the same manner as the projects (ie, as feasibility expenditure on revenue account).

Application of BP Australia test (BP Australia Ltd v Commissioner of Taxation for the Commonwealth of Australia [1966] AC 224 (PC))

Although the decision on the above issue was enough for Andrews J to decide the case in favour of TrustPower, her Honour considered the *BP Australia* indicia in order to determine, whether, if the resource consents were separate assets, they were capital or revenue assets.

What was the need or occasion that called for the expenditure?

Andrews J accepted that the purpose or occasion for the expenditure was not solely or principally to obtain resource consents. The expenditure was incurred as part of TrustPower's investigation into the feasibility of the projects to define the parameters of possible projects, and to enable an assessment of possible projects against TrustPower's other options for sourcing electricity to sell to customers.

Andrews J found that this aspect points to the expenditure being on revenue rather than capital account.

Were the payments made from fixed or circulating capital?

Andrews J did not find the fixed/circulating capital test useful in this case for two reasons:

1. First, there is little or no evidence as to the source of funds used for the expenditure.
2. Secondly, even if the focus is on the use of the expenditure, then it would require a determination of the nature of the resource consents (as capital or revenue assets) before it could be applied.

Was the expenditure of a once and for all nature producing assets or advantages that were of an enduring benefit for TrustPower?

Andrews J stated that she considered this test within the context of TrustPower's development pipeline.

Andrews J accepted TrustPower's submissions that most of the expenditure was not primarily directed at obtaining the resource consents, but was to assess the feasibility of the projects and so was recurrent in nature, being continually incurred to investigate and define the feasibility of the various projects.

Andrews J referred to the case of *Commissioner of Taxation v Ampol Exploration Ltd* (1986) 13 FCR 545 to support her conclusion that this aspect of the test indicates that the expenditure was of a revenue nature.

Were the assets or advantages produced of an enduring benefit to TrustPower?

Although Andrews J accepted TrustPower's submission that there is an inherent uncertainty surrounding the terms and duration of resource consents, and whether projects will be progressed further, the consents last for a significant period, and therefore provide an enduring benefit.

Andrews J found that this aspect indicates that the expenditure incurred in obtaining resource consents should be regarded as capital rather than revenue expenditure.

How would the payment be treated on ordinary principles of commercial accounting?

Expert evidence on accounting standards was called by both parties. The experts focussed on two New Zealand Equivalent to International Accounting Standards ("NZIAS") standards: *NZIAS 16 – Property, Plant and Equipment and NZIAS 38 – Intangible Assets*.

For the purposes of this discussion, Andrews J found that if the resource consents are stand-alone assets (contrary to her earlier finding), they could only be intangible assets. As such, it is doubtful that NZIAS 16 would apply.

Andrews J concluded that while an offer was made to purchase one of the projects, including the resource consents, TrustPower did not apply for the consents with the intention of selling them. Further, in the light of TrustPower's evidence that there were always more projects in the development pipeline than it had the financial and resource capability to construct, TrustPower could not have demonstrated the availability of adequate technical, financial, or other resources to complete the projects and use the resource consents.

On this basis, under NZIAS 38, the expenditure would not be recognisable as capital and would properly be treated as revenue.

Was the expenditure incurred on the business structure of TrustPower, or as part of the process by which income was earned?

Andrews J accepted TrustPower's submission that the consents are not means by which TrustPower can produce income, in the absence of a commitment to proceed to construct the project concerned. Although the consents were necessary for the project to be constructed, they did not generate any electricity, and they did not create any income for TrustPower.

Andrews J was satisfied that, even if the resource consents were separate assets, they could not be regarded as part of TrustPower's business structure. Andrews J concluded that this aspect indicated that the resource consents should be found to be revenue assets.

From a practical and business point of view, is the expenditure to be regarded as capital or revenue in nature?

Andrews J concluded that, even if the resource consents were stand-alone assets, from a business and practical point of view, they were revenue assets, and the expenditure to obtain them was revenue in nature.

TrustPower did not use the resource consents in the tax years concerned, and did not generate any income from the consents. Andrews J accepted that the resource consents were of value to TrustPower only as part of a "bundle", "package", or "suite" of rights, and as part of the development pipeline, which itself is only one part of TrustPower's business development.

