

# TAX INFORMATION

## Bulletin

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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](http://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](mailto: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/](http://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
ED0179	Draft General Depreciation Determination: Carports	The Commissioner proposes to set a general depreciation rate for “Carports – freestanding or lean-to” under the “Buildings and structures” asset category in the Commissioner’s Table of Depreciation Rates.	31 July 2015
ED0180	Draft General Depreciation Determination: Rail Passenger Service Electric Multiple Units	The Commissioner proposes to set a general depreciation rate for “Rail passenger service Electric Multiple Units” under the “Transportation” asset category in the Commissioner’s Table of Depreciation Rates.	31 July 2015

# IN SUMMARY

## Legislation and determinations

### Special Accrual Determination S36: Application of the financial arrangements rules to a public-private partnership agreement

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This determination relates to an arrangement involving the finance, design, construction and on-going provision of operation and maintenance services in respect of the Facilities by a limited partnership under a public-private partnership agreement with the Crown.

### Special Accrual Determination S37: Application of the financial arrangements rules to the D&C Phase of a public-private partnership agreement

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This determination relates to payments received by a limited partnership for the design and construction of Facilities under a public-private partnership agreement with the Crown.

### Special Accrual Determination S38: Application of financial arrangements rules to loans by NZ Dairy Farming Trusts to New Zealand resident farmers

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This determination relates to loans from NZ Dairy Farming Trusts to New Zealand resident farmers. Under the loans, farmers will pay an establishment fee, milk-priced interest, land-priced interest and early repayment interest (if a loan is repaid before the agreed maturity date). This determination specifies that the milk-priced interest payable or accrued by a farmer in an income year together with a portion of the establishment fee and a portion of the estimated land-price interest is income for the trust in the income year and is expenditure for the farmer in the income year.

## Questions we've been asked

### QB 15/05: Income tax – Insurance – term life insurance policy taken out by employee with employer paying the premiums on employee's behalf

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This item considers the income tax treatment of a term life insurance policy taken out by an employee for their own benefit where the premiums are paid by the employer. It concludes that the amount of the premiums is deductible to the employer and subject to PAYE for the employee. Lump sums paid out under the policy will not be taxable income of the employee (or the employee's estate).

### QB 15/06: Income tax – Insurance – term life insurance policy taken out by employer for the benefit of an employee

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This item considers the income tax treatment of a term life insurance policy taken out by an employer for the benefit of an employee (or their spouse, civil union partner, de facto partner, or child). It concludes that the amount of the premiums is deductible to the employer and subject to FBT. Lump sums paid out under the policy will not be taxable income of the employee (or the employee's estate).

## Items of interest

### **Notice: The question we've been asked "Loan guarantor's loss when guarantee is called on – deductibility"**

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This notice advises that the Commissioner has withdrawn the Question We've Been Asked "Loan guarantor's loss when guarantee is called on – deductibility" *Tax Information Bulletin* Vol 7, No 2 (August 1995) with effect from the beginning of the 2015–16 income year.

## Legal decisions – case notes

### **Interpretation of section 89K(1) of the Tax Administration Act 1994: the meaning of "as soon as reasonably practicable"**

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This was a decision of the Taxation Review Authority confirming that the Commissioner of Inland Revenue had properly refused to exercise her discretion to accept the disputants' late statements of position as they were not issued "as soon as reasonably practicable" as required by s 89K(1) of the Tax Administration Act 1994.

### **Court of Appeal denies application for interim relief**

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The Court of Appeal dismissed Mr John George Russell's application to the Court of Appeal for a stay/grant of interim relief of the Commissioner of Inland Revenue's bankruptcy proceeding.

### **High Court upholds Taxation Review Authority decisions and strikes out challenges finding them to be an abuse of process**

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The High Court struck out the challenge proceedings of Dr Muir and others in relation to assessments for various tax years ranging from 1997 to 2010. The High Court also dismissed appeals against decisions of Judge Barber striking out Dr Muir's challenges for the 1998 to 2006 years and refusing to recall his strike-out decision.

## 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.

### SPECIAL DETERMINATION S36: APPLICATION OF THE FINANCIAL ARRANGEMENTS RULES TO A PUBLIC-PRIVATE PARTNERSHIP AGREEMENT

This Determination may be cited as Special Determination S36: "Application of the financial arrangements rules to a public-private partnership agreement".

#### 1. Explanation (which does not form part of the determination)

1. This determination relates to an arrangement (the Project) involving the finance, design, construction and on-going provision of operation and maintenance services in respect of the Facilities by a limited partnership (the Partnership) under a public-private partnership agreement (the Project Agreement) with the Crown. The Holding Partnership will be the sole limited partner in the Partnership, holding 100% of the Partnership.
2. The limited partners in the Holding Partnership are Limited Partner A and Limited Partner B. Limited Partner A is a limited partnership. Limited Partner B is a limited liability company. Limited Partner B and each taxable limited partner of Limited Partner A are together referred to as the Taxable Limited Partners.
3. The Project Agreement comprises three basic components for each Facility:
  - A design and construction phase (the D&C Phase) under which the Partnership agrees to design and construct the Facility for the Crown in consideration for a fixed lump-sum payment (the D&C Payment), payable on completion of the D&C Phase;
  - A Facility Lease entered into by the Partnership and the Crown, under which the Partnership pays an amount representing the rental under the Facility Lease to the Crown (the Rental Prepayment); and
  - An operations and maintenance phase (the O&M Phase) under which, in consideration for quarterly payments (the Unitary Charge), the Partnership will provide operation and maintenance services to the Crown over a term beginning once the Facility is ready for operation and ending 25 years after completion of the last-completed Facility.
4. The Partnership will enter into:
  - A Construction Agreement with a contractor (the Contractor), under which the Contractor will design and construct each Facility in consideration for monthly and milestone payments; and
  - An Operation and Maintenance Contract (the O&M Contract) with a service provider (the Service Provider), under which the Service Provider will provide the on-going operation and maintenance (and other) services in consideration for monthly payments.
5. The Partnership will raise external debt from a range of third party financiers (the Senior Debt).
6. The Partnership may raise subordinated debt from the Holding Partnership, which may in turn raise subordinated debt from Limited Partner A and Limited Partner B (Subordinated Debt).
7. The Partnership will enter into Interest Rate Swaps in respect of the Senior Debt.
8. The Facility Lease, O&M Phase of the Project Agreement, Construction Agreement and O&M Contract are all excepted financial arrangements. The D&C Phase of the Project Agreement, Senior Debt, Subordinated Debt and Interest Rate Swaps are financial arrangements to which the Partnership is a party. The Project, including all of these agreements, is a wider financial arrangement.
9. *Special Determination S37: Application of the financial arrangements rules to the D&C Phase in a public-private partnership* applies to the D&C Payment under the D&C Phase.
10. This determination prescribes:
  - the amount of consideration that is solely attributable to each Facility Lease;
  - how the financial arrangements rules apply to the O&M Phase of the Project Agreement, the Construction Agreement and the O&M Contract for each Facility; and

- the method for spreading the payments made under the Senior Debt, Subordinated Debt and Interest Rate Swaps.

## 2. Reference

1. This determination is made under ss 90AC(1)(bb) and 91AC(1)(h) of the Tax Administration Act 1994.

## 3. Scope of determination

1. This determination applies to the Partnership in respect of the Project (which is set out in detail in Private Ruling BR Prv 15/11 issued on 28 April 2015), including the following arrangements:
  - The D&C Phase of the Project Agreement, under which the Partnership agrees to design and construct each Facility for the Crown and will receive a fixed lump-sum payment (the D&C Payment) for each Facility once the Facility is ready for operation (which is the subject of *Special Determination S37: Application of the financial arrangements rules to the D&C Phase of a public-private partnership*).
  - The O&M Phase of the Project Agreement, under which the Partnership will provide on-going operation and maintenance services to the Crown for 25 years following completion of the last-completed Facility to the Crown in consideration for quarterly payments.
  - The Facility Lease for each Facility, under which the Partnership will lease the Facility from the Crown for a period ending 25 years following completion of the last-completed Facility and will make the Rental Prepayment to the Crown. The Rental Prepayment will be equal to and will offset the D&C Payment.
  - A Construction Agreement with the Contractor, under which the Contractor will design and construct the Facility in consideration for payments under the Construction Agreement.
  - An O&M Contract with the Service Provider following completion of the last-completed Facility, under which the Service Provider will provide the on-going operation and maintenance (and other) services in consideration for payments under the O&M Contract.
  - Senior Debt, under which the Partnership will borrow an agreed sum from external lenders for a term of 5 years from financial close of the Project (Financial Close). The Senior Debt will be a capitalising, interest only senior debt facility that converts to an amortising senior tranche on the Conversion Date. It is expected that the Senior Debt will be refinanced within 5 years of Financial Close and every 5 years thereafter over the term of

the Project. Under IFRS (as the standards apply at the date of this Determination), the Senior Debt (and any subsequent re-financings) will initially be recognised at fair value plus integral fees, and subsequently measured using the amortised cost using the effective interest method (regardless of whether hedge accounting is applied). The Senior Debt will not be treated as a hedge of another financial arrangement.

