

TAX

CURRENT ACCOUNT DRAWINGS DEEMED TAX AVOIDANCE

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The Taxation Review Authority has upheld the Inland Revenue's assessment that a series of current account drawings made by a property developer from his trust and corporate entities amounted to tax avoidance.

The newly released decision has implications worth considering. In this update we review the Taxation Review Authority (TRA) reasoning and conclusions.

The issue in dispute

The case concerned a taxpayer who over a 12 year period borrowed a series of current account loans amounting to over \$5 million from entities effectively controlled by him. He received only a modest salary from the entities over that period.

Inland Revenue alleged that the regular use of current account drawings by the taxpayer in this way was a device used by him to avoid the receipt of otherwise taxable salary, wages or distributions from the relevant entities. As there was no objective reason for using the device other than avoiding tax, Inland Revenue argued, its use amounted to tax avoidance. Inland Revenue reconstructed the loans (less loan repayments made by the taxpayer) as income to the taxpayer and assessed the taxpayer for tax on that income. It also imposed 100% penalties (subject to

reductions for prior good behaviour) for adopting what it alleged was an abusive tax position.

The result

The TRA agreed with Inland Revenue and upheld the reconstruction of the loans as income to the taxpayer. The TRA went further and noted that Inland Revenue had been generous to the taxpayer in taking into account the repayments made by the taxpayer. It also confirmed the imposition of 100% penalties (with abatements) for adopting an abusive tax position.

The TRA's reasoning

The TRA was not swayed by the taxpayer's argument that as his entities rolled profit generated by one development into the next (each development being undertaken in a new entity), there would eventually have been a significant amount of tax to pay. The TRA noted that most profits from a development project were rolled into the next project without being taxed - profits from one entity were distributed to the next which had already incurred offsetting deductions from the commencement of the new project. It regarded the taxpayer's assertion as "entirely speculative", noting that as the taxpayer controlled the entities in question

he could in effect maintain the arrangement indefinitely. The TRA regarded it as a conceptual difficulty for the taxpayer that tax avoidance as defined in the Income Tax Act includes the postponement of a liability for income tax.

On the facts before it, the TRA was satisfied that the arrangements involved artifice and contrivance - key indicators of tax avoidance. Factors which it regarded as relevant in this respect included the movement of funds between the taxpayer's entities "at will", the drawing and repayment of loans by the taxpayer if and when the taxpayer decided, the financing of repayments of loans by the taxpayer from the taxpayer's other entities and the generally interest-free nature of the loans.

The TRA was influenced by what it saw as a lack of commerciality in the arrangement - lack of commerciality being another indicator of tax avoidance. It was, the TRA held, commercially unrealistic that the taxpayer would provide his development expertise for no remuneration. No third party employee or contractor, the TRA stated, would ever agree to such an arrangement. Likewise, from the perspective of the entities involved, the TRA saw it as lacking commercial benefit to the creditor entities that when those entities themselves required funds for development projects, the entities did not seek repayment of the interest free loans to the taxpayer but instead external borrowings were arranged from third party financiers.

The TRA was satisfied that the evidence supported Inland Revenue's assertion that the loans were substitutes for income in the taxpayer's hands. It noted that the taxpayer's own witnesses had confirmed that the taxpayer required the loans to fund his living expenses, and that there were regular and frequent drawings over the years in question - recurrence being a

traditional indicator that a source of payments is income in nature to the recipient.

The TRA noted that the case did not involve the relationship between incentive provisions in the Income Tax Act and the Act's general anti-avoidance provision, unlike the 2008 Supreme Court case *Ben Nevis* and the recent *BNZ* and *Westpac* conduit cases in the High Court. However the TRA had regard to the "Parliamentary contemplation" approach of the Supreme Court majority in *Ben Nevis*, finding that Parliament would not have contemplated the avoidance of the taxing provisions in question in the manner adopted by the taxpayer.

The TRA's approach to reconstruction

The TRA noted the wide discretion in respect of reconstruction afforded to Inland Revenue by the avoidance provision in the Income Tax Act, echoing the comments in that regard of the High Court in the *BNZ* and *Westpac* conduit cases. If the arrangement had not been entered into, the TRA noted, the taxpayer would have been required to take his drawings as income and not as loans. It therefore saw it as appropriate that the loans when advanced be reconstructed to the taxpayer as personal income. The TRA noted that it regarded Inland Revenue as having been overly generous in taking into account repayments made by the taxpayer against the loans. However, it did not alter Inland Revenue's assessments in that respect.

