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WEEKLY COMMENT: WEDNESDAY 20 JUNE 2012

1. Earlier this year Inland Revenue released a draft Interpretation Statement on the *Deductibility of expenditure incurred in borrowing money* (which closed for comments on 16 March). Recently Public Rulings *BR PUB 12/01 - 12/03* were issued, and these deal with the deductibility of break fees incurred to terminate a loan.

2. In a broad sense, expenditure incurred in connection with borrowed money can fall into two categories:

   (a) Expenditure incurred in negotiating a loan, reviewing the terms and conditions, comparing terms etc., all of which fall into the "pre-loan expenditure" category. Also in this category would be expenditure to meet the requirements (if any) for entering into the loan agreement.

   (b) Interest and other on-going expenditure incurred to service the loan fall into the "loan expenditure" category:

      (i) Included in this category would be expenditure to vary the terms of the loan without terminating the loan.

      (ii) Expenditure incurred, if any, in terminating the loan should also fall into the "loan expenditure" category. To the extent that some of this expenditure may be incurred after the loan is terminated, there may be a case for arguing that the expenditure is in a third "post-loan" category. However, such expenditure is included in the Base Price Adjustment ("BPA") "wash-up" calculation, and the better view, therefore, is that it is not a separate third category, but simply part of the second "loan expenditure" category.

Pre-loan expenditure

3. The "pre-loan expenditure" category is the subject of the draft IS on *Deductibility of expenditure incurred in borrowing money*. The focus is on section DB 5, which 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 section DB 5:

   (a) The expenditure must be incurred by the taxpayer; and

   (b) The expenditure must be incurred in borrowing money; and

   (c) The borrowed money must be used by the taxpayer as capital in the derivation of gross income.

Features of section DB 5

4. **Section DB 5 overrides the capital limitation**: Generally borrowed money is regarded as an addition to capital: Ca*ltex 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. Section DB 5 overrides the capital limitation in section DA 2(1) and allows a deduction for such expenditure.

5. **Section DB 5 applies to non-contingent and non-integral fees**: The Commissioner considers that section DB 5 does not by necessary implication exclude the application of the financial arrangements rules. Where borrowing costs are consideration that is taken into account in calculating income or expenditure under the financial arrangements rules, the amount and timing of the expenditure are determined by the financial arrangements rules. As non-contingent fees and non-integral fees paid or payable under a financial arrangement are not taken into account in calculating income or expenditure under the financial arrangements rules, whether such fees are deductible is to be determined under section DA 1 or section DB 5.

6. **Expenditure that is usually deductible under section DB 5**: It is stated in the draft IS that it is not possible to provide a comprehensive list of expenditure deductible under section DB 5. Whether or not a particular expenditure is deductible under section DB 5 depends on whether the expenditure meets the requirements of the section as set out in the IS. However, expenditure that is usually deductible under section DB 5 includes:
   - Legal fees in connection with establishing the loan.
   - Valuation fees, where the lender requires a valuation.
   - Guarantee fees.
   - Lenders mortgage insurance (where the cost is passed on to the borrower).
   - Loan procurement fees.
   - Survey fees, where the lender requires the surveying.
   - Mortgage brokers commissions.
   - Cost of arranging bank overdrafts.
   - Expenses of debenture issues (drafting, advertising and printing prospectuses).

Requirements of section DB 5

7. **Expenditure must be incurred**: In *Felt and Textiles v CIR* [1969] NZLR 493 the Supreme Court held that the issuing of debentures at a 1% discount did not involve any expenditure in borrowing money. However, the expenditure need not be paid at the time, providing the taxpayer is definitively committed to it: In *King v CIR* [1974] 2 NZLR 190 expenditure required under the terms of the loans that was added to the borrowed money was held to be deductible. See also *Ure v FCT*, 81 ATC 4,100 (FCA).

8. **Expenditure must be incurred in borrowing money**: The taxpayer must actually borrow money in order for the following related expenditure to be deductible under section DB 5. If expenses are incurred in attempting to borrow money and the borrowing

does not proceed, no deduction is allowed: *Case L101* (1989) 11 NZTC 1,533; *Case Q61* (1983) 83 ATC 319. This is an important point: If the borrowing does not proceed, there is a risk the expenditure could be "black hole" expenditure that is neither deductible nor depreciable.

9. **Expenditure must relate to the establishment of a new loan**: Costs incurred in refinancing or a "rollover" of a loan may be incurred in establishing a new loan, but it will be a question of fact in each case. Where the intention is merely to vary or modify the terms of the prior contract without altering them in substance there will be no new contract. [An extension of the term of a loan contract, made under a provision in the contract contemplating such an extension, is a variation of the contract and is 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).] However, if the second agreement is inconsistent with the first to an extent that goes to the very root of it, a new contract will have come into existence: *Morris v Baron & Co* [1918] AC 1. In *Baker v Merckell* [1960] 1 All ER 668 (CA) an extension of the term of a lease beyond the original term was seen as a surrender of the old lease and a grant of a new one. For the expenditure to be deductible under section DB 5, there must be an establishment of a new loan.

