



THE UNIVERSITY OF
WAIKATO
Te Whare Wānanga o Waikato

Department of Accounting

Working Paper Series

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Property Owners?**

By

Jim Ryan

Number 91

December 2006

MANAGEMENT SCHOOL

Te Raupapa

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ISSN 1173-7182

Tax Relief Still Available For Small Property Owners?

Jim Ryan

Teaching Fellow

Waikato Management School, Hamilton, New Zealand

Email: JIMRYAN@mngt.waikato.ac.nz

Abstract

This comment considers how it is possible to gain tax advantages through living in a lifestyle block and renting out some of the land, while recognising possible risks of tax avoidance. The comment concludes that each situation must be looked at on a case by case basis.

1. INTRODUCTION

For many years New Zealanders have had the “dream” of owning a lifestyle block (which usually is in the 2 to 5 hectare range) to enable their family to enjoy the outdoor life and yet have a block of land that would not require the time, effort and money that would be required to be in business in the farming sector. This focus on the lifestyle block of land is usually when their children are in their early teenage years. Often the block of land will be used for a variety of uses, such as olives, nuts, as well as the more traditional pursuits raising beef calves, running of a few head of sheep and exercising the family horse. Obviously the property is not being used for the purpose of running a farming business¹ and therefore the cost of running the property and the financing costs are not able to be claimed as a deduction against the other assessable income of the taxpayer (such as a wage or salary from employment or self-employed professional income).

Is it possible to have a lifestyle block and enjoy the experience of country living and at the same time receive a tax break? This topic is interesting and relevant today as there are a number of cities where the rural zone is only minutes from the city central business district and the appeal of a little more land and less congestion of dwellings has become more of a priority for families. An example is in the Waikato District Council (Tamahere Ward) where the number of building applications (on an average of 1 hectare) for new dwellings has risen 83 percent from 2005 to 2006 according to Waikato District Council building statistics.²

A family can still enjoy the lifestyle block and offset the costs of running their property against assessable income by changing the focus on how the property is used. If the property is leased out the rental is automatically classed as income for tax purposes (CC 1(2)(a)) of the Income Tax Act 2004³ and the expenses and depreciation are deductible from this income,⁴ to the extent that these expenses relate to producing income as per the general permission section on deductions (s DA 1(1)(a)). The result is that the owner of the property is able to live on a lifestyle block and have the added advantage of reducing that person’s taxable income. The question of tax avoidance is also addressed in this comment, however it is the author’s view that this is unlikely to be an issue for a person who purchases a lifestyle block and

¹ Refer to the test of Richardson J in *Grieve v C of IR* (1984) 6 NZTC 61,682 (CA).

² Waikato District Council, (2006) *Building Statistics 2005 – 2006* (Waikato District Council, Hamilton).

³ The provisions in this comment refer to the Income Tax Act 2004 (ITA 2004) unless otherwise stated.

⁴ Although these expenses may need to be apportioned, which is an issue discussed later in this comment.

immediately leases it out, assuming they do not act in a manner that would come within the ambit of s BG 1.

It is argued in this comment that it is possible to gain a tax shield due to the relationship of subsection CC 1(2)(a) with that of subsection DA 1(1)(a). Therefore, to the extent that the expenditure on the lifestyle block relates to the income received from lease of the block, then that expenditure is deductible. If the result of deducting the expenditure from the income is a loss, then the loss is able to be offset against the taxpayer's other assessable income for that year. Regard must be had to subsection DA 1 (1)(b). This subsection has a focus of the expenditure being incurred in the course of a taxpayer carrying on a business. If the taxpayer is not in the "business" of leasing then this subsection is not relevant.

Section 2 of this comment sets out a hypothetical situation that forms the basis of the following discussion, with section 3 considering the issue of the relevance of not being in the business of renting. Section 4 discusses the rental income (s CC 1(2)(a)) and its link to deductibility of expenditure (ss DA 1(1)(a) & DB 6), with section 5 examining the tax avoidance issues. Section 6 sets out the conclusions.