- Subordinated Debt, under which Limited Partner A and Limited Partner B may lend to the Holding Partnership and the Holding Partnership may lend to the Partnership.
  - Interest Rate Swaps, under which the Partnership will pay a fixed rate of interest to the swap counterparties, and receive a floating rate in return.
2. This determination is made subject to the following conditions:
    - The Taxable Limited Partners each use IFRSs to prepare financial statements.
    - The Taxable Limited Partners will each recognise income derived from the Crown during the D&C Phase and the O&M Phase of the Project Agreement, and will deduct expenditure incurred in relation to the Facility Lease, Construction Agreement and O&M Contract, in each case, under the relevant provisions of the Income Tax Act 2007 (outside of the financial arrangements rules).
    - The Taxable Limited Partners each do not use the fair value method for the Senior Debt if the Senior Debt is treated as a hedge of another financial arrangement under IFRS and uses for the other financial arrangement a method that is neither the IFRS financial reporting method nor the method required under Determination G29: Agreements for Sale and Purchase of Property Denominated in Foreign Currency: Exchange Rate to Determine the Acquisition Price and method for spreading income and expenditure.
    - The Taxable Limited Partners will each recognise income in respect of the D&C Payment in the manner prescribed by *Special Determination S37: Application of the financial arrangements rules to the D&C Phase in a public-private partnership*.
    - The continued application of Private Ruling BR Prv 15/11 issued on 28 April 2015.
    - The final executed documentation is not materially different from the draft documentation that Inland Revenue received on 24 October 2014, 16 January 2015, 12 April 2015 and 23 April 2015.

#### 4. Principle

1. Each Facility Lease is an excepted financial arrangement under s EW 5(9). Any amount that is solely attributable to an excepted financial arrangement described in ss EW 5(2) to (16) is not an amount that is taken into account under the financial arrangements rules (s EW 6(2)). This determination specifies the amounts that are solely attributable to a Facility Lease that are not taken into account under the financial arrangements rules.
2. The O&M Phase, Construction Agreements and O&M Contracts are “short-term agreements for sale and purchase” as defined in s YA 1, and are excepted financial arrangements under s EW 5(22), provided that payment under the Construction Agreements and O&M Contracts is required within 93 days of an invoice being rendered. Any amount that is solely attributable to an excepted financial arrangement described in ss EW 5(17) to (25) that is part of a financial arrangement is an amount that is taken into account under the financial arrangements rules (s EW 6(3)). This determination specifies that no amounts payable to or by the Partnership in respect of the O&M Phase, Construction Agreements and O&M Contracts are required to be spread under the financial arrangements rules.
3. The D&C Phase, Senior Debt, Subordinated Debt and Interest Rate Swaps are “financial arrangements” under s EW 3. This determination specifies that the payments made to or by Limited Partner A and Limited Partner B, in proportion to their share in Holding Partnership, under the Senior Debt, Subordinated Debt and Interest Rate Swaps must be spread under the financial arrangements rules in accordance with this determination.
4. This determination does not deal with the treatment of the D&C Payment which is subject to a separate determination (*Special Determination S37: Application of the financial arrangements rules to the D&C Phase in a public-private partnership*).

#### 5. Interpretation

1. In this determination, unless the context otherwise requires:
  - All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
  - Capitalised terms have the same meaning as set out in the Project Agreement.
  - “IFRS” means International Financial Reporting Standards as defined in s YA 1.

#### 6. Method

1. The Rental Prepayment paid in respect of a Facility Lease, and the property interest granted to the Partnership under a Facility Lease, are solely attributable to the Facility Lease and are not taken into account under the financial arrangements rules.
2. The Taxable Limited Partners are not required to spread any amounts under the financial arrangements rules in respect of the:
  - O&M Phase of the Project Agreement;
  - Construction Agreement;
  - O&M Contract.
3. The IFRS financial reporting method in s EW 15D may be used to allocate income and expenditure (other than “non-integral fees” as defined in s YA 1) over the term of the Senior Debt and none of the restrictions for application of the IFRS financial reporting method contained in s EW 15D(2B) apply.
4. The IFRS financial reporting method in s EW 15D may be used to allocate income and expenditure (other than “non-integral fees” as defined in s YA 1) in respect of any subsequent refinancing of the Senior Debt over the term of the relevant refinancing, provided that the terms of any such refinancing are materially similar to the terms of the Senior Debt. This determination paragraph does not affect each Taxable Limited Partner’s obligation to perform a base price adjustment under s EW 31 at the time of each refinancing.
5. The IFRS financial reporting method in s EW 15D may be used to allocate income and expenditure (other than “non-integral fees” as defined in s YA 1) over the term of the Subordinated Debt provided that none of the restrictions for the application of this reporting method in s EW 15D(2B) apply and provided that each Taxable Limited Partner uses the same IFRS method to allocate both income and expenditure under the Subordinated Debt for financial reporting purposes.
6. None of the mandatory spreading methods in ss EW 15H or EW 15I apply to the Interest Rate Swaps. Over the term of the Interest Rate Swaps, income or expenditure may be allocated using either:
  - the expected value method in s EW 15F (other than for “non-contingent fees” as defined in s YA 1) provided that the swaps are not treated as a hedge of other financial arrangements for which the “fair value method” is used; or
  - the IFRS financial reporting method in s EW 15D (other than for “non-integral fees” as defined in

s YA 1) provided that the swaps are not treated as a hedge of other financial arrangements for which a method other than the IFRS financial reporting method is used;

provided that each Taxable Limited Partner uses the same method for the entire term of the Interest Rate Swaps.

7. This determination does not affect each Taxable Limited Partner's obligation to perform base price adjustments under s EW 31 in respect of the Interest Rate Swaps.

## 7. Example

This example illustrates the application of the method set out in this determination.

This example is based on the following parameters:

Commencement of D&C Phase	1 May 2015
Completion of D&C Phase	16 September 2017
Completion of O&M Phase	21 December 2041
D&C Payment from the Crown	\$1,000
Aggregate payments to the Contractor	(\$850)
Facility Lease prepayment	(\$1,000)
Quarterly payments from the Crown during the O&M Phase	\$30
Quarterly payments to the Service Provider	(\$15)
Annual interest on the Senior Debt	(\$85)
Annual net payments in respect of the Interest Rate Swaps	(\$7)

The Taxable Limited Partners are not required to spread any amounts under the financial arrangements rules in respect of the Facility Lease, O&M Phase of the Project Agreement, Construction Agreement and O&M Contract.

The amounts that must be spread under the financial arrangement rules are:

- Interest on the Senior Debt calculated in accordance with the IFRS financial reporting method in s EW 15D;
- Interest on the Subordinated Debt calculated in accordance with the IFRS financial reporting method in s EW 15D;

- Payments in respect of the Interest Rate Swaps calculated in accordance with the expected value method in s EW 15F or the IFRS financial reporting method in s EW 15D; and
- Amounts in respect of the D&C Payment as specified in *Special Determination S37: Application of the financial arrangements rules to the D&C Phase in a public-private partnership*.

This Determination is signed by me on the 28th day of April 2015.

**Howard Davis**

Director (Taxpayer Rulings)



## SPECIAL DETERMINATION S37: APPLICATION OF THE FINANCIAL ARRANGEMENTS RULES TO THE D&C PHASE OF A PUBLIC-PRIVATE PARTNERSHIP AGREEMENT.