10. **Expenditure must relate solely to the loan**: To be deductible under section DB 5, the expenditure must relate solely to the loan, and must not be consideration for valuable benefits other than the loan. This is based on a body of Australian and Canadian case law. The Commissioner quotes the court in *Elirpa Construction & Materials Ltd v Canada* [1955] 2 CTC 2,968 as follows:

    "… 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."

11. On this basis, it is the Commissioner's view that the premiums under term life or any other type of life insurance, including mortgage repayment insurance, are not deductible under section DB 5, because they are consideration for a benefit other than the loan (being the right to be paid the sum insured under the policy). Premiums payable on life insurance policies assigned to lenders as security for loans were held to be non-deductible in *Case 64* 10 CTBR 189 and in *Case Y21*, 91 ATC 250, because the premiums were capital expenditure being consideration for a capital asset (the policy). In *Antoine Gueretin Ltée v R* [1981] CTC 351 the court considered that 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 the payment of the premium on the term life policy did not result in the diminution of the borrower's property.

12. [Note: the IS contains a discussion of two Canadian cases where the premiums were held to be deductible: *Côté-Reco Ltd Limited v MNR* [1980] CTC 2,019 and *Economy Carriers Ltd v MNR* [1984] CTC 2,210. However, The Commissioner considers that higher-level authority contradicts the decisions in *Côté-Reco* and *Economy Carriers*, and that the weight of authority establishes that premiums on life insurance, including term life insurance, are not deductible under section DB 5.]

13. By contrast, lender's mortgage insurance and guarantee fees are deductible on the basis that they relate solely to the loan. Both lender's mortgage insurance and guarantee fees are for the benefit of the lender, and the borrower derives no consideration other than the loan. However, such expenditure would be part of the expenditure of a financial

arrangement and would need to be spread by non-cash basis persons. Cash basis persons would be able to deduct the expenditure when incurred.

14. [A person will be a cash basis person if:

    (a) The following thresholds are not exceeded:

    (i) The income and expenditure for all the person's financial arrangements for the income year does not exceed $100,000; or

    (ii) The value of all the person's financial arrangements on every day of the income year does not exceed $1 million; and

    (b) The difference between the accrual treatment and the cash treatment of all the person's financial arrangements does not exceed $40,000 for the income year.

    Note that as a result of the changes made by the Taxation (Business Tax Measures) Act 2009 with effect from the 2009-10 income year a non-natural person may be a cash basis person.]

Expenditure to terminate a loan

15. Expenditure incurred in repaying money is not expenditure incurred in borrowing money so it is not deductible under section DB 5: *Case 31* 10 CTBR 92; *Riviera Hotel v MNR* [1972] CTC 157; *Neonex International Ltd v R*, 78 DTC 6,339 (FCC). In *Riviera Hotel* a payment of bonus interest to extinguish an existing mortgage was an expense incurred in repaying money. In *Neonex* a prepayment bonus required for an early repayment of the loan was an expense incurred to get rid of the first lender.

16. In the Commissioner's view, expenditure incurred for the discharge of the mortgage is not expenditure incurred in borrowing money, whether or not the discharge of the mortgage is acquired 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.

17. In *Case G50* (1985) 7 NZTC 1,212 legal fees and disbursements relating to the discharge of mortgages were held to be deductible under the predecessors to sections DA 1 and DB 5. The Commissioner does not consider that decision to be correct.

18. However, fees to exit early from a loan should be deductible as part of the BPA when a loan is terminated. In *BR PUB 12/01 - 12/03* the Commissioner has discussed the implications when a loan is terminated early, and when the terms of a loan are varied. The examples below are based on the examples provided in the *Commentary* to the rulings.

BPA upon early exit from a fixed interest loan

19. "AD" has entered into a fixed interest loan (a financial arrangement under section EW 3) for $200,000 @ 10% , and used the money to acquire property from which the rental income is derived. AD terminates the loan at the end of Year 2:

    - To refinance with a loan from another bank; or
    - Because the rental property is sold.

20. AD pays a break fee of $10,000 to terminate the loan earlier than its agreed repayment date. A BPA is required under section EW 29.

21. Most landlords are likely to be cash basis persons under FA rules and not required to use a spreading method. However, they are still subject to the FA rules and will be required to do a BPA when the loan is repaid in full.

22. The formula for calculating a BPA is in section EW 31 [5]. The formula for the borrower is:

[Consideration] - [income] + [expenditure] + [amount remitted]

23. The break fee of $10,000 is "consideration" in section EW 31 (7) as "consideration that has been paid… by the person for or under the financial arrangement".

