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WEEKLY COMMENT: FRIDAY 17 JULY 2015

1. This week and next week I look at two Taxation Review Authority ("TRA") cases where deductions were disallowed:

   (a) *Case* 17/2014, TRA 008/13 [2014] NZTRA 17, 9 December 2014, which concerned whether expenditure on land was deductible as part of a business, or because the land was revenue account property; and

   (b) *Case* 10/2015, TRA 013/10 [2015] NZTRA 10, 29 June 2015, which concerned whether management fees paid by a trust to an associated company were deductible or whether they were a tax avoidance arrangement.

2. Both cases involve a number of interesting issues relating to tax-deductibility and also the potential cost of getting it wrong, in terms of shortfall penalties. This week I look at *Case* 17/2014.

Case 17/2014: Whether deductions incurred in a business

3. *Case* 17/2014 concerned a land development project that did not proceed. The taxpayer company entered into an agreement to purchase land in February 2006 and the chronology of subsequent events is as follows:

   (a) Between March 2006 and June 2007 the taxpayer paid deposit instalments totalling just over $1.9m.

   (b) In March 2008 the vendor advised the taxpayer that the agreement was at an end and sought to return the deposit because the vendor had failed to obtain resource consent, by the appointed date of 31 January 2008, for subdivision of a larger property which the land was part of. The taxpayer refused to accept this and the parties agreed the deposit would be held by the taxpayer's lawyers as stakeholder pending resolution of their dispute.

   (c) In April 2008 a resource consent relating to the land, which the taxpayer had applied for, was granted, and shortly after that, in May 2008, the taxpayer commenced proceedings to require the vendor to complete the contract.

   (d) In July 2008 the vendor obtained its resource consent for subdivision of its larger property, and indicated its desire to complete the contract and requested release of the deposit.

   (e) On 24 July 2008 – the date on which the taxpayer's business was held to have ceased – the taxpayer advised the vendor the contract was at an end, apart from the taxpayer's right to seek damages for losses incurred.

   (f) Following 24 July 2008 the taxpayer made applications for finance for the project, but without any supporting personal guarantees, with the expectation that the applications

would be declined, apparently to support the disputant's claim that the vendor's delay had prejudiced attempts to fund the project.

(g) On 16 December 2010 the dispute between the taxpayer and the vendor was heard in the High Court, and a settlement was reached whereby half of the funds held by the taxpayer's lawyers ($1.1m) plus costs of $70k were paid to the vendor, and the taxpayer retained the other half of the deposit.

(h) On 9 December 2011, the taxpayer entered into a separate agreement to sell its remaining rights relating to the agreement, referred to as the "development project rights" for $650,000 to a separate purchaser. The rights consisted of the resource consent rights relating to the land and the documentation related to the project.

(i) On 5 March 2013 the resource consent for land use eventually expired because the sale of the development project rights did not proceed.

4. In 2011 the Commissioner commenced investigating this transaction. The Commissioner disallowed all income tax deductions claimed by the taxpayer after 24 July 2008 (the date on which the taxpayer's lawyers stated the contract was at an end) on the basis that the taxpayer was not in business after that date. The major expense the taxpayer had sought to deduct after 24 July 2008 was the loss of $1.1m related to the forfeiture of half of the deposit.

Expenditure incurred after the taxpayer's business had ceased

5. The taxpayer claimed that:

(a) It was in business until at least December 2011 and the expenses incurred after 24 July 2008 were related to the business;

(b) The land was held on revenue account and the taxpayer had an expectation of deriving assessable income after 24 July 2008 from the sale of its equitable interest in the land, the land itself, the resource consent and related documents, and any damages, or alternatively the expenditure incurred after 24 July 2008 related to trying to escape from an onerous revenue account contract;

(c) The forfeited deposit together with some legal fees were expenses the taxpayer had been legally committed to from June 2007;

(d) The expenditure was deductible because any corresponding damages received would have been income under s. CG 4 (this argument was raised late in the proceedings).

6. The judge noted the leading New Zealand case on what is a business is *Grieve v Commissioner of Inland Revenue* (1984) 6 NZTC 61,682 (CA), where Richardson J held that in order to determine whether or not a taxpayer is in business involves a two-fold inquiry as to the nature of the activities carried on and the intention of the taxpayer in engaging in those activities. Richardson J considered that an intention to make a profit was sufficient, however, if realistically there seems no real prospect of profit, the taxpayer's claim that they intended to carry on a business for profit may be viewed circumspectly.