This Determination may be cited as Special Determination S37: "Application of the financial arrangements rules to the D&C Phase of a public-private partnership agreement".

### 1. Explanation (which does not form part of the determination)

1. This determination relates to an arrangement (the Project) involving the finance, design, construction and on-going provision of operation and maintenance services in respect of the Facilities by a limited partnership (the Partnership) under a public-private partnership agreement (the Project Agreement) with the Crown. The Holding Partnership will be the sole limited partner in the Partnership, holding 100% of the Partnership.
2. The limited partners in the Holding Partnership are Limited Partner A and Limited Partner B. Limited Partner A is a limited partnership. Limited Partner B is a limited liability company. Limited Partner B and each taxable limited partner of Limited Partner A are together referred to as the Taxable Limited Partners.
3. The Project Agreement comprises three basic components for each Facility:
  - A design and construction phase (the D&C Phase) under which the Partnership agrees to design and construct the Facility for the Crown in consideration for a fixed lump-sum payment (the D&C Payment), payable on completion of the D&C Phase;
  - A Facility Lease entered into by the Partnership and the Crown, under which the Partnership pays an amount representing the rental under the Facility Lease to the Crown (the Rental Prepayment); and
  - An operations and maintenance phase (the O&M Phase) under which, in consideration for quarterly payments (the Unitary Charge), the Partnership will provide operation and maintenance services to the Crown over a term beginning once the Facility is ready for operation and ending 25 years after completion of the last-completed Facility.
4. The Partnership will enter into:
  - A Construction Agreement with a contractor (the Contractor), under which the Contractor will design and construct each Facility in consideration for monthly and milestone payments; and
  - An Operation and Maintenance Contract (the O&M Contract) with a service provider (the Service

Provider) in respect of each Facility, under which the Service Provider will provide the on-going operation and maintenance (and other) services in consideration for monthly payments.

5. The Partnership will raise external debt from a range of third party financiers (the Senior Debt).
6. The Partnership may raise subordinated debt from the Holding Partnership, which may in turn raise subordinated debt from Limited Partner A and Limited Partner B (Subordinated Debt).
7. The Partnership will enter into Interest Rate Swaps in respect of the Senior Debt.
8. The Facility Lease, O&M Phase of the Project Agreement, Construction Agreement and O&M Contract are all excepted financial arrangements. The D&C Phase of the Project Agreement, Senior Debt, Subordinated Debt and Interest Rate Swaps are financial arrangements to which the Partnership is a party. The Project, including all of these agreements, is a wider financial arrangement.
9. *Special Determination S36: Application of the financial arrangements rules to a public-private partnership* applies to arrangements in the wider financial arrangement, excluding the D&C Payments.
10. This determination prescribes the portion of each D&C Payment treated as income under the financial arrangement rules (the Interest Component) and the method for spreading that income.

### 2. Reference

1. This determination is made under ss 90AC(1)(bb) and 91AC(1)(i) of the Tax Administration Act 1994.

### 3. Scope of determination

1. This determination applies to the Partnership in respect of the Project (which is set out in detail in Private Ruling BR Prv 15/11 issued on 28 April 2015), including the D&C Phase of the Project Agreement for each Facility, under which the Partnership agrees to design and construct the Facility for the Crown and will receive a fixed lump-sum payment (the D&C Payment) once the Facility is ready for operation.
2. This determination is made subject to the following conditions:
  - The design and construction costs of each Facility are agreed between the Partnership and the Crown

on an arm's length basis and set out in the Base Case for the relevant Facility under the Project Agreement as referenced in the definition of "Design and Construction Payment" in clause 1.1 of the Project Agreement.

- The Taxable Limited Partners each use IFRSs to prepare financial statements and to report for financial arrangements.
- The continued application of private ruling BR Prv 15/11 issued on 28 April 2015.
- The final executed documentation is not materially different from the draft documentation that Inland Revenue received on 24 October 2014, 16 January 2015, 12 April 2015 and 23 April 2015.

#### 4. Principle

1. During the D&C Phase of the Project Agreement, the Partnership will receive consideration from the Crown (in the form of the D&C Payment) for each Facility and will in turn provide consideration to the Crown (in the form of the completion of each Facility that is part of the Project and the transfer of its rights, set out in clause 12.2(c) of the Project Agreement, in each Facility). The D&C Phase of the Project Agreement for each facility is a "financial arrangement" under s EW 3 and an "agreement for the sale and purchase of property or services" under s YA 1.
2. The Partnership and the Crown have agreed that each D&C Payment includes capitalised interest (clause 13.6(c) of the Project Agreement). The Interest Component of each D&C Payment will be income under the financial arrangements rules under subpart EW.
3. During the D&C Phase for each Facility the Partnership has variable expenditure commitments that will accrue. The capitalised interest component of each D&C Payment is intended to offset the expected funding costs incurred on these commitments.
4. The Interest Component is calculated with reference to expected funding costs. No adjustment is made for variances between actual and expected costs as the D&C Payment for each Facility, including capitalised interest, is agreed in advance.
5. The Interest Component of each D&C Payment needs to be spread over the term of the D&C Phase for the Facility to which it relates.

#### 5. Interpretation

1. In this determination, unless the context otherwise requires:
  - All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.

- Capitalised terms have the same meaning as set out in the Project Agreement.
- "IFRS" means International Financial Reporting Standards as defined in s YA 1.

#### 6. Method

##### *Calculation of Interest Component*

1. The value of the completion of a Facility and transfer of the Partnership's rights to the Crown, set out in clause 12.2(c) of the Project Agreement, is the agreed design and construction costs of the relevant Facility (excluding Fitout) set out in the Base Case for the relevant Facility under the Project Agreement.
2. The D&C Payment less the agreed design and construction costs of the Facility (excluding Fitout) set out in the Base Case for the relevant Facility under the Project Agreement is the Interest Component that is income under the financial arrangements rules.
3. BR Prv 15/11 rules on the portion of the D&C Payment that is not income under the financial arrangements rules, and that portion is not considered in this determination.

##### *Spreading of Interest Component*

4. The method for determining the amount of income that is to be allocated to each income year is as follows:
  - a) The expected design and construction costs of the Facility (excluding Fitout) as set out in the Base Case for the relevant Facility are treated as having been incurred at the beginning of each of the income years that make up the D&C Phase for each Facility (the Annual Expenditure). No adjustment will be made to the Annual Expenditure in any income year to reflect actual expenditure in that year.
  - b) The interest allocated to each income year is then calculated in accordance with the following formula:

$$\text{Interest} = \text{OB} \times \text{R}$$

Where:

**OB** is the sum of the Annual Expenditure for that income year, plus the Annual Expenditure and interest attributable to any previous income year.

**R** is the internal rate of return (based on annual rests) calculated using the notional cash flows in paragraph a) above at the beginning of each income year as outflows, and the D&C Payment at the end of the D&C Phase as the only inflow.

#### 7. Example

This example illustrates the application of the method set out in this determination.

The Partnership and the Crown agree to the D&C Payment under the Base Case sheet that the D&C Payment equals \$60,000.

The Base Case sets out that the agreed design and construction costs of the Facility (excluding Fitout) are to be \$55,500.

The value of the "completion of the relevant Facility and the transfer of the rights set out in clause 12.2(c)" of the Project Agreement, as set out in clause 13.4(a) of the Project Agreement, is equal to \$55,500.

The Interest Component of the D&C Payment is \$4,500 by implication of the valuation under this determination.

The Taxable Limited Partners will each spread the Interest Component over the term of the D&C Phase of the Project Agreement, as follows.

The Annual Expenditure incurred and treated as having been incurred at the beginning of the relevant income year is as follows:

Year	Actual D&C Costs
1	(\$2,500)
2	(\$35,000)
3	(\$18,000)
D&C Payment	\$60,000
	(\$55,500)

Based on receipt of the \$60,000 D&C Payment in Year 3, the Project has an internal rate of return of 4.62%.

The Interest Component is therefore spread as follows:

Year	Actual D&C costs	Cumulative	Interest income
1	(\$2,500)	(\$2,500)	\$115
2	(\$35,000)	(\$37,615)	\$1,737
3	(\$18,000)	(\$57,352)	\$2,648
		\$60,000	
	(\$55,500)		\$4,500

This Determination is signed by me on the 28th day of April 2015.

