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WEEKLY COMMENT: FRIDAY 12 JUNE 2015

1. This week I look at:

   (a) Public Rulings Unit Issues Paper No. 8 *Unit trusts – whether more than one unit holder is required* ("the Issues Paper"), released by Inland Revenue on 11 March 2015 for submissions until 21 April 2015; and

   (b) Draft Question We've Been Asked PUB0219: *Income tax – Whether the cost of acquiring an option is part of the cost of acquiring revenue account land* ("the draft QWBA"), released on 12 March 2015 for submissions until 24 April 2015.

Unit trusts issues paper

2. Inland Revenue has reconsidered whether a unit trust requires more than one unit holder. The Commissioner's preliminary revised view is that a trust with a single subscriber, purchaser or contributor can be within the definition of a unit trust in the *Income Tax Act 2007*.

3. This differs from the Commissioner's current published position set out in the Commentary to BR Pub 95/5A – *Relationship between the "unit trust" and "qualifying trust" definitions*, (published in *Tax Information Bulletin* Vol. 8, No. 10, December 1996, p. 15) which is that there must be more than one unit holder in order for a trust to be a unit trust. The Commissioner has stated that this position will continue to be applied until the revised position is published, and any change in position will be applied prospectively. There will also be transitional measures for taxpayers who have adopted structures relying on the existing published position.

4. The definition of "unit trust" in s. YA 1 is of central importance. The relevant part of the definition states that a "unit trust":

   "means a scheme or arrangement that is made for the purpose or has the effect of providing facilities for subscribers, purchasers, or contributors to participate, as beneficiaries under a trust, in income and capital gains arising from the property that is subject to the trust".

5. The discussion in the Issues Paper is focused on whether the definition:

   (a) Merely requires "the effect of providing facilities" for the beneficiaries; or

   (b) Requires there to be multiple – i.e. more than one – "subscribers, purchasers, or contributors".

6. Two conflicting approaches are canvassed and discussed:

   (a) One approach looks at the constituting documents to see whether the necessary facilities are provided, and the Commissioner's preferred application of this approach is to look at

the legal relationships entered into, rather than intention or how a unit trust actually operates; and

(b) The other approach assumes Parliament had in mind collective investment vehicles and looks at all of the circumstances, particularly the intention, to see whether facilities are provided for multiple subscribers, purchasers, or contributors, and under this approach multiple subscribers etc. would generally be required.

7. The legal relationships test looks at the establishing documents to see how an entity is set up. It involves an analysis of the scheme or arrangement to establish whether the legal rights and obligations created by it provide facilities of the necessary kind. Under this approach, the relevant inquiry is not a factual one to determine whether in fact, the persons are actually participating in the facilities provided. Therefore, an entity could be a unit trust within the definition if there is only one subscriber, provided there were facilities for multiple subscribers.

8. The second approach looks at all the information available, particularly the intention of the trustees, and at what actually happens in practice. A slight variation of this approach would be to place less emphasis on intention and more emphasis on all the factors taken together. Under this approach, the fact that the trust deed says it is possible for the trust to have multiple subscribers does not establish that the arrangement is made for multiple subscribers if an overall assessment of the facts establishes that no such opportunity for multiple subscribers to participate was actually provided (or intended to be provided) by the scheme or arrangement.

9. The problem that the Commissioner has identified with the latter (second) approach is that entities could potentially fall in and out of the definition as circumstances change, leading to what would seem to be unintended tax effects, a lack of certainty, and compliance issues. Moreover, involving intention as part of the test would raise questions and uncertainties about how such a test would work.

10. The discussion in the Issues Paper examines the meaning of the following aspects of the unit trust definition:

(a) Made for the purpose or has the effect;

(b) Facilities;

(c) Trust;

(d) Subscribers, purchasers, or contributors to participate;

(e) Entities specifically excluded suggest more than one member.

11. While the use of the word “purpose” would include ascertaining intention, the words “has the effect” arguably require looking only at objective factors, and the words “made for the purpose” arguably directs the enquiry to how an entity is established by looking at the constituting documents. This interpretation is supported by tax avoidance case law, which requires the purpose of a tax avoidance arrangement to be determined objectively. Therefore, the words “made for the purpose or effect” could be read as directing and confining the enquiry to the legal relations entered into when the entity is established.

12. "Facilities" refers to the means for doing something. If the view is taken that the inquiry is an objective one, the scheme or arrangement would require analysing to determine whether the legal rights and obligations created by it provide facilities of the necessary kind. It is noted, and considered to be significant, that the legislature chose to refer to "facilities for subscribers" instead of "a scheme or arrangement for subscribers", or one that "involves subscribers".

13. There must be a trust, and the four essential elements of a trust must be present: a trustee, trust property, a beneficiary and trustee obligations.

14. The words "subscribers, purchasers, or contributors" seem to be used in the sense of meaning a person who provides money (or its equivalent) in exchange for receiving something of value. These words give a flavour of plurality as they suggest participating along with others in the funds of an entity.

15. There are a number of specified exclusions listed in the definition, including superannuation funds and employee share purchase schemes. The implication of the listed excluded entities is that they would otherwise be within the definition. The listed entities all have multiple members, which might provide some support for arguing that there must be more than one member for an entity to be a unit trust. However, the argument is stated to be not particularly strong and some of the listed entities might have only one subscriber.

16. The Issues Paper contains a quite lengthy discussion on whether the "numbers rule" could apply – i.e. whether the use of the words in plural also imply the singular. The conclusion is that the rule is not particularly helpful in the circumstances, because considering whether the rule applies involves a consideration of the same issues already discussed above.