7. The arguments in this case centred around when the taxpayer ceased carrying on its business. Based on the Commissioner's submissions, the judge set out the indicators that a taxpayer is no longer in business drawn from the relevant cases as follows:

(a) An intention to sell the underlying profit structure (*Case G8* (1985) 7 NZTC 1,021 and *Case F31* (1983) 6 NZTC 59,712);

(b) A cessation of trade or decrease in the activities being undertaken (*Case G8* and *Slater v Commissioner of Inland Revenue* (1996) 17 NZTC 12,545);

(c) The underlying business activity or structure is no longer being used in the production of income or business (*Case J16* (1987) 9 NZTC 1,089);

(d) Legal proceedings or other activities directed towards salvaging the position where there has been a "bad bargain" will not be deductible (*Case J16*);

(e) Legal and settlement costs will be deductible only if they are made to protect the taxpayer's income earning process or are part of normal business costs associated with the industry (*Cox v Commissioner of Inland Revenue* (1992) 14 NZTC 9,164, *Herald and Weekly Times v Federal Commissioner of Taxation* [1932] HCA 56).

8. In the judge's view, the disputant's focus clearly changed after 24 July 2008 and the disputant's time, effort and resources moved from advancing settlement of the purchase to getting out of the agreement, which had by then become a bad bargain. This conclusion was supported by the loan applications made with the expectation that they would be declined.

9. The judge placed no weight on the subsequent agreement to sell the "development project rights" and on the argument that it reflected a continuation of the taxpayer's business, because:

   (a) Expert evidence given for the Commissioner was that the resource consent had no value to a third party without the land;

   (b) The plans relating to the resource consent were available to the public to search;

   (c) No evidence was given by the proposed purchaser of the development project rights;

   (d) No evidence was given as to the plans that were actually to be purchased or how the price was arrived at; and

   (e) Importantly, the business being undertaken by the taxpayer was property development, and it was not in the business of selling resource consents – the proposed transaction had nothing to do with the property development business and was nothing more than a further attempt to defray the losses suffered by the taxpayer.

10. Therefore, the judge found the taxpayer had ceased its property development business on 24 July 2008 and there was no nexus between that business and any of the expenses incurred.

Whether expenditure on revenue account

11. The judge then dealt with the taxpayer's other contentions regarding why the expenditure should be regarded as being on revenue account. The taxpayer submitted that the land would have been acquired for the purpose of sale or for an undertaking or scheme entered into or devised for the purpose of making a profit. Therefore the expenditure should be deductible as a cost of revenue account property under s. DB 23.

12. The taxpayer submitted that, furthermore, all expenses were on revenue account and deductible under s. DA 1, including the forfeited deposit funds which the taxpayer contended were in substance:

   (a) A payment by the taxpayer to escape an onerous agreement; or

   (b) A loss on the disposal of equitable rights in and to the land; or

   (c) A payment of damages.

Payment to escape an onerous agreement was made after the business had ceased

13. The taxpayer submitted that expenses incurred in order to escape an onerous contract are deductible where the contract relates to an asset held on revenue account. The judge discussed the cases relied on by the taxpayer:

    (a) In *Commissioner of Inland Revenue v McKenzies New Zealand Limited* (1988) 10 NZTC 5,233 a payment to escape a lease was held to be capital because the lease was a capital asset. However, the Court suggested that such a payment could constitute revenue expenditure "in special cases where there are sufficient indicators pointing the other way, for example, where the right to possession of the premises for the remaining short period of the lease is considered worthless and the rent payments then made in advance are discounted to reflect the time value of money".

    (b) In *The Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] UKPC 3, [1964] AC 948 the taxpayer paid another company to cease production for 12 months to allow it to continue its own production and sales in the face of falling prices. The Privy Council held the payment was a cost related to the company's production for the year and was analogous to an operating cost.

    (c) In *W Nevill and Co Ltd v Federal Commissioner of Taxation* [1937] HCA 9, (1937) 56 CLR 290, the company paid a lump sum to terminate the employment of a managing director. The Court found the expenditure was on revenue account because the business activity was continuing and the payment was to save the salary of the outgoing employee and end his control.

14. The judge agreed with the submissions for the Commissioner that the above cases "were based on sensible commercial decisions to keep the particular businesses profitable" and "were not aimed at extracting those companies from all business activity". In the present case, the taxpayer's payment to escape its onerous contract was made after the business had ceased. The only income earned after that was interest on the deposit. Therefore, the judge found that:

    (a) There was no nexus between the expenditure incurred and the deriving of assessable income from the taxpayer's property development activity; and

    (b) There was no nexus between the taxpayer deriving its interest income and the expenditure incurred to extract itself from the agreement.