**Howard Davis**

Director (Taxpayer Rulings)

## SPECIAL DETERMINATION S38: APPLICATION OF FINANCIAL ARRANGEMENTS RULES TO LOANS BY NZ DAIRY FARMING TRUSTS TO NEW ZEALAND RESIDENT FARMERS

This determination may be cited as Special Determination S38: "Application of financial arrangements rules to loans by NZ Dairy Farming Trusts to New Zealand resident farmers."

### 1. Explanation (which does not form part of the determination)

1. This determination relates to Loans between an NZ Dairy Farming Trust (the Fund) and New Zealand resident Farmers.
2. The Fund will lend money to Farmers under the Loan Agreement.
3. Loans from the Fund to Farmers will rank as junior debt of the Farmers. In general, a trading bank will provide senior debt, working capital, transactional banking facilities (and other banking facilities) to Farmers. For each Loan, the Fund, the trading bank and the Farmer will enter into an inter-creditor security agreement.
4. Under the Loan Agreement, a Farmer will pay:
  - an Establishment Fee;
  - Milk-Priced Interest;
  - Land-Priced Interest; and
  - Early Repayment Interest (if the loan is repaid before the agreed maturity date).
5. Milk-Priced Interest will be payable monthly and will be charged at a single rate of interest for each 12-month milk season ending 31 May. The Milk-Priced Interest rate for each milk season will be linked to Fonterra's prevailing Farmgate Milk Price for milk supplied for that season. Fonterra forecasts the Farmgate Milk Price at the start of a milk season for the season and provides quarterly updates to the forecast. If the forecast increases, Milk-Priced Interest payments for the season to date will increase and Farmers will make a catch-up payment as part of the next monthly Milk-Priced Interest payment. When Fonterra finalises the Farmgate Milk Price for the season ended 31 May (generally in September), the Fund will calculate a final interest reconciliation and Farmers will make an adjustment payment.
6. Land-Priced Interest is payable on maturity of the Loans, with the rate linked to the increase in a land price index (for the area in which the Farmer's Farm is located).
7. This determination applies to calculate and allocate the Fund's income and Farmers' expenditure under the Loans for each income year over the term of the Loan

Agreement (other than the income year in which the base price adjustment is calculated).

### 2. Reference

This Determination is made under ss 90AC(1)(bb) and 90AC(1)(d) of the Tax Administration Act 1994.

### 3. Scope

1. This determination applies to the tax treatment of the Loan Agreement by the Fund and Farmers.
2. Farmers applying this determination pursuant to s EW 15E of the Act must meet the requirements of s EW 15E(1)(c).
3. In accordance with s EW 20 of the Act, this determination cannot be applied by Farmers who are able, and choose, to use the straight-line method to calculate and allocate income and expenditure under financial arrangements.
4. The Funds will use IFRS to prepare financial statements and to report for financial arrangements.

### 4. Principle

1. The Loan Agreement is a financial arrangement under s EW3(3) of the Act that is not part of a wider financial arrangement.
2. This determination specifies that the Milk-Priced Interest payable or accrued by a Farmer in an income year together with a portion of the Establishment Fee and a portion of the estimated Land-Priced Interest calculated by reference to the movement between:
  - (A) the average level of the Index at the end of each quarter in the income year; and
  - (B) the average level of the Index at the end of each quarter in the preceding income year;
 is income for the Fund in the income year and is expenditure for the Farmer in the income year.
3. In the income year the Loan Agreement matures (or when the rights and obligations of the Fund or Farmers cease as specified in s EW 29 of the Act), the Fund and Farmers must calculate income and expenditure under the base price adjustment in s EW 31 of the Act.

### 5. Interpretation

In this determination, the following expressions have the following meanings:

**the Act** means the Income Tax Act 2007.

**Establishment Fee** means the fee payable by the Farmer to the Fund when the funds under the Loan Agreement are drawn down.

**Farm** means a Farmer's farm land.

**Farmer** means the borrower under a Loan Agreement.

**Fund** means the trustee(s) of an NZ Dairy Farming Trust that enters into a Loan Agreement with a Farmer.

**IFRS** means International Financial Reporting Standards as defined in s YA 1.

**Index** means:

- a) the REINZ Dairy Land Price Index, or
- b) the PropertyIQ Index, or
- c) a similar land price Index,

applying to the area in which a Farmer's Farm is located.

**Loan** means the funds advanced by the Fund to a Farmer under a Loan Agreement.

**Loan Agreement** means a debt instrument issued by the Fund to a Farmer:

- a) for use in purchasing or developing the Farmer's Farm;
- b) for a fixed term;
- c) on an interest only basis;
- d) under which interest is payable by the Farmer to the Fund on loan principal, comprising:

monthly payments made during the term of the Loan Agreement pegged to Fonterra's forecasted Farmgate Milk Price, as adjusted for Fonterra's final Farmgate Milk Price for the year (Milk-Priced Interest); and a balloon payment at the time the Loan is repaid at a rate equal to the percentage difference between:

the average level of the Index at the end of each of the last four quarters before the Loan is repaid; and the average level of the Index at the end of the last four quarters before the loan was drawn down (Land-Priced Interest); and

any interest due as a result of early repayment of the Loan principal (Early Repayment Interest);

- e) under which the Loan principal is payable to the Fund at the maturity of the Loan Agreement.

**NZ Dairy Farming Trust** means a trust that is a New Zealand tax resident and is managed by AgInvest Holdings Limited or an associate, which lends money to Farmers under the Loan Agreement.

## 6. Method

1. The Fund's income for a Loan Agreement for an income year equals:

- a) the Establishment Fee divided by the term of the Loan Agreement (in years);
- b) the Milk-Priced Interest payable by the Farmer to the Fund for that income year;

- c) a portion of the estimated Land-Priced Interest payment due on maturity of the Loan equal to:

- i) in the income year the Loan is drawn down:

$$\frac{\text{Average level of the Index at the end of each quarter in the income year} - \text{average level of the Index at the end of the last four quarters before Loan drawn down}}{\text{Average level of the Index at the end of the last four quarters before Loan drawn down}} \times \text{loan principal}$$

- ii) in following income years (except for the year in which the base price adjustment must be calculated):

$$\frac{\text{Average level of the Index at the end of each quarter in the income year} - \text{average level of the Index at the end of each quarter in the preceding income year}}{\text{Average level of the Index at the end of the last four quarters before Loan drawn down}} \times \text{loan principal}$$

provided that no account will be taken of any movement in the average level of the Index below the average level of the Index at the end of the last four quarters before the Loan was drawn down.

2. The Farmer's expenditure for a Loan Agreement for an income year equals:

- a) the Establishment Fee divided by the term of the Loan Agreement (in years);
- b) the Milk-Priced Interest payable by the Farmer to the Fund for that income year. If the Farmer files its tax return before the Milk-Priced Interest is finally calculated for a period that falls within the income year, the Farmer should use the Milk-Priced Interest most recently calculated before the Farmer files its return;
- c) a portion of the estimated Land-Priced Interest payment due on maturity of the Loan equal to:

- i) in the income year the Loan is drawn down:

$$\frac{\text{Average level of the Index at the end of each quarter in the income year} - \text{average level of the Index at the end of the last four quarters before Loan drawn down}}{\text{Average level of the Index at the end of the last four quarters before Loan drawn down}} \times \text{loan principal}$$

- ii) in following income years (except for the year in which the base price adjustment must be calculated):

$$\frac{\text{Average level of the Index at the end of each quarter in the income year} - \text{average level of the Index at the end of each quarter in the preceding income year}}{\text{Average level of the Index at the end of the last four quarters before Loan drawn down}} \times \text{loan principal}$$

provided that no account will be taken of any movement in the average level of the Index below the average level of the Index at the end of the last four quarters before the Loan was drawn down.

### 7. Example

1. This example illustrates the application of the method (set out in this determination) for determining the income and expenditure under the Loan Agreement for an income year.