2. HYPOTHETICAL SITUATION

To elucidate the arguments to be advanced in this comment, consider the following hypothetical example.

Suppose that a person is in business as a vet and she decides that her family should live in the country area so that they are able to enjoy the benefits of being surrounded by nature and a quieter lifestyle. She has saved \$350,000 and wants to buy 3 hectares of land and build a modest home on 0.4 of a hectare. She will lease out the remaining 2.6 hectares (87 percent) to a local farmer. She buys the land for \$500,000 (with no improvements on it) and borrows the full amount from the bank, agreeing to an interest rate of 8.7 percent. She then uses her savings of \$350,000 to have her home and swimming pool constructed. When all the construction has finished she immediately leases out the 2.6 hectares to the local farmer for \$3,000 pa. The farmer will be responsible for the maintenance (e.g. repairing fences, fertilising the land) of the leased property.

Figure 1 sets out a summary of her income and expenses that relate to the 2.6 hectares which is leased out.

Figure 1: Calculation of Income/Loss for Vet⁵

| | | |
|------------------------|---------------|-----------------|
| | | \$ |
| Lease income | | 3,000 |
| Less expenditure | | |
| Rates (87%) | 4,250 | |
| Telephone rental (50%) | 180 | |
| Accountancy | 450 | |
| Interest (87%) | <u>37,845</u> | |
| Total expenditure | | <u>42,725</u> |
| Loss | | <u>(39,725)</u> |

This loss of (\$39,725) is then offset against her other income; in this case her only other income is from the Vet business and this amounts to \$255,000.

Figure 2 sets out the vet’s taxable income:

Figure2: Calculation of Taxable Income for Vet

| | | |
|------------------------------|--|-----------------|
| | | \$ |
| Vet business profits | | 255,000 |
| Loss from rental of property | | <u>(39,725)</u> |
| Taxable Income | | 215,275 |

The tax effect of this loss would be a tax saving of \$15,493 (\$39,725 x 39 percent). This tax saving is not just for the current year, it will continue for the number of years that the land is leased out.

⁵ There could also be home office depreciation claimed.

3. BUSINESS AND THE LINK TO SUBSECTION DA 1(1)(B)?

Section DA 1 is the general permission authorising a person to claim a deduction. It encompasses depreciation, expenditure or loss. Section DA 1(1)(a) and (b) provide for the deductibility of any particular expenditure, depreciation or loss *to the extent* that these are:

- (a) incurred by the taxpayer in deriving the taxpayer's assessable income and/or excluded income; or
- (b) incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's assessable income and/or excluded income

Taking section DA 1(1)(b) first, the issue is therefore whether or not the vet is in the business of leasing land. Section DA 1(1)(b) recognises that the business may have expenditure that does not point to the specific derivation of income, but which is made to keep it trading. Whether or not a person is "carrying on a business" is a question of fact and such factors as the taxpayer's intention are examined; see for example, *Grieve v CIR*.⁶

Generally a person who purchases a lifestyle block will not be operating a business if that person is running a few head of sheep and/or a few head of cattle as that person's intention (as supported by the scale of operations and the volume of transactions) is not to make a profit. Rather it is clearly to enable that person's family to achieve a lifestyle that could not be achieved in the city. It follows therefore that section DA 1(1)(b) will not allow any deductions because the expenditure or loss needs to be incurred in the course of carrying on of a *business for the purpose of deriving* assessable income, and in this circumstance the person is not in business.

What about the situation where the property is leased out? Does this amount to a business? Case *F111*⁷ is relevant here where a university lecturer who received rental income was deemed to be in business as she:

- owned two houses and a block of five flats;
- collected the rents;

⁶ *Grieve v C of IR* (1984) 6 NZTC 61,682.

⁷ *Case F111* (1984) 6 NZTC 60,066.

- interviewed the tenants;
- did some of the repair work herself; and
- had knowledge of the property market.

Clearly the vet is not in circumstances similar to the university lecturer. She is not in the business of leasing. Consequently section DA 1(1)(b) is no basis for the vet to substantiate a deduction for her expenses in connection with the land which she acquired as she only receives the lease money, is not involved with maintaining the property and does not own any other properties.