17. There follows a discussion on legislative history of the income tax definition, as well as a consideration of the implications of the *Unit Trusts Act 1960* (which is to be repealed from 1 April 2017 or earlier, following which unit trusts will be regulated by the *Financial Markets Conduct Act 2013*). The conclusion from the historical analysis is that while there are reasonable grounds for concluding that Parliament seemed to have collective investment vehicles in mind, it does not necessarily follow that there must therefore be more than one subscriber. A single subscriber entity can potentially carry on the same type of investment activity as an entity with multiple subscribers, and the rules Parliament enacted might appropriately apply to such an entity.

18. There is a brief discussion of the implications of the reference in the portfolio investment entity ("PIE") rules in s. HM 9 to "a trustee of a trust that would be a unit trust if there were more than one subscriber". The conclusion is that Parliament and the drafters had in mind the Commissioner's published position in BR Pub 95/5A.

19. The overall conclusion in the Issues Paper is that having one subscriber, purchaser or contributor will not necessarily mean that an entity is not a unit trust. However, if there is no possibility of an entity including more than one subscriber, such an entity might be thought not to have the defining characteristic of a unit trust. Such situations would include:

    (a) If the deed provided facilities for only one subscriber and prohibited further subscribers, or at least provided no ability for more subscribers to invest; or

    (b) Where entry of a further subscriber was contingent upon some event that is not possible, or highly unlikely.

Draft QWBA on the cost of acquiring an option

20. Section DB 23 allows a person a deduction for expenditure they incur as the cost of revenue account property. The timing of the deduction, under s. EA 2(2) is the earlier of the income year in which the person disposes of the property or the income year in which the property ceases to exist.

21. The question is whether the cost of acquiring an option to buy land, where the land is revenue account property, which is then exercised in order for the land to be acquired, will also form part of the cost of acquiring the land, and therefore be deductible under s. DB 23.

22. The answer, for the reasons set out in the draft QWBA and discussed briefly below, is that the cost of acquiring the option is deductible under s. DB 23 because it is part of what is outlaid in order to acquire the underlying land.

23. The question arose in the context of the enactment of s. CB 15B, which states that a person acquires an estate, interest or option that is land on the date that begins a period in which the person has an estate, or interest in, or an option to acquire, the land.

24. An option to acquire land or an estate or interest in land is itself land for income tax purposes, as defined in s. YA 1. It has apparently been suggested that s. CB 15B requires the separate consideration of different estates or interests in, or options to acquire estates or interests in, the same underlying physical land. Therefore, the cost of acquiring an option would only be deductible if the option is revenue account property.

25. The Commissioner disagrees. The issue of the timing of the acquisition of land, dealt with under s. CB 15B, is entirely separate from the issue of what the cost of the land is. The Commissioner considers that the cost of an option will form part of the cost of acquiring the underlying land because:

    (a) While "cost" is not defined for the purposes of s. DB 23, numerous cases have considered the meaning;

    (b) In *Tasman Forestry Limited v CIR* (1999) 91 NZTC 15,147 (CA), the cost of shares acquired in companies that owned forests, where the forests were subsequently distributed in specie to the new owners, was held to be the cost of the timber, because the shares were acquired for the purpose of acquiring the forests;

    (c) In *CIR v Atlas Copco* (NZ) Ltd (1990) 12 NZTC 7,327, the High Court agreed with the taxpayer that GST input tax should be excluded from the cost of fringe benefits, because in the case of a registered vendor and purchaser there are three components of a sale transaction – the vendor's obligation to pay output tax, the purchaser's payment of the price, and the purchaser's deduction of input tax – and the deduction of input tax is not analogous to a "later transaction with a third party";

    (d) The cases establish that:

        (i) Cost means something that must be given up in order to acquire something and has a wider meaning than payment on purchase; and

        (ii) A transaction must be viewed in its commercial reality, and some assistance may be derived from common business parlance and practice.

26. A further issue then discussed is the implications of the option itself being revenue account property. In that case, the general permission, in s. DA 1, must be satisfied in the sense that there must be a nexus between the cost of the option and income derived. The consequences are helpfully summarised in a table:

    (a) Where the option is revenue account property:

    (i) If the option is not exercised (because, for example, it simply expires), it is probably unlikely that any income will be derived, and the general permission will not be satisfied, so there can be no deduction for the cost of the option;

    (ii) If the option is not exercised, but the business limb of the general permission is satisfied, then a deduction will be allowed for the cost of the option;

    (iii) If the option is exercised and the land acquired is held on capital account, there will be no deduction for the cost of the option, as it will be seen as part of the cost of the land;

    (iv) If the option is exercised and the land acquired is held on revenue account, a deduction will be allowed for the cost of the option as part of the cost of the land in the year of disposal of the land, providing the cost of the option has not otherwise been deducted;

    (b) Where the option is acquired on capital account:

    (i) If the option is not exercised, no deduction will be allowed for the cost of acquiring the option;

    (ii) If the option is exercised and the land acquired is held on capital account, there will be no deduction for the cost of the option, as it will be seen as part of the cost of the land;

    (iii) If the option is exercised and the land acquired is held on revenue account, a deduction will be allowed for the cost of the option as part of the cost of the land in the year of disposal of the land, providing the cost of the option has not otherwise been deducted.

27. Two examples are given to demonstrate the deduction for an option as part of the cost of land.

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