Andrews J found that TrustPower's expenditure incurred in obtaining the resource consents was incurred as part of the feasibility process and was, therefore, revenue in nature.

Was TrustPower's expenditure in obtaining resource consents incurred for the purposes of improving its interest in the underlying land?

The Commissioner submitted that the resource consents provided TrustPower with the rights to construct and operate power plants on the land, and thereby improved the functionality of the land. The Commissioner referred to *ECC Quarries* as authority for the proposition that expenditure incurred to obtain planning permission to improve the functionality of land (ie, a capital asset) is capital.

Andrews J found that the present case is distinguishable from the situation in *ECC Quarries* where the planning permission could not, by law, be transferred.

Andrews J concluded that if she was required to consider the Commissioner's argument, that the resource consents enhanced the value of the underlying land and were therefore capital, she would find against the Commissioner.

The Commissioner has appealed this decision and she will continue to apply her view of the law in the interim.

EMPLOYEE INDEMNITY FUND A TAX AVOIDANCE ARRANGEMENT

Case	TRA 11/10
Decision date	6 November 2013
Act(s)	Income Tax Act 2004, Tax Administration Act 1994
Keywords	Tax avoidance, misappropriation, abusive tax position

Summary

The arrangement did not meet the requirements of sections DC 5, DA 1 DB 6 or DB 7 of the Income Tax Act 2004. The arrangement was also a tax avoidance arrangement and the shortfall penalty for taking an abusive tax position was appropriately applied by the Commissioner of Inland Revenue ("the Commissioner"). Further, the requirements for a deduction under section DB 33 were not satisfied.

Facts

In the income tax years ended 31 March 2004 to 31 March 2006, the disputant participated in an arrangement which purported to constitute an employee indemnity fund ("the EEF") for the benefit of the disputant's employees.

Ultimately, the disputant claimed deductions in the relevant income years for contributions, fees, insurance and interest paid under the EEF. The Commissioner reversed the deductions and assessed the disputant for shortfall penalties.

In an earlier proceeding (*Case 8* (2012) 25 NZTC 15,824) the disputant argued that the promoters of the EEF had defrauded them and that where there is such a fraud there can be no tax avoidance.

On 11 September 2012, the Taxation Review Authority ("TRA") gave a threshold decision on this point, confirming that fraud on the disputant did not preclude the tax avoidance provisions from applying to the arrangement.

The hearing for the substantive matters in dispute proceeded on 6 May 2013.

Decision

Section DC 5

The TRA held that the EEF did not meet the requirements of section DC 5. In particular, the contributions to the EEF were not set aside or paid to provide individual personal benefits to employees of the disputant and that the EEF was not established in a way that fully secured the rights of employees to receive the benefits.

Rather, the TRA considered the EEF appeared to be more in the nature of an insurance policy for the disputant (as the employer) in the event that it was unable to meet employment-related costs. In any event, any benefits that could be regarded as personal to the employees appeared to be benefits the employees were already entitled to pursuant to statute and/or their employment contracts. Further, the funds the disputant purportedly set aside to provide individual personal benefits to the employees were no more than book entries and/or were not accessible by the employees.

Section DA 1

The TRA found that it may have been arguable that any expenditure incurred that was directly related to the risk factors identified in the EEF would have had the requisite nexus with the disputant's income-earning business.

However, the TRA considered that because the expenses claimed related to the EEF and not the risk categories themselves, the expenditure was one step removed from actual expenditure on the risk factors. Further, the EEF was more akin to setting aside money as a contingency fund for the benefit of the disputant, rather than as a redundancy fund for employees. In addition, the EEF did not deplete over time, no claims were made and no bonuses paid to employees.

Section DA 2

The TRA considered that the expenditure was capital in nature because the contributions were an attempt to establish the nucleus of a fund that was an identifiable asset of an enduring nature; employee benefits did not accrue from the establishment of the EEF; and the disputant's director had confirmed that he saw the arrangement as a retirement fund for his own benefit.

Sections DB 6 and DB 7

The TRA considered that there was no evidence that established that any of the purported interest payments were, in fact, payments of interest in relation to the loan.

