

24/8/2014

Tax deductions: *Brown v Commissioner of Inland Revenue*

A taxpayer was not entitled to claim deductions for bank interest incurred by his trust

Brown v Commissioner of Inland Revenue [2014] NZHC 1599B

The High Court upheld the Taxation Review Authority's decision that the taxpayer, a chartered accountant, was not entitled to interest deductions for bank loans taken out by the taxpayer and his wife's trust. (*X (Chartered Accountant) v Commissioner of Inland Revenue [2013] NZTRA 3*).

The High Court also agreed with the TRA that a shortfall penalty of 20 per cent for not taking reasonable care should be imposed on the taxpayer.

Facts

The CIR disallowed interest deductions claimed by the taxpayer on the grounds that there was not a sufficient nexus between the payments made by the taxpayer and the taxpayer's income earning process.

The taxpayer practised as a chartered accountant through a company. ("Accounting"). The taxpayer, his wife and business partner were the company's directors. In 2000 the taxpayer settled a trust. His wife and business partner were the trustees. In that year the trust borrowed \$420,000 from the bank and on-lent this to Accounting for the purpose of purchasing an accountancy practice. In 2004 the trust borrowed a further \$250,000 from the bank and on-lent it to Accounting for the purpose of acquiring another accountancy practice. Accounting gave a guarantee of the trust's indebtedness to the bank. The taxpayer, his wife and business partner gave guarantees of Accounting's indebtedness to the bank.

Over the three income years in dispute (2005, 2006, 2007) the taxpayer paid the bank interest of nearly \$100,000 charged to the trust on the loans.

The issue

The issue before the Taxation Review Authority and the High Court was whether the payment of interest by the taxpayer, owed by the trust met the requirements of the general permission for deductibility under s DA 1 of the Income Tax Act 2004 (ITA 2007, s DA 1). Section DA 1 allows a deduction for expenditure incurred by a taxpayer in deriving the taxpayer's assessable income.

The taxpayer's argument

The taxpayer contended the required nexus between the expenditure and his assessable income was met because he expected to be reimbursed. Such reimbursement would be assessable income in his hands and that the payments he made had a nexus with deriving that assessable income. The taxpayer relied on a Minute of the trustees which recorded that

at the Bank's request it was agreed that the taxpayer would pay the interest and principal payments on the two loans.

The TRA and the High Court's decision

The TRA (which the High Court agreed) found that there was no written agreement between the trust and the taxpayer recording the arrangement and that there was no agreement, written or oral, that the trust would repay the taxpayer so there was no contractual obligation on the trust to pay the taxpayer the amount of interest he paid on its behalf.

The High Court upheld the TRA's decision and rejected that the taxpayer's argument that the trust was liable to reimburse the taxpayer under either ss 84 and s 85 of the Judicature Act 1908 or under the common law right of indemnification. A prerequisite to the application of ss 84 and 85 is that the person seeking to invoke the rights conferred is "surety for the debt of another" or "liable with another for any debt or duty".

The taxpayer's claim that he had a right of indemnity failed because the taxpayer was not a guarantor of the trust's indebtedness to the bank. Rather Accounting had guaranteed the trusts indebtedness to the bank. Accounting had guaranteed the trusts indebtedness to the bank. The taxpayer had guaranteed Accounting's indebtedness to the bank. Accounting incurred no indebtedness to the bank in respect of interest payable by the trust to the bank. It could only have incurred such indebtedness if the bank had demanded payment under its guarantee. The bank did not.

Therefore, because there was no contract between the taxpayer and the trust requiring the trust to reimburse the taxpayer and because the trust was not required under any statutory or common law right to indemnity to reimburse the taxpayer, any reimbursement would be entirely voluntary. In such circumstances the High Court found that it could not be said that the payments made by the taxpayer were incurred by him in deriving future assessable income by way or reimbursement. Such absence of any legal obligation to reimburse arising from the incurring of the expenditure means that there was no nexus between the expenditure and the potential for assessable income by reimbursement.

The High Court did not determine whether, even if there was a legal obligation on the trust to repay the taxpayer the interest paid by him, the expectation of reimbursement would meet the test in s DA 1. The Court did say (in the absence of any Court authority) that it would be reluctant to conclude that in circumstances where a particular item of expenditure does not have any other nexus with the derivation of any other assessable income, the existence of a right to be reimbursed that item of expenditure by another is sufficient to make both the payment and the subsequent reimbursement part of the income earning process.

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