2. The example is based on a Loan Agreement as follows:

Start date	1 August 2014	
End date	31 July 2024	
Loan principal	\$1,000,000	
Establishment Fee	\$5,000	
Milk-Priced Interest	Farmgate Milk Price	Interest rate
	Milk Price < \$5.26	2.5%
	5.25 < Milk Price < \$7.01	6% minus .02% for each cent below \$7.00
	7.00 < Milk Price < \$9.01	6% plus .02% for each cent above \$7.00
	\$9.00 < Milk Price	10%
Land-Priced Interest	Principal Amount x the percentage difference between: <ul style="list-style-type: none"> <li>the average level of the Index at the end of each of the last four quarters before the Loan is repaid; and</li> <li>the average level of the Index at the end of the last four quarters before the Loan was drawn down</li> </ul>	

### 2015 income year

3. This example assumes that in the 2015 income year:
- The Farmgate Milk Price for the 2015 season is \$7.50, so that the Milk-Priced Interest rate for the period to 31 March is 7.00% (6.00% + (.02% x 50)).
  - The average level of the Index at the end of each of the last four quarters before the Loan was drawn down was 103, and the average level of the Index at the end of each quarter in the 2015 income year is 106.
4. Income to the Fund under this determination for the Loan for the 2015 income year will be:

Total Milk-Priced Interest payable to Fund for 2015 income year	\$1M x 7.00% x 8/12 = \$46,666.67
Portion of estimated Land-Priced Interest allocated to income year	\$1M x ((106 - 103) / 103) = \$29,126
Portion of Establishment Fee allocated to income year	\$500
Total income under Loan Agreement for income year	\$76,292.67

### 2016 income year

5. This example assumes that in the 2016 income year:
- The Farmgate Milk Price for the 2016 season is \$5.10, so that the Milk-Priced Interest rate for the period 1 June 2015 to 31 May 2016 is 2.5%.
  - The average value of the Index at the end of each quarter in the 2016 income year is 95, and the Farmer has a March balance date.
6. Expenditure for the Farmer under this determination for the Loan for the 2016 income year will be:

Total Milk-Priced Interest payable to Fund for income year	\$1M x 7.00% x 2/12 = \$11,666.67
	\$1M x 2.50% x 10/12 = \$20,833.33
Portion of estimated Land-Priced Interest allocated to income year	\$1M x ((103 - 106) / 103) = -\$29,126
Portion of Establishment Fee allocated to income year	\$500
Total expenditure under Loan Agreement for income year	3,874

This determination is signed by me on the 15th day of May 2015.

**Howard Davis**  
Director (Taxpayer Rulings)

## 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 15/05: INCOME TAX – INSURANCE – TERM LIFE INSURANCE POLICY TAKEN OUT BY EMPLOYEE WITH EMPLOYER PAYING THE PREMIUMS ON EMPLOYEE'S BEHALF

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

This Question We've Been Asked is about ss CA 1, CE 1(1), CE 5, CX 4, DA 1, DA 2, RD 2, RD 3, RD 5(2) and the definition of "salary or wages" in s YA 1.

#### Question

1. What is the income tax treatment of a term life insurance policy that is:
  - taken out by an employee (the employee is the policy holder), and
  - the premiums are paid by the employer on the employee's behalf?

#### Answer

2. The employer will generally be entitled to a deduction for the premiums paid.
3. The amount of the premiums will be treated as salary or wages and, therefore, subject to PAYE.
4. Lump sums paid out under a term life insurance policy will not be taxable income of the employee (or the employee's estate).

#### Explanation

5. Inland Revenue recently undertook a review of all Public Information Bulletins (see <http://www.ird.govt.nz/technical-tax/pib-review/>). During that review two items on the income tax treatment of insurance in an employment context were identified as being out of date. The two items are "Staff insurance schemes" (*Public Information Bulletin* No 70 (December 1972): 11) and "Life and accident insurance policies" (*Public Information Bulletin* No 106 (July 1980): 2). Those PIBs covered a number of different scenarios. We intend to replace the PIBs with a series of Questions We've Been Asked (QWBAs) covering common scenarios.
6. This QWBA considers the situation where an employee takes out a term life insurance policy and the employer pays the premiums. It does not cover the situation where an employer takes out a life insurance policy for the employee's benefit.

7. Term life insurance pays out the sum insured (as a lump sum) if the life insured dies during the term of the policy.

#### *Deductibility of premiums*

8. A person is allowed a deduction for an amount of expenditure or loss to the extent that it is incurred by them in the course of carrying on a business for the purpose of deriving assessable (or excluded) income (s DA 1). Section DA 2 sets out some limitations on deductibility. For example, expenditure that is capital in nature, or expenditure incurred in deriving exempt income, is not deductible (s DA 2(1) and (3)).
9. In most cases, salary and wage costs will be deductible because they will satisfy the nexus test in s DA 1 and none of the general limitations will apply. The payment of a life insurance premium for an employee is a business cost just like salary or wages. Therefore, provided the costs of an employee's salary or wages are deductible, the costs of paying the insurance premiums will be too.

#### *Amount of premium paid taxable in the hands of the employee*

10. An employee's income includes "expenditure on account" of that employee (s CE 1(1)(b)). Expenditure on account of an employee means a payment **made by an employer** relating to expenditure **incurred by an employee** (or to be incurred by an employee) (s CE 5(1)). This is subject to certain exceptions (in s CE 5(3)), none of which are relevant here. In particular, the exclusion in s CE 5(3)(a) will not apply as the expenditure would not be deductible to the employee in the absence of the employment limitation (being a payment made to secure a capital benefit). The exclusions in s CE 5(3)(f)–(i) are not relevant as they only apply when the employer takes out the insurance policy.
11. In the situation covered by this QWBA, the employee has a legal obligation to the insurance company to pay the insurance premiums. Therefore, the amount of the insurance premiums has been incurred by the

employee. The employer is paying the premiums to the insurance company. Therefore, the payment of the insurance premiums is expenditure on account of the employee and is the employee's income.

12. A payment of expenditure on account of an employee is part of the employee's "salary or wages" (s RD 5(2)). A payment of salary or wages is a "PAYE income payment" (s RD 3). Therefore, the PAYE rules apply and the amounts are subject to PAYE. The amount of the premiums needs to be grossed up before PAYE is calculated. That is, the amount of the premium paid is the amount net of tax.
13. As the payment of the premium is assessable income to the employee, the fringe benefit tax rules will not apply (s CX 4).
14. There are other potential implications of having the gross amounts of the premiums included in an employee's salary or wages. For example, there are various other circumstances where obligations, eligibility, or entitlements may be calculated based on an employee's salary or wages (for example Kiwisaver and Working for Families Tax Credits).

#### *Income tax treatment of proceeds*

15. The proceeds received by an employee (or their estate) under a term life insurance policy are not income. An amount is income if it comes within a provision of Part C of the Act (s CA 1(1)). There are no specific provisions that tax payments under term life insurance policies.
16. An amount is also income if it is income under ordinary concepts (s CA 1(2)). A lump sum payment under a life insurance policy is not income under ordinary concepts.

#### **Example**

17. The following example is included to assist in explaining the application of the law.

18. Sally takes out a term life insurance policy with XYZ Insurance Ltd (XYZ). The sum insured is payable to Sally's family in the event of her death. Sally's employer, Flamingo Plumbing Ltd (FPL), pays the premiums to XYZ on Sally's behalf. FPL and Sally want to know the income tax implications of this.
19. FPL is allowed a deduction for the amounts of premium paid to XYZ. The amounts of premium paid will be treated as part of Sally's salary or wages. These amounts are, therefore, subject to PAYE. Any lump sum paid out under the policy to Sally (or her estate) will not be subject to income tax.

#### **References**

<b>Related rulings/statements</b>
"Staff insurance schemes" <i>Public Information Bulletin</i> No 70 (December 1972): 11
"Life and accident insurance policies" <i>Public Information Bulletin</i> No 106 (July 1980): 2
<b>Subject references</b>
Expenditure on account of an employee; Life insurance
<b>Legislative references</b>
Income Tax Act 2007 – ss CA 1, CE 1(1), CE 5, CX 4, DA 1, DA 2, RD 2, RD 3, RD 5(2) and the definition of "salary or wages" in s YA 1



## QB 15/06: INCOME TAX – INSURANCE – TERM LIFE INSURANCE POLICY TAKEN OUT BY EMPLOYER FOR THE BENEFIT OF AN EMPLOYEE

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

This Question We've Been Asked is about ss CA 1, CE 1(1), CE 5, CX 2, CX 4, CX 16, CX 37, DA 1, DA 2, GB 32, RD 3, RD 5(2) and the definitions of "expenditure on account of an employee" and "salary or wages" in s YA 1.