Tax avoidance

The TRA concluded that the arrangement had a purpose or effect of tax avoidance. Further, the TRA considered that no evidence existed that supported the disputant's purported purpose of creating a pool of money to meet future employment-related costs.

The TRA considered that the arrangement was artificial, contrived and something of a pretence; it was commercially unusual and there were no economic consequences incurred by the disputant. Ultimately, when viewed in a commercially realistic way, the tax avoidance purpose was pursued as a goal in itself and was therefore not merely incidental.

The disputant alleged that the arrangement was a fraud on it by the promoters but the TRA again confirmed that was irrelevant to determining whether or not section BG 1 applies. In any event, the TRA stated that the reasons the disputant gave in support of fraud allegations also supported a finding of tax avoidance.

The TRA confirmed that the reconstruction carried out by the Commissioner was an appropriate exercise of section GB 1.

Shortfall penalties

The TRA considered that, when viewed objectively, the positions taken were not about as likely as not to be correct.

Further, the TRA considered that the positions taken were in relation to an arrangement that had a dominant purpose of tax avoidance and accordingly, the Commissioner acted appropriately and correctly in imposing an abusive tax position shortfall penalty under section 141D.

Section DB 33

The disputant asserted, on the basis of its allegations of fraud, it was entitled to deductions under section DB 33 for misappropriation.

The TRA considered that proof of fraud by the promoters was not relevant for the purposes of section DB 33. The TRA concluded that the disputants had failed to prove that property had been misappropriated in the course of the disputant's business by a person rendering services to the disputant.

PROPERTY RENTAL ACTIVITIES A BUSINESS AND NOT A PASSIVE INVESTMENT

Case	TRA 16/12
Decision date	31 October 2013
Act(s)	Income Tax Act 2004
Keywords	Passive investment, rental business, Working for Families Tax Credits

Summary

The taxpayer and her husband were found to be carrying on a small, residential property rental business. The scale and volume of the operation, and the commitment of time, effort and finance involved were found to have been considerable and not merely passive investments as the taxpayer maintained. This finding resulted in a consequential re-calculation of their Working for Families Tax Credits ("WfFTC") entitlements.

Impact of decision

The Taxation Review Authority ("TRA"), in determining whether or not the taxpayer was engaged in business, applied the two-limb test in *Grieve v The Commissioner of Inland Revenue* [1984] 1 NZLR 101 ("*Grieve*"). Accordingly, the TRA confirmed that *Grieve* is still the leading case on whether or not a taxpayer is involved in a business.

In that regard, the TRA confirmed that the letting of residential properties will not be merely passive investments if the scale and volume of the operation, and the commitment of time, effort and finance involved are considerable.

Facts

This case involves a challenge by the taxpayer to the Commissioner of Inland Revenue's ("the Commissioner") amended WfFTC and income tax assessment for the tax year ended 31 March 2008.

The taxpayer and her husband have two children. The taxpayer was in receipt of WfFTC based on her "family income" being the combined income of the taxpayer and her husband. The taxpayer also claimed WfFTC in the 2009, 2010 and 2011 years on the same basis as the 2008 year.

In early 2007 the taxpayer and her husband attended a seminar organised by X Ltd relating to the purchase of rental properties for investment purposes. Following this, they became clients of J Ltd, a firm involved in conducting seminars relating to the taxation of rental properties. The firm was listed as their tax agent from 15 May 2007.

In August 2007 they registered for WfFTC. Both the taxpayer and her husband were in full-time employment and had not received WfFTC in prior years as their combined family income exceeded $100,000, making them ineligible to claim.

On 27 September 2007 their accountant sent a fax to the Commissioner stating that the taxpayer and her husband's total 2008 family income was estimated to be $73,936. This calculation included salary/wages of $143,000 less rental losses from residential rental properties of $69,064.

Rental properties

In 2004 the taxpayer and her husband purchased a rental property that was sold on 27 March 2007. Rental losses of $6,022.58 from this property were used in claiming WfFTC for the 2008 year.

In August 2004 the taxpayer and her husband purchased a property that is the family residence but is also occupied by the taxpayer's parents-in-law who lease a portion of the home. No written rental agreement existed, but they pay $250 rental in cash per week.