24. The break fee will not be ignored as a "non-contingent fee" because the fee is not "for services provided for the taxpayer becoming a party to the financial arrangement and payable whether or not the financial arrangement proceeds". The fee is payable to allow the taxpayer to cease being a party to the financial arrangement.

25. [The scope of these rulings excludes landlords who have adopted the international financial reporting standards ("IFRS") financial reporting method under section EW 15D or section EW 15G, so the question of whether the break fee constitutes a non-integral fee is not discussed.]

26. Under the BPA at the end of Year 2:
    - Consideration received is $200,000 (the original loan).
    - Consideration paid is $200,000 (the loan repaid) <u>plus</u> $40,000 (interest @10% for 2 years) <u>plus</u> $10,000 (break fee). Consideration paid is therefore $250,000.
    - Income is zero.
    - Expenditure is $20,000 (the interest incurred in Year 1 and deducted in Year 1).
    - Amount remitted is zero.

27. The BPA at the end of Year 2 is therefore:

[$200,000 - $250,000] – [0] + [$20,000] + [0] = [-$30,000]

28. This negative BPA amount is expenditure incurred under the FA rules under section EW 31(4), and will be deductible in the year it is incurred under section DB 7 (if AD is a company) or section DB 6 and the general permission in section DA 1 (if AD is a non-corporate or QC or an LTC). Where the borrowed money was used to purchase property from which rental income is derived, the Commissioner's view is that the general permission will be satisfied and the amount of the negative BPA will be deductible under section DB 6.

Variation of the terms of a loan

29. AD Ltd has entered into a fixed interest loan of $100,000 for 3 years, and the money has been used:
    - To acquire a property from which rental income is derived; or
    - To refinance another loan used for that purpose.

30. Let's assume that AD Ltd is not a cash basis person, so the total annual expenditure assuming a straight-line spreading method would be:

($100,000 + $30,000 - $100,000)/3 = $10,000 per annum.

31. In Year 2, AD Ltd pays a break fee of $2,500 to the lender to adjust the interest rate down to 8% per annum. This is sometimes referred to as an "interest rate switch". [A break fee will often be charged in these circumstances.]

32. As a result, the interest charge in Year 1 remains at $10,000, but the interest charges in Years 2 and 3 are $8,000 per year. Total interest is $26,000.

33. Revised annual expenditure assuming a straight-line spreading method is:

    ($100,000 + $26,000 + $2,500 - $100,000)/3 = $9,500 per annum.

34. In these circumstances, where the renegotiation of the interest rate is simply a variation of the loan and that same loan continues in existence, a BPA is not required (unless the change in the interest rate is effected by way of the existing loan being discharged and a new loan agreement being entered into).

35. The deductibility of the break fee depends on whether or not the taxpayer is a cash basis person.

Non-cash basis persons

36. Taxpayers like AD Ltd, who are not cash basis persons, and cash basis persons who have chosen to adopt a spreading method, will be required to apply to determination G25 because the loan is a fixed interest rate loan. The amount of the break fee will be included in the calculation under the determination. An adjustment will be made in the year of variation and the deduction of the break fee will effectively be spread over the term of the loan.

37. The Determination G25 formula to calculate expenditure for Year 2 is:

    $$a - b - c + d$$

    where

    'a' is the sum of all amounts that would be income to the end of the current year (Year 2), if the changes had been known as at the date the finance arrangement was acquired or issued (= zero); and

    'b' is the sum of all expenditure to the end of the current year (Year 2), if the changes had been known as at the date the financial arrangement was issued (= $19,000 @ $9,500 per year for two years); and

    'c' is the sum of all amounts treated as income to the end of the previous income year (= zero); and

    'd' is the sum of all amounts treated as expenditure to the end of the previous income year (= $10,000 interest deducted in Year 1).

    [0] - [$19,000] - [0] + [$10,000] = $9,000.

38. Expenditure in Year 2 under the determination G25 adjustment is therefore $9000. (Expenditure in Year 3 will be $9,500 under the straight-line spreading method – see paragraph 33.)

Cash basis persons

39. Cash basis persons will be able to deduct the amount of the break fee when it is incurred under the general permission in section DA 1, unless they choose to adopt a spreading method.

40. Where a cash basis person does not adopt a spreading method, the break fee will be incurred whether it is actually paid or simply added to the balance of the loan: *King v CIR* (1973) 1 NZTC 61,107. Where the borrowed money was used to purchase property from which rental income is derived, the Commissioner's view is that the general permission will be satisfied and the break fee will be deductible.

41. [Section DB 5 will have no application in the circumstances because all that occurs is a variation of the interest rate, and the break fee cannot be said to have been incurred in borrowing money.]

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