### Question

1. What is the income tax treatment of a term life insurance policy that is taken out by an employer and where an employee (or their spouse, civil union partner, de facto partner or child) is the beneficiary?
2. This item applies to both individual term life policies and group life policies where the employees (or associates) are the beneficiaries of the policy.

### Answer

3. The employer will generally be entitled to a deduction for the premiums paid.
4. The premiums paid will be subject to fringe benefit tax (FBT).
5. Lump sums paid out on death under a term life insurance policy will not be taxable income of the employee (or the employee's estate).

### Explanation

6. Inland Revenue recently undertook a review of all Public Information Bulletins (see <http://www.ird.govt.nz/technical-tax/pib-review/>). During that review, two items on the income tax treatment of insurance in an employment context were identified as being out of date. The two items are "Staff insurance schemes" (*Public Information Bulletin* No 70 (December 1972): 11) and "Life and accident insurance policies" (*Public Information Bulletin* No 106 (July 1980): 2). Those PIBs covered a number of different scenarios. We intend to replace the PIBs with a series of Questions We've Been Asked (QWBAs) covering common scenarios.
7. This QWBA considers the situation where a term life insurance policy is taken out by an employer for the benefit of an employee (or their spouse, civil union partner, de facto partner or child).
8. Term (or temporary) life insurance pays out the sum insured (as a lump sum) if the life insured dies during the term of the policy.

### Deductibility of premiums

9. A person is allowed a deduction for an amount of expenditure or loss to the extent that it is incurred by them in the course of carrying on a business for the purpose of deriving assessable (or excluded) income (s DA 1). Section DA 2 sets out some limitations on deductibility. For example, expenditure that is capital in nature, or expenditure incurred in deriving exempt income, is not deductible (s DA 2(1) and (3)).
10. In most cases, salary and wage costs will be deductible because they will satisfy the nexus test in s DA 1 and none of the general limitations will apply. The payment of a life insurance premium for the benefit of an employee (or their family) is a business cost just like the employee's salary or wages. Therefore, provided the costs of an employee's salary or wages are deductible, the costs of paying the insurance premiums will be too.

### When amount of premium is subject to PAYE

11. An employee's income includes "expenditure on account" of that employee (s CE 1(1)(b)), as defined in s CE 5. Section CE 5(2) expressly includes premiums paid by an employer who takes out certain life insurance policies for the benefit of an employee or their family members:

#### CE 5 Meaning of expenditure on account of an employee

...

#### Inclusion

- (2) **Expenditure on account of an employee** includes a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child. This subsection is overridden by subsection (3)(f) to (i).

12. Section CE 5(3)(f)–(i) exclude premiums under certain policies from being expenditure on account of an employee under s CE 5(2). The potentially relevant exclusions are:

#### CE 5 Meaning of expenditure on account of an employee

...

#### Exclusions

- (3) **Expenditure on account of an employee** does not include—

...

- (f) a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, if—
  - (i) the premium cannot be refunded to, or converted to cash by, the employee or an associated person; and
  - (ii) the only benefits that are payable under the policy are those payable on the death of the employee, or their spouse, civil union partner, de facto partner, or their child, or those payable because of accident, disease, or sickness of the employee, or their spouse, civil union partner, de facto partner, or their child;
- (g) a premium that an employer that is a close company pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, to the extent to which the expenditure is treated as a dividend under subpart CD (Income from equity):
- (h) a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, if the policy is, or is included in, a superannuation category 1 scheme, a superannuation category 2 scheme, or a superannuation category 3 scheme:
- (i) a premium that an employer pays on a life insurance policy taken out for the benefit of the employee, or their spouse, civil union partner, de facto partner, or their child, if the policy is held by or for the trustees of a superannuation category 3 scheme:

...

13. Paragraph (g) applies where a close company (being the employer) pays a premium on a life insurance policy to the extent that it is treated as a dividend under subpart CD. The treatment of these policies is not considered in this item. Similarly, paragraphs (h) and (i) apply to life insurance policies that are, or are included in, or are held by or for the trustees in, certain superannuation schemes. This item does not consider the treatment of these policies.
14. Paragraph (f) excludes from “expenditure on account of an employee” premiums on life insurance policies where:
  - the premium cannot be refunded to, or converted to cash by, the employee or an associated person; and
  - the only benefits payable are those payable on the death of the employee (or relevant family member),

or those payable because of accident, disease, or sickness of the employee (or relevant family member).

15. In the case of a term life policy taken out by an employer, an employee (or associate) will have no ability to have the premium refunded or converted to cash. Further, the only insurance benefit payable under this term life policy is a benefit payable on death. Consequently, para (f) will apply to exclude the premiums from being “expenditure on account of an employee”.
16. As the payment of the premium by the employer is not expenditure on account of an employee and is not assessable income of the employee, it is necessary to consider whether FBT applies (s CX 4).

*When amount of premium is subject to FBT*

17. Under s CX 2, a “fringe benefit” is a benefit that is provided by an employer to an employee in connection with their employment and comes within one of ss CX 6, CX 9, CX 10, or CX 12–CX 16, or is an unclassified benefit under s CX 37. Some benefits are also excluded from being fringe benefits by specific provisions in subpart CX. None of those exclusions are relevant here.
18. It is the provision of the policy rather than any payment under the policy that is the relevant “benefit” for FBT purposes. The provision of a life insurance policy is an economic benefit to an employee as they receive cover under the policy without the need to pay for it themselves.
19. Section CX 16 specifically includes certain life insurance policies as fringe benefits. It applies when an employer pays a “specified insurance premium”. The potentially relevant definition of “specified insurance premium” is set out in s CX 16(4):

**CX 16 Contributions to life or health insurance**

...

*Life insurance*

- (4) The first kind of policy referred to in subsection (3) is a policy of insurance on the life of the employee or their spouse, civil union partner or de facto partner, or on their joint lives, or on the life of their child, to which all the following apply:
  - (a) for policies other than whole of life policies, the minimum term is—
    - (i) 10 years; or
    - (ii) 5 years, for a policy whose maturity date is no earlier than the date on which a life assured reaches 60 years of age; and
  - (b) the only benefits payable earlier than 10 years from the start of the policy or its maturity date, whichever is earlier, are—

- (i) benefits payable for the death of a life assured; or
  - (ii) additional benefits payable for an accident to a life assured or disease or sickness of a life assured; and
- (c) the policy—
- (i) provides for a payment on the death of a life assured of a benefit that is not a return of premiums, is substantially capital, and is not materially less than the total benefit payable under the policy otherwise than for death; or
  - (ii) is a policy on the life of a person who, because of ill health or physical disability, is unable to effect a policy of the kind described in subparagraph (i) at ordinary rates; or
  - (iii) is a deferred life assurance policy on the life of a child.
20. If a term life insurance policy meets the requirements of s CX 16(4) it will be subject to FBT under s CX 16(1). However, many term life policies will not meet the requirements of s CX 16. Group insurance policies, for example, will often not meet the minimum term requirements set out in s CX 16(4)(a).
21. If a term life policy does not meet the requirements of s CX 16, it will be an unclassified benefit under s CX 37. Section CX 37 applies to benefits that an employer provides to an employee in connection with their employment that are not covered or excluded by a more specific provision. Section CX 16 applies to “specified insurance premiums”. When the predecessor to s CX 16 was enacted, there were different rates of FBT for different types of benefits. Relevantly, specified insurance premiums were subject to FBT at a lower rate than other benefits. Therefore, historically, specified insurance premiums were subject to FBT under a predecessor to s CX 16 while other insurance premiums were subject to FBT under a predecessor to s CX 37. The FBT rules have maintained this distinction, although, there are now few differences between applying s CX 16 and s CX 37.
22. There are no provisions in subpart CX that would exclude a term life insurance policy from being subject to FBT. Therefore, a term life insurance policy will be subject to FBT either under s CX 16 or CX 37.
23. Where an employer provides a fringe benefit to a person associated with an employee, s GB 32 treats the benefit as if it were provided by the employer to the employee. This is subject to the shareholder-employee exemption in s GB 32(2) and the look-through company exemption in s GB 32(2B). Therefore,

premiums paid on term life insurance policies taken out by an employer for the benefit of an employee’s spouse, civil union partner, de facto partner or child will also be subject to FBT.