The taxpayer and her husband also purchased two properties, following the property investment seminar, which are both leased to Housing New Zealand.

The rental losses for the 2008 tax year for each of these four properties were used by the taxpayer and her husband in claiming WfFTC. The gross income claimed for this income year was $42,550.65. The total expenses claimed were $130,897.27.

The Commissioner amended the taxpayer's returns on the basis that the taxpayer and her husband were carrying on a rental property business in the 2008 tax year. The rental losses were added back in the specified "family income" when calculating WfFTC entitlements pursuant to section KD 1(1)(f) of the Income Tax Act 2004.

Decision

In determining whether the taxpayer was in business, the TRA referred to the leading case of *Grieve*. In that case, Richardson J held that the decision whether or not a taxpayer is in business involved a two-fold enquiry as to the nature of the activities and the intention of the taxpayer in engaging in such activities. His Honour set out the factors to be taken into consideration in determining the nature of the activities carried out as being the: period over which they are engaged in; the scale of operations and the volume of transactions; the commitments of time, money and effort; the pattern of activity; and the financial results.

The TRA found that the second limb of the *Grieve* test was met as the taxpayer and her husband had a clear intention of making a pecuniary profit. She noted that it does not matter that a taxpayer may have a number of different intentions; as long as one of those intentions is to make a pecuniary profit that is sufficient.

Her Honour considered the principal issue in the case related to the first limb of the *Grieve* test: namely the nature of the activities carried on, and in particular, whether they are sufficient to constitute a business.

Her Honour noted that the taxpayer was involved in residential property letting, which it is well established can amount to a business.

The taxpayer's position was that the rental properties owned by her and her husband were merely passive investments and that there was insufficient activity to constitute a business.

The Commissioner contended that there was sufficient activity to constitute a business.

After referring to the rental operation, the taxpayer's administrative and maintenance responsibilities in relation to the rental properties, and the nature and extent of the activities carried out by the taxpayer, illustrated by the expense claims made by the taxpayer and her husband, the TRA stated at [30]:

> As well as this personal commitment of time and effort, the financial commitment involved for the disputant and her husband was very considerable.

Accordingly, the TRA did not consider on the evidence that the investments were "passive". Her Honour stated at [32]:

> The activities in which the disputant and her husband were engaged (and the associated time investment) were typical of a small rental property business.

Having concluded that the taxpayer was engaged in a rental property business in the 2008 tax year, the TRA found that the taxpayer's rental losses for the 2008 tax year were business losses and should therefore be excluded for the purposes of calculating the disputant's entitlement to WfFTC.

UNSUCCESSFUL CLAIM FOR RECOVERY OF A STATUTORY DEBT OWING UNDER SECTION 46 OF THE GOODS AND SERVICES TAX ACT, UNSUCCESSFUL APPLICATION FOR JUDICIAL REVIEW

Case	Inbound Tour Services Limited v Commissioner of Inland Revenue
Decision date	13 November 2013
Act(s)	Goods and Services Tax Act 1985, Limitation Act 1950, Tax Administration Act 1994
Keywords	Statutory debt owing under section 46 of the GST Act 1985, Limitation Act defence, Judicial Review

Summary

The taxpayer was unsuccessful in its claim for a statutory debt owing as the Court held the Commissioner of Inland Revenue ("the Commissioner") had not breached her obligations under section 46 of the Goods and Services Tax Act 1985 ("GST Act"). The grounds for Judicial Review were rejected.

Impact of decision

The complicated and somewhat unusual facts in this case limit the implication of the decision on section 46 of the GST Act.

Facts

In 2000 Ernst and Young ("EY") approached a number of inbound tour operators ("ITOs"), including Inbound Tour Services South Pacific Limited ("ITS"). EY advised ITS that it had formed a view that a proposed legislative amendment to the GST Act (the proposed introduction of section 11 (2A) of the GST Act 1985, introduced by section 80 of the Taxation (Remedial Matters) Act with application on or after 20 May 1999 and later renumbered to section 11A(2)) meant that members of the ITO industry should have been zero-rating travel packages sold to overseas clients.