4. RENTAL INCOME AND THE LINK TO SUBSECTION DA 1(1)(A)?

Section DA 1(1)(a) requires a stricter nexus between the incurring of the expenditure or loss and the deriving of assessable income. If the owner of the property leases it out then the income received will fall under subsection CC 1(2)(a). The expenditure which relates to this income will be deductible as there is a definite nexus to this income.

The other point that covers both these subparagraphs is that the deduction is allowed *to the extent* that the expenditure or loss incurred in deriving assessable income or in the course of carrying on a business for that purpose. *To the extent* means that *apportionment* of expenditure or loss may have to be made between their deductible and non-deductible elements.⁸ This apportionment is a question of *fact*, as to how much is correctly apportioned to the generation of assessable income or the carrying on of a business. The courts have made it clear that the Commissioner of Inland Revenue's (Commissioner's) duty is only to ascertain what expenditure the taxpayer *has* incurred in gaining or producing income or carrying on the business, not what *would or should* normally be expended. This was confirmed in *Ronpibon Tin v. FCT*⁹ the High Court of Australia made the following comments about the Australian provision which corresponds to section DA 1:

⁸ See for example *Buckley & Young Ltd v C of IR* (1978) 3 NZTC 61,271 (CA) and *C of IR v Banks* (1978) 3 NZTC 61,236 (CA).

⁹ *Ronpibon Tin NL v FC of T* (1949) 8 ATD 431.

“It is important not to confuse the question of how much of the actual expenditure of the taxpayer is attributable to the gaining of assessable income with the question of how much would a prudent investor have expended in gaining the assessable income. The actual expenditure in gaining the assessable income, if and when ascertained, must be accepted. The problem is to ascertain it by an apportionment. It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent ...”

Section DA 1(1)(a) deals with taxpayers that are not in business. It underlines that the expenditure or loss must be incidental and relevant to the production of income. It is not necessary that the outgoing relates to income of the same tax year.¹⁰ In fact a deduction is still claimable if no assessable income is produced, providing that the outgoing was directed towards the expected production of income.¹¹ Section DA 2(2) prevents deductibility of expenditure which is of a private or domestic nature.

In the case of our vet the private expenditure has not been claimed as this has been apportioned to reflect the private use of the property, e.g. rates for the property.

Is the full amount of the interest deductible? Section DB 6 applies in this case. Section DB 6 states that a person is allowed a deduction for interest as long as the general permission (in this case section DA 1(1)(a)) is satisfied and the general limitations (in this case the denial of deductions for private expenditure under section DA 2(2)) are satisfied. As stated above, s DA 1(1)(a) is satisfied as the apportioned amount of interest, having the required nexus, is paid on the loan which was used to purchase the land which in turn produces rental income. Section DA 2(2) is satisfied as the vet is not claiming that portion of the interest which relates to the loan to purchase the land on which the family home has been built on. The only amount being claimed is the amount that relates to the proportion of the property which is being leased to the farmer.

5. TAX AVOIDANCE

Assume that the vet has been using the property for hobby farming activities and now changes her activity to leasing the property which produces income from rental. There may be many

¹⁰ Refer to *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295

¹¹ See n 9.

valid commercial (non tax) reasons for this change, e.g. the time commitment (the vet business requires more hours), or the family of the taxpayer has now grown up and moved away from the property, or it is financial and an extra source of income is required. The focus now is whether or not tax avoidance will be an issue if the taxpayer changes the use of the property from hobby farming to leasing and receiving rental income.

How does tax avoidance fit in the above situation? In relation to the deductions provisions, consideration must be given to any specific anti-avoidance provision and also to section BG 1 and subsection BB 3(1). Section BG 1 is the general anti-avoidance provision and section BB 3(1) provides that the Commissioner may counteract a tax advantage from a tax avoidance arrangement.