#### *Operational matters*

24. It is possible that some employers may have been incorrectly applying s CX 16 rather than s CX 37 to term life insurance policies that they have provided for employees.
25. If employers have previously returned FBT on term life insurance policies under s CX 16 rather than s CX 37, the Commissioner will not be seeking to amend those previous FBT returns. However, employers must use the correct provision for any FBT returns filed for the period beginning 1 April 2015 onwards.
26. Any applications by taxpayers to have their FBT returns amended under s 113 will be considered by the Commissioner on a case by case basis.

#### *Income tax treatment of proceeds*

27. The proceeds received by an employee (or their estate) under a term life insurance policy are not income. An amount is income if it comes within a provision of Part C of the Act (s CA 1(1)). There are no specific provisions that tax payments under term life insurance policies.
28. An amount is also income if it is income under ordinary concepts (s CA 1(2)). A lump sum payment under a life insurance policy is not income under ordinary concepts.

#### **Example**

29. The following example is included to assist in explaining the application of the law.

30. Red Herring Fishing Ltd (RHF) takes out a term life insurance policy for one of its employees, Jared Stone. The policy is for a term of two years. The only benefit payable under the policy is if death occurs during the policy term. In such a case, the sum insured is paid to the employee’s estate. RHF pays the premiums, which are non-refundable. RHF and Jared want to know the income tax implications of this arrangement.
31. RHF is allowed a deduction for the amounts of premium paid. The amounts of premium paid are not subject to PAYE. Also, they are not subject to s CX 16(4). However, they are “unclassified benefits” and, therefore, subject to FBT under s CX 37. Any lump sum paid out under the policy will not be subject to income tax.

## References

<b>Related rulings/statements</b>
“Part I – The Income Tax Amendment Act (No 2) 1988” <i>Public Information Bulletin</i> No 174 (May 1988): 35
“Life and accident insurance policies” <i>Public Information Bulletin</i> No 106 (July 1980): 2
“Staff insurance schemes” <i>Public Information Bulletin</i> No 70 (December 1972): 11
<b>Subject references</b>
Expenditure on account of an employee; FBT; Fringe benefit; Life insurance;
<b>Legislative references</b>
Income Tax Act 2007 – ss CA 1, CE 1(1), CE 5, CX 2, CX 4, CX 16, CX 37, DA 1, DA 2, GB 32, RD 3, RD 5(2), and the definitions of “expenditure on account of an employee” and “salary or wages” in s YA 1

## ITEMS OF INTEREST

### NOTICE: THE QUESTION WE'VE BEEN ASKED "LOAN GUARANTOR'S LOSS WHEN GUARANTEE IS CALLED ON – DEDUCTIBILITY"

The question we've been asked "Loan guarantor's loss when guarantee is called on – deductibility" (the QWBA) was published in *Tax Information Bulletin* Vol 7, No 2 (August 1995). The QWBA concerns provisions in Part EH of the Income Tax Act (ITA) 1994. Relevantly, it sets out how s EH 4(8) of the Income Tax Act 1994 (now s DB 15 of the Income Tax Act 2007) applies to a guarantor claiming a deduction for an amount paid out under a guarantee.

In the Commissioner's view, there are a number of aspects of the QWBA which are ambiguous, misleading or incorrect. The QWBA is withdrawn effective from the beginning of the 2015–16 income year. Taxpayers taking a taxpayer's tax position after that date should not rely on the views set out in the item.

In the course of attempting to clarify these matters, a number of further issues have arisen around how the financial arrangements rules apply to guarantees. Because some of these issues are policy matters, the Commissioner is first going to consider the policy matters to determine whether the law should be amended. Once this has been done, the Commissioner will consider issuing a statement clarifying the issues for guarantees.

## 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.

### INTERPRETATION OF SECTION 89K(1) OF THE TAX ADMINISTRATION ACT 1994: THE MEANING OF "AS SOON AS REASONABLY PRACTICABLE"

<b>Case</b>	TRA 016/14 and TRA 017/14 [2015] NZTRA 08
<b>Decision date</b>	20 May 2015
<b>Act(s)</b>	Tax Administration Act 1994
<b>Keywords</b>	Section 89K(1), section 89K(6), "as soon as reasonably practicable"

#### Summary

This was a decision of the Taxation Review Authority ("TRA") confirming that the Commissioner of Inland Revenue ("the Commissioner") had properly refused to exercise her discretion to accept the disputants' late statements of position ("SOPs") as they were not issued "as soon as reasonably practicable" as required by s 89K(1) of the Tax Administration Act 1994 ("TAA").

#### Facts

The disputants issued proceedings under s 89K(6) of the TAA challenging the Commissioner's refusal to accept their late SOPs.

On 1 December 2009, the disputants took title to two residential properties ("the Properties") from the trustees of the G Trust and claimed goods and services tax ("GST") input tax deductions. The disputants had been incorporated to purchase the Properties with finance provided by the two finance companies which had financed the G Trust. The G Trust was controlled by Mr G, who was facing various creditor claims and charges of tax evasion.

By letter dated 7 October 2010, the disputants were notified of the Commissioner's decision to assess the disputants' GST as nil without the issue of notices of proposed adjustment in accordance with s 89C(eb) of the TAA.

On 31 May 2013, Ms Y, the disputants' accountant requested all information held by the Commissioner in relation to the disputants pursuant to the Official Information Act 1982 ("OIA").

On 17 June 2013, the Commissioner replied stating that the information would be supplied when the Commissioner's SOPs and disclosure notices were issued. The SOPs and disclosure notices were issued on 11 September 2013. However, the information requested under the OIA was omitted. The information was eventually sent by courier under a covering letter of 11 October 2013 albeit it was incorrectly addressed.

The disputants requested an extension to file their SOPs, which they were granted until 12 December 2013. On 11 December 2013, Ms Y advised that she was still waiting for the relevant information and requested a further extension to file the disputants' SOPs.

In a letter dated 23 December 2013, the disputants were advised that there was no statutory authority for the Commissioner to provide an extension in relation to the issue of a SOP outside of the response period and were referred to s 89K of the TAA.

It was accepted by the disputants that the folder of documents was received on 15 January 2014.

On 25 March 2014, the disputants' counsel wrote to the Commissioner seeking confirmation that if SOPs were provided within three weeks of the Commissioner's response that they would be accepted as being within the required timeframe. On 2 April 2014, the Commissioner declined to give such a confirmation.

The disputants' SOPs were provided to the Commissioner under cover of a letter dated 22 May 2014. In that letter the disputants made an application that the SOPs be accepted under s 89K of the TAA as having been provided within the applicable response period.

On 23 July 2014, the Commissioner refused the disputants' application.

## Decision

The TRA was firmly of the view that the disputants in the two challenges had failed to issue their SOPs “as soon as reasonably practicable” as required by s 89K of the TAA and the Commissioner had properly refused to exercise her discretion to accept the late SOPs.

Judge Sinclair acknowledged that the Commissioner’s investigation was protracted and complicated by her wider investigation. However, her Honour agreed with the Commissioner that the time taken to complete her investigation is not a relevant factor when considering the disputants’ response time.

The TRA stated that allegations of sham and tax avoidance are not uncommon and that the law in relation to both areas is reasonably settled. Accordingly, while careful analysis of the facts was required, no matters of particular complexity had been identified by the disputants that would have made the preparation of their SOPs especially time consuming.

Judge Sinclair further stated that the disputants had the ability to apply to the High Court for an extension of time for issuing their SOPs before the expiry of the response period but had failed to do so.

The TRA found that in effect the disputants had taken over six months to provide their SOPs from the date that they were originally due. The TRA also found that the disputants had shown no urgency in responding to the Commissioner’s SOPs and that it was reasonable to expect that preparatory work on the SOPs would have been commenced by the disputants prior to receipt of the documents requested under the OIA.

Judge Sinclair considered it to be of particular importance that the matters arose within the disputes process contained in Part 4A of the TAA where there are strict time frames within which particular steps are to be taken.