Consequently, ITS claimed a goods and services tax ("GST") refund of $545,255.48 for GST accounted for between 1993 and 20 May 1999.

A section 46 letter was sent to the taxpayer's agent on the 15th working day but was not received until some days later. As this occurred prior to *Commissioner of Inland Revenue v Sea Hunter Fishing Ltd* (2002) 20 NZTC 17,478 (CA) ("*Sea Hunter*"), all parties were of the view that section 46 of the GST Act had been complied with. However, the taxpayer's agent was told verbally by Inland Revenue staff that there would be an investigation into the GST return within the 15-day period.

A number of similar GST claims were made by other members of the ITO industry and a fiscal risk of $150–$200 million was identified. An ITO project was commenced by Inland Revenue and advice sought from the Solicitor General. Following consultation, a decision was made by Parliament that, to avoid doubt, the amendment to the GST Act would be made retrospective. The retrospective legislation contained a "savings provision" (section 241(6) of the Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001). The effect of the retrospective legislation was that the GST refunds claimed by members of the ITO industry (including ITS) would not be payable as claimed. However, a decision was made that the ITO industry's profit margin (known as the "facilitation fee") could be zero rated.

Accordingly, the Commissioner entered into two "agreed adjustments" with ITS, one to record that the original GST claim of $545,255.48 would not be paid and the second agreement recorded an agreement for a partial GST refund of $119,000 for ITS's facilitation fee.

ITS filed proceedings against the Commissioner in 2012 for a statutory debt owing due to a breach of section 46 of the GST Act and for Judicial Review.

Decision

Limitation Act

The Commissioner filed an amended Statement of Defence and sought leave to raise a defence based on the application of the Limitation Act 1950 to ITS's claim after the close of pleadings.

Ronald Young J allowed the Commissioner to raise the Limitation Act defence but held section 163 acted to "effectively disengage" (paragraph 70 of the judgment) the Limitation Act. His Honour rejected the Commissioner's argument that section 163 of the Tax Administration Act 1994 ("TAA") only applied to the Commissioner's power to recover tax and did not apply to the current case (being a claim for a statutory debt). His Honour found that the plain wording of section 163 did not suggest its application was limited to the Commissioner, and that the other provisions in Part 10 of the TAA suggested section 163 applied to taxpayers and the Commissioner alike. His Honour also agreed with ITS's counsel that section 45 of the GST Act acted as a limitation period, so that section 33 of the Limitation Act 1950 (which states that the Limitation Act will not apply where an enactment prescribes its own limitation period) applied.

Breach of section 46 GST Act

Section 46 of the GST Act requires that once the Commissioner receives a GST refund, she must either pay the GST refund claimed or notify the taxpayer that an investigation will be conducted or request further information from the taxpayer within 15 working days (under section 46 of the GST Act). At the time ITS's refund was claimed, the Commissioner believed the requirements of section 46 were complied with if the Commissioner sent the required notification to the taxpayer by the 15th day. The later decision in *SeaHunter* held that this was incorrect and Inland Revenue has since changed its practice. ITS claimed that because they had not received notification of a further investigation of the GST return within 15 working days of filing their return, the Commissioner had breached section 46 and was required to pay the GST refund to ITS.

His Honour referred to the fact that notification given under section 46(5) of the GST Act did not have to be in writing in 2001 (paragraph 114 of the judgment). His Honour held that notification had been given within the timeframe so the Commissioner had complied with section 46(5) of the GST Act. His Honour referred to the policy behind section 46 of the GST Act (at paragraphs 96–97) as outlined in *Contract Pacific v CIR* [2010] NZSC 136 and to the evidence of the correspondence between the Commissioner and EY. This showed that EY had known

a refund was unlikely to be paid within 15 days from the outset and had expected the Commissioner to make a comprehensive review of the GST claim.

Retrospective legislation and the savings provision

Section 11A(2) of the GST Act, as retrospectively enacted, confirmed that GST would be payable where the performance of service would be received in New Zealand. The Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001 ("TAMP Act") also contained a "savings provision".