No loss on disposal of equitable rights in the land

15. The taxpayer submitted that an equitable interest in the land was acquired for the purpose of disposal and the expenditure on the forfeited deposit was deductible on that basis. The judge disagreed:

    (a) First, the payment did not relate to the cost of acquiring the equitable interest – it was paid under a settlement agreement as damages and costs to the vendor; and

    (b) At the time the equitable interest was acquired in March 2006 the taxpayer intended to complete the project and had no intention to dispose of the equitable interest.

Payment of damages was not revenue expenditure

16. The taxpayer's arguments that the payment of damages was revenue expenditure were disposed of by the judge as follows:

    (a) The taxpayer argued that it was an occupational hazard for property developers and the expense was an "expected expense" connected to the activities of the taxpayer and deductible under the precedent in *Herald & Weekly Times*. The judge disagreed, because the taxpayer had entered into a property development project that became uneconomic and wanted to get out of the venture.

    (b) The taxpayer argued that the expenditure was allowed by s. DB 23, which allows a deduction for the cost of revenue account property, or s. DB 26, which allows a deduction for the cost of a profit-making undertaking or scheme. The judge noted that s. DB 23 does not override the requirements for the general permission, which was not satisfied in this case, and there was no profit-making undertaking or scheme.

    (c) The taxpayer argued that the payment of damages was expenditure related to deriving income in the sense that the whole deposit could be regarded as forfeited but, by agreeing to pay only half, the taxpayer in substance received the other half as income to which the expenditure related. The judge did not consider there was any logic to this argument, as the funds returned to the taxpayer were the taxpayer's own funds and not income.

No expenditure incurred before the business had ceased

17. The taxpayer argued that the forfeited deposit and some legal expenses were expenses which the taxpayer had been legally committed to before the business had ceased. The taxpayer referred to *Case F31* (1983) 6 NZTC 59,712 (where expenses incurred in a farming business before the date of a decision to sell the land were able to be apportioned and deducted) and a number of Australian cases: *Amalgamated Zinc (De Bavay's) Ltd v Federal Commissioner of Taxation* [1935] HCA 81, (1935) 54 CLR 295, *AGC (Advances) Ltd v Federal Commissioner of Taxation* [1975] HCA 7, (1975) 132 CLR 175, *Placer Pacific Management Pty Ltd v Commissioner of Taxation* [1995] FCA 1362, (1995) 95 ATC 4459.

18. The judge noted that "it is not in issue that deductions may be incurred after a business has ceased which relate to income earned in a previous year when the business was trading. However, in the present case the damages and legal fees were paid in relation to a negotiated settlement paid out of the deposit moneys, as opposed to a payment of the deposit moneys itself (which had occurred before the business ceased). Therefore, there was no nexus between the damages paid and the taxpayer's previous business activity.

No deduction based on hypothetical insurance recovery income

19. The taxpayer argued, as a new proposition of law raised at the hearing, that if it had been successful in its High Court litigation to recover expenses incurred prior to when the business ceased, such a recovery would have been taxable under s. CG 4 (which taxes insurance or indemnity recoveries to the extent of deductions previously allowed). Therefore, legal fees relating to the High Court litigation were deductible through being incurred in relation to such potential income.

20. The judge disagreed. Section CG 4 applies when an amount is derived up to the amount of a deduction previously allowed. No amount was derived because the taxpayer was unsuccessful in its High Court litigation. Therefore, the argument was hypothetical.

21. Moreover, the taxpayer is not in the business of civil litigation. Therefore, there was no nexus between the legal fees and the income earning activity relied upon under s. CG 4. In any case, the taxpayer had not produced any breakdown of legal fees which were specifically incurred in relation to the claim for recovery of costs.

Shortfall penalty

22. The Commissioner had imposed a 20% shortfall penalty under s. 141B of the *Tax Administration Act 1994* for taking an unacceptable tax position in relation to the deduction for the forfeited deposit. This had been reduced to 10%, after allowing for a 50% reduction in accordance with s. 141FB for previous good behavior. The tax shortfall was $391,938 and the shortfall penalty imposed was, therefore, $39,193.

23. The judge upheld the penalty on the following grounds:
    (a) Based on the Supreme Court's view on the meaning of the phrase "about as likely as not to be correct" discussed in *Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue* [2008] NZSC 15, [2009] 2 NZLR 289, the merits of the arguments supporting the taxpayer's interpretation must be substantial.
    (b) In *Case U47* (2000) 19 NZTC 940, Judge Barber stated the words "as likely as not" indicate an even balance of 50/50.
    (c) In this case, the taxpayer's claim for deductions for the expenditure relating to the forfeited deposit did not have any prospect of being close to a 50% chance of success.

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