## COURT OF APPEAL DENIES APPLICATION FOR INTERIM RELIEF

<b>Case</b>	Russell v Commissioner of Inland Revenue
<b>Decision date</b>	8 May 2015
<b>Act(s)</b>	Court of Appeal (Civil) Rules 2005
<b>Keywords</b>	Interim relief, bankruptcy, judicial review, r 12 of the Court of Appeal (Civil) Rules 2005

## Summary

The Court of Appeal dismissed Mr John George Russell’s (“Mr Russell”) application to the Court of Appeal for a stay/grant of interim relief of the Commissioner of Inland Revenue’s (“the Commissioner”) bankruptcy proceeding.

## Facts

Mr Russell’s judicial review of the Commissioner’s decision to reject his proposal for instalment payments was struck out (*Russell v Commissioner of Inland Revenue* [2015] NZHC 754) and he appealed to the Court of Appeal.

This judgment relates to Mr Russell’s application to the Court of Appeal for a stay or interim relief (pending the outcome of his appeal of the High Court decision) to restrain the Commissioner from commencing bankruptcy proceedings against him.

Mr Russell had expressed that he could not meet his obligations but offered to pay all that he can. Mr Russell’s initial proposal was to pay instalments of \$1,000 per week for the rest of his life, leaving the Commissioner to pursue any claim for the remaining tax against his estate. A variant was also proposed by Mr Russell under which he offered to pay a lump sum of \$150,000, which he would borrow against future earnings.

The Commissioner did not accept that Mr Russell could pay no more than he has offered, and therefore rejected both proposals. She now seeks to initiate bankruptcy proceedings against Mr Russell.

## Decision

The Court of Appeal found that granting Mr Russell a stay or interim relief was not necessary to preserve his position:

1. Firstly, the Court found no reason to presume that the High Court will, or must, deal with the application for adjudication in bankruptcy before Mr Russell’s appeal is heard on 24 June 2015.
2. Secondly, the Court agreed with the Commissioner that Mr Russell’s position can be protected in the bankruptcy proceedings. The Court highlighted that the High Court has jurisdiction to halt the bankruptcy proceeding for such period as it thinks fit. The Court added that the High Court is less constricted when managing the bankruptcy proceeding, in which it may hear evidence allowing Mr Russell to verify his claim, as well as delaying its final decision if it thinks fit.
3. Thirdly, the Court held that Mr Russell’s position will be no worse should the High Court carry on and determine the Commissioner’s proceeding. If Mr Russell is found to be unable to pay more than he has offered, the High Court may refuse an order

of adjudication in the exercise of its discretion. In addition, the Court held that Mr Russell would be unable to claim to have been disadvantaged should the premise of his judicial review application be unfounded.

The Court concluded with the view that Mr Russell's appeal of the High Court decision has weak prospects of success and that his application for interim relief should have been made in the High Court in the first instance.

## HIGH COURT UPHOLDS TAXATION REVIEW AUTHORITY DECISIONS AND STRIKES OUT CHALLENGES FINDING THEM TO BE AN ABUSE OF PROCESS

<b>Case</b>	Muir & Others v Commissioner of Inland Revenue
<b>Decision date</b>	22 April 2015
<b>Act(s)</b>	Tax Administration Act 1994
<b>Keywords</b>	Trinity, test case, stayed case, mutuality of interest, abuse of process.

### Summary

The High Court struck out the challenge proceedings of Dr Muir and others in relation to assessments for various tax years ranging from 1997 to 2010. The High Court also dismissed appeals against decisions of Judge Barber striking out Dr Muir's challenges for the 1998 to 2006 years and refusing to recall his strike-out decision.

### Facts

The 11 plaintiffs were investors or LAQCs of investors in the Trinity Scheme. The challenges in this proceeding had been stayed under the TAA awaiting determination of the test cases which were the Trinity challenges determined by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* ([2008] NZSC 115). The challenges had been consolidated with two appeals from the Taxation Review Authority ("TRA").

With leave from the Court, the majority of the plaintiffs either discontinued their challenge proceedings or took no part in the hearing. The remaining parties were the first plaintiff, Dr Muir, the fourth plaintiff, Mr Maude, the eighth plaintiff, Hillvale Holdings Ltd, and the eleventh plaintiff, Waikato Residential Properties Ltd. Mr Maude, Hillvale Holdings Ltd and Waikato Residential Properties Ltd advised that they would take no active part in the hearing and would simply adopt the submissions made by Dr Muir.

Accordingly, the Court was considering:

1. challenge proceedings by Dr Muir and others to the 2007 to 2010 assessments and Dr Muir's challenge to the 1997 assessment; and
2. appeals by Dr Muir from decisions of Judge Barber in the TRA striking out Dr Muir's challenges for the 1998 to 2006 years and refusing to recall his strike-out decision.

The Commissioner of Inland Revenue ("the Commissioner") submitted that the challenges, while fresh challenges in the sense that they related to later or different assessments, nevertheless arose out of the Trinity Scheme and were identical to the tax challenges already determined by the Supreme Court. The challenges before the Court sought to re-litigate the legal analysis of the Trinity Scheme. However, the issue was subject to the doctrine of issue estoppel with the result that it was an abuse of process to issue the current proceedings.

The Commissioner also submitted that Dr Muir's appeals should be dismissed for the same reasons.

Dr Muir submitted that the Commissioner made incorrect tax assessments in so far as the "black letter" analysis of the Trinity Scheme was not based on the accrual rules. Dr Muir submitted that the Trinity Scheme required analysis under subpart EH of the Income Tax Act 1994 ("the Act") and not under subpart EG of the Act, which had been the basis for the Courts' analysis of the Trinity Scheme. Dr Muir submitted that the application of subpart EH is mandatory where there is a financial arrangement and that it was unlawful to fail to apply it. He contended that subpart EH required there to be a calculation of a core acquisition price in order to determine the interest to be spread, and thereby see what is left to depreciate under subpart EH.

### Decision

The Court followed the approach summarised in *Attorney-General v Prince and Gardner* ([1998] 1 NZLR 262 (CA) at 267) and adopted in *Couch v Attorney-General* ([2008] NZSC 45, [2008] 3 NZLR 725) regarding strike-out applications. This approach dictates that before the Court may strike out proceedings, the causes of action must be so clearly untenable that they cannot possibly succeed. The jurisdiction to strike out is to be used sparingly, although the fact that the application requires extensive argument does not exclude the jurisdiction.

The Court cited the summary of Fisher J in *Russell v Taxation Review Authority* ((2000) 19 NZTC 15,924 (HC) at [19] and [20]) regarding its position on applications alleging abuse of process. In that case Fisher J held that proceedings can



be dismissed in whole or in part as an abuse of the process of the Court where the cause of action pleaded could not succeed because of the existence of an issue estoppel with respect to one or more of the essential elements of the cause of action, or where the pleaded cause of action represents an attempt to litigate or re-litigate issues which ought properly to have been included in the previous proceedings.

The Commissioner's case was that Dr Muir stood to gain from the Trinity scheme because he was the architect, advisor and investor, and the guiding hand behind Redcliff Forestry Venture Ltd. The challenges and appeal were seeking to re-litigate the legal analysis of the Trinity Scheme and this was an abuse of process.

The primary basis for the strike-out application and dismissal here was that the issue sought to be raised had been finally determined by the Supreme Court in three judgments. There was a final decision as to the appropriate analysis of the Trinity Scheme and an issue estoppel because the Supreme Court had determined all matters between the plaintiffs and appellant, their privies and the Commissioner.

The Court found that there was "no basis for concluding that Dr Muir was not a privy to the parties in *Ben Nevis*" with the result that the Supreme Court judgment is binding upon him. To allow re-litigation of the issue would be an abuse of process.

The Court then went on to briefly refer to the positions of the remaining plaintiffs and found they also were clearly privies and bound by the Supreme Court judgments.

The Court concluded that that the current plaintiffs were estopped from disputing the determinations of the Supreme Court judgments as binding on them as if they were parties to those proceedings. They therefore were estopped from raising arguments concerning the treatment of the Trinity Scheme and appropriate assessments.

The Court also concluded that this was a clear case of an abuse of process which must not be allowed to continue. It may also be viewed as a collateral attack on the final decisions of the Supreme Court and is equally an abuse of process on that ground.

For the above reasons, the Court held that the Commissioner is entitled to an order striking out the challenge proceedings and also an order dismissing the appeals against the TRA decisions.



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