His Honour found the purpose of the savings provision must have been to ensure that taxpayers who had received a refund would be entitled to keep the refund and that the savings provision applied to claims "affirmatively approved by the Commissioner", and not refunds which were generated by the Commissioner's legislative obligation under section 46. His Honour stated that even if ITS had received the refund after 15 working days, they would have known that (pending investigation) they may not retain the refund. His Honour held that while the Commissioner processed the GST return she did not assess whether ITS was entitled to it on the merits before the enactment of the TAMP Act, and so the savings provision does not apply (paragraphs 156–158 of the judgment).

Judicial Review

ITS applied for Judicial Review on a number of grounds. The Commissioner argued that Judicial Review was not available to ITS, as following the decision in *Tannadyce Investments Ltd v Commissioner of Inland Revenue* [2011] NZSC 158; [2012] 2 NZLR 153 ("*Tannadyce*"), Judicial Review in tax disputes is only available in "exceptionally rare cases".

His Honour agreed that the effect of *Tannadyce* is that Judicial Review will only be available in "exceptionally rare cases" but held that by entering into the Agreed Adjustments, the disputes resolution process was no longer available to ITS, therefore Judicial Review was available to it. His Honour then went on to consider each of the grounds of Judicial Review as alleged.

(a) Natural justice and procedural fairness

ITS claimed the Commissioner failed to disclose that the savings provision could apply to ITS and that the Commissioner did not consider ITS fell within the provision, and that ITS could receive the partial refund without forfeiting the right to the full amount.

His Honour found the Commissioner had always maintained that the savings provision did not apply to ITS, and there was nothing to suggest the Commissioner had ever thought the savings provision could apply to ITS. The Commissioner considered the agreed adjustments reflected the law, and ITS had received independent legal advice.

ITS also claimed that the Commissioner breached natural justice by saying if the refund was paid, it would be before March 2001 (when the TAMP Act was enacted).

His Honour found that there was no reviewable error. The comment allegedly made was an unreviewable comment, and not an undertaking (paragraphs 187–188 of the judgment).

(b) Maladministration

ITS claimed the Commissioner deliberately deferred payment of the refund to prevent the savings provision applying to ITS, because while the Commissioner had all the information to make the decision by February 2001, the Commissioner did not make a decision until May of the same year.

His Honour found that the Commissioner had complied with section 46 of the GST Act and so could not have acted with maladministration. He also found the Commissioner's decision to freeze all GST claims that were under investigation was innocuous (paragraphs 196–197 of the judgment).

PROCEEDINGS STRUCK OUT FOR FAILING TO COMPLY WITH UNLESS ORDERS

Case	Petroulias v Commissioner of Inland Revenue
Decision date	21 November 2013
Act(s)	High Court Rules
Keywords	Strike out, unless order

Summary

The proceedings were struck out by the court for failing to comply with unless orders.

Impact of Decision

While a strike-out is a step of last resort the Court has confirmed that there can be little point in making "unless orders" if the courts fail to give effect to them.

Facts

The Commissioner of Inland Revenue ("the Commissioner") has assessed Mr Petroulias (jointly and severally with another taxpayer) under section 141EB of the Tax Administration Act 1994 for promoter penalties amounting to $6,326,352.23. Mr Petroulias challenged the application of the penalty.

Timetable orders, made by the High Court on 15 March 2013, included the provision of discovery by both parties.

Mr Petroulias failed to provide discovery by the required date.

The Commissioner sought an extension to the timetable and obtained an "unless order" from the Court on 15 July 2013, requiring Mr Petroulias to provide discovery by 31 July 2013 and briefs of evidence by 20 September 2013.

Mr Petroulias did not comply with the timetable orders.

Decision

Collins J considered that nothing Mr Petroulias had submitted caused any doubt as to the appropriateness of the Commissioner's submissions, noting that Mr Petroulias had simply turned a blind eye to the timetable orders and "unless order".

His Honour noted that a strike-out is a step of last resort but stated that there can be little point in making "unless orders" if the courts fail to give effect to them. Accordingly, the Court decided the proceeding should be struck out.

CASE TRANSFER AND CONSOLIDATION

Case	Commissioner of Inland Revenue v Garry Albert Muir and others
Decision date	31 October 2013
Act(s)	Tax Administration Act 1994
Keywords	Transfer of proceedings, consolidation

Summary

The Commissioner of Inland Revenue ("the Commissioner") was successful in her application to have a number of cases originally filed in the Taxation Review Authority ("TRA") transferred to the High Court and consolidated with other High Court cases concerning the same dispute.