Is the decision right?

The impact of the decision is wide ranging. It is potentially relevant to any trust beneficiary or shareholder of a closely held company who from time to time takes an advance from the relevant trust or company.



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In its decision, the TRA notes that if the current account drawings in question had merely been advances on the trading activities of a trust until the success of the relevant project was determined, that would probably not have amounted to tax avoidance. The TRA appears to have regarded the extent and regularity of the drawings in question as a significant factor in its decision.

Drawing the line, though, between acceptable borrowing activity and activity amounting to tax avoidance (assuming the TRA's decision was correct in law) may not always be simple. It is a common feature of trusts and closely held companies that from time to time the individuals behind those entities utilise funds from those entities by way of loans. This can be done for a variety of reasons – unlocking equity from unrealised capital gains for use in business or for investment purposes, or as a short term advance against expected salary or distributions, for example. Beneficiaries and shareholders who follow this practice need to take care that their activity does not, on the TRA's reasoning, amount to tax avoidance, particularly where the drawings are used to meet ordinary personal living expenses of the borrower or his or her family, and regardless of whether those drawings are actually repaid.

Questions worth asking

There are certain aspects of the TRA's decision which warrant further investigation, and which may well be explored in more detail should the case be appealed. The TRA's decision appears to be premised on the assumption that beneficiaries of trading trusts or shareholders in closely held companies who are involved in the business of the trust or company should be paid salary or wages for their contribution to the activities of the trust or company. That has never been a

legal requirement in New Zealand.

Similar issues have been canvassed in the recent *Penny* and *Hooper* cases - those involving the surgeons who, Inland Revenue asserts, engaged in tax avoidance activity by paying themselves allegedly non-market salaries from their companies - which are currently being heard on appeal at the Court of Appeal.

Inland Revenue asserts in those cases that the surgeons should have derived market level salaries. Whether the amount of the loans derived by the taxpayer in the case before the TRA, however, reflected a "market" salary for a businessman such as the taxpayer, does not appear to have been discussed before the TRA. If the *Penny* and *Hooper* cases are eventually decided in Inland Revenue's favour (Inland Revenue lost at the High Court), then it is unclear what impact those decisions would have on this case. Would this taxpayer only be deemed to have derived income to the extent of a market level salary, if that could be established on the facts? If so, what nature would the balance of the loans then have for tax purposes – would they then retain their status as loans?

It must be accepted that many taxpayers fund their activities (and their lifestyle) from capital gains, whether derived passively or from active involvement in the business giving rise to those gains. This is a function of New Zealand's general stance of not taxing capital gains. Broken down in this way, it is not unusual that capital gains fund living expenses without the imposition of tax. This does not appear to have influenced the TRA's reasoning in this case, however.

Another issue arising from the decision relates to the impact of the financial arrangements rules in the Income Tax Act on the taxpayer. Ordinarily, if a debt is forgiven rather than repaid, the amount

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forgiven will be income to the debtor under those rules. It is not clear how the TRA regarded those rules as applying, if at all, to the outstanding debts owed by the taxpayer. Presumably, given the recharacterisation of the loans as ordinary income, taxpayer would not be taxed again on debt forgiveness income which would otherwise arise under those rules when the outstanding balance of the loans were forgiven (if that in fact occurred).

Also, despite their recharacterisation as income for tax purposes, the loans to the taxpayer retain their status at law as loans. A liquidator of the creditor trusts could therefore claim repayment from the taxpayer of the outstanding balance of the loans. In theory at least this could result in the taxpayer being required to repay his debts to the trusts after having been taxed on all or part of those debts, under Inland Revenue's reconstruction. In this case Inland Revenue only assessed the taxpayer for the balance of the loans outstanding. If the taxpayer later repaid that outstanding balance (whether at the request of a liquidator or otherwise), would that balance then still be regarded by Inland Revenue as income? If so, this would compare unfavourably (for the taxpayer) to the situation where a loan to a shareholder which has been deemed by the dividend rules in the Income Tax Act to be a dividend to the shareholder is later repaid – in those circumstances the shareholder is entitled to a reversal of the tax paid.

The potential significance of the decision in this case should not be understated and could affect a significant number of taxpayers. If correct, it represents a further conservative shift in tax avoidance jurisprudence. We await the outcome of any appeal with interest.

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