Impact of decision

The transfer and consolidation will allow the court to deal with matters in a comprehensive, efficient and relatively inexpensive manner. In agreeing to the transfer and consolidation, the court considered and applied the same considerations set out in *Commissioner of Inland Revenue v Deepsea Seafoods (No 1) Limited* (2004) 21 NZTC 18,469 (HC) ("*Deepsea Seafoods*").

The litigation history, especially since 2002, was one of the strong reasons for awarding the orders.

Facts

This application relates to the ongoing challenges filed by the respondents, disputing the finding that the Trinity Scheme was a tax avoidance scheme.

The Commissioner applied for the transfer of 66 proceedings (brought by 11 challengers) from the TRA to the High Court and consolidation of those proceedings with some related appeals and proceedings already in the High Court.

Decision

Before considering the issues, the Court first had to determine whether the Commissioner could bring this application by way of an originating application under Part 19 of the High Court Rules. The Court granted leave to the Commissioner with reference to Randerson J's judgment in *Commissioner of Inland Revenue v McIlraith* (2003) 21 NZTC 18,112 (HC).

In relation to the transfer of proceedings, Toogood J referred to the case of *Deepsea Seafoods* where the relevant considerations for transfer of proceedings from the TRA to the High Court were considered, the main ones being:

- the magnitude of the tax in dispute, public importance or complexity of the matter;
- the likelihood of the matter arising again in the future assessments; and
- the likelihood of appeals from the TRA.

The respondent objected to the transfer on the basis that:

- the Commissioner is merely seeking to strike out the challenges;
- the substantive issue is not complex;
- not all Trinity challenges would be dealt with in the High Court if the Commissioner is successful in its present application; and
- high litigation costs are asserted by the Commissioner and this is prejudicial to the challengers in circumstances where costs awards are not available in the TRA.

In response, Toogood J considered that:

- as the issue is already before this Court in the appeal proceedings, no injustice to the challengers arises if the proceedings are transferred;
- the issue is a complex one and even if it was not, it would not be an end to the matter;
- the High Court is capable of addressing discrete issues even if proceedings are transferred, and there is a substantive similarity in the issues;
- potential liability of respondents to costs in the High Court is not influential, and there is a public interest element in transferring the proceedings to eliminate a tier of appeals.

Toogood J also criticised the attitude the Trinity investors adopted, particularly those who did not settle their

challenges after the *Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289. He stated at [25]:

> More compelling, in favour of transfer, is the attitude which has been adopted by the Trinity investors who did not settle their challenges after the *Ben Nevis* decision of the Supreme Court. That has been to continue to seek avenues to relitigate the issues decided against them. I accept the Commissioner's proposition that little confidence can be placed in the challengers accepting any precedent-setting judgment or judgments which might be issued in the proceedings currently before this Court or in any one proceeding which might, as suggested by Dr Muir, be transferred as if it were, in effect, a test case. The prospect that notwithstanding an unfavourable outcome for the appeal proceedings currently before the Court, the other challengers will continue to argue their respective cases is not fanciful given the litigation history.

Toogood J referred to *Commissioner of Inland Revenue v A Taxpayer* (2003) 21 NZTC 18,001 (HC), where O'Regan J determined that transfer of Trinity litigation underlying the *Ben Nevis* decision was appropriate given the complexity of the issues and the amount of tax at stake. Toogood J stated at [27]:

> … transfer will bring the resolution closer to finality. All relevant factors weigh heavily in favour of transfer.

In relation to the consolidation of the proceedings, Toogood J again referred to *Deepsea Seafoods* where consolidation was ordered. He applied the same considerations, and ordered consolidation, noting that consolidation was desirable to save time and cost for the parties and the Court.

In addition, the Court made ancillary orders requiring the respondents to file and serve on the Commissioner amended statements of claim in all of the transferred proceedings on or before 5 December 2013, with the Commissioner to file and serve statements of defence by 20 February 2014.

Costs were awarded to the Commissioner.

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