The first issue is to establish whether or not there has been a tax avoidance arrangement. The word “arrangement” is relevant here. The word arrangement is defined in the ITA 2004 in s OB 1, which states that “arrangement”: “means an agreement, contract, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried out”.

Indeed the Inland Revenue Department (IRD) has in its exposure draft on BG 1¹² commented that: “Therefore, it is considered that the legislative reference to “plan” is to some detailed proposal for doing or achieving something between two or more persons”.

It is arguable therefore that a tax avoidance arrangement could apply to the situation of a person changing the use of their land from hobby farming to leasing the land, particularly if this is part of an arrangement, such as in accordance with a detailed plan. The definition of tax avoidance¹³ includes:

- (a) directly or indirectly altering the incidence of any income tax:
- (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
- (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax.

¹² Inland Revenue, *Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004*, Exposure Draft (24 September 2004), para 3.2.18.

¹³ Section OB 1 definition of “tax avoidance”.

The IRD has the view that the above definition is relevant for a single person (taxpayer).¹⁴

“The definition of “tax avoidance” requires the single taxpayer approach. Paragraph (b) clearly applies on a single taxpayer basis as it refers to relieving “any person” from a liability to pay income tax. The words “any person” can only be interpreted as applying to a single taxpayer in isolation.”

The Commissioner goes on to say that:¹⁵

“Paragraph (c) is also arguably framed with only a single taxpayer in mind, on the basis that only single taxpayers will suffer a liability to income tax, and therefore the tax avoidance is the alteration of that single taxpayer’s liability.”

The focus must therefore be on whether or not the “purpose” or “effect” is “not merely incidental”. The *Challenge* case is relevant here where Woodhouse P stated (in the Court of Appeal):¹⁶

“I am satisfied as well that the issue as to whether or not a tax saving purpose or effect is “merely incidental” to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.”

A little later on Woodhouse P stated:¹⁷

“When construing section 99 and the qualifying implementations of the reference in subsection (2)(b) to “incidental purpose” I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as the extent to which it appears to involve exploitation of the Statute while in direct pursuit of tax benefits. To put the matter another way, there is all the difference in the world, I think, between the prudent attention on the one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it and its pursuit on the other hand simply to achieve a manufactured tax advantage.”

¹⁴ See n 12, paras 3.5.3 and 3.5.4

¹⁵ See n 12.

¹⁶ *C of IR v Challenge Corporation Ltd* (1986) 8 NZTC 5001, 5005-6.

¹⁷ See n 16. **[Include here references to some articles on s 99 and BG 1, such as in this *Journal*.]**

The second issue is that taxing statutes have previously been interpreted strictly and therefore the legislation must make it clear that a taxpayer is liable to pay a particular tax in specified circumstances. Lord Cairns said in *Partington v. AG*:¹⁸

“As I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be”.

More recently the approach to interpretation of tax statutes has been set out by McKay J in the *Alcan* case.¹⁹ McKay J states that:²⁰

- “words are to be given their ordinary meaning”;
- “[i]f ... the words are capable of more than one meaning and the object of the legislation is clear, then the words must be given 'such fair, large and liberal construction' as will best ensure the attainment of the object of the Act”;
- where “the particular purpose is unclear ... the safest guide to meaning will be found in the actual words of the statute”;
- “[o]ne should certainly approach the question of statutory interpretation on the premise that the legislature will not have intended absurdity or injustice”;
- “[t]he true meaning must be consonant with the words used, having regard to their context in the Act as a whole, as to the purpose of the legislation to the extent that this is discernible”;
- in determining the scheme and objectives of the legislation, what is required is “... a careful reading of its historical context of the whole Statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations”; and

¹⁸ *Partington v. AG* (1869) LR 4 E & I App HL

¹⁹ *C of IR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175.

²⁰ See n 19, paras 11-24. **[Include here some articles on interpretation of tax legislation.]**

- A Court ought not to adopt “a ‘purposive’ construction ... which went beyond any meaning that could be justified by the words of the statute read in the light of the purpose of the legislation”.

It is argued that the tax legislation has been specifically set up to treat income from the land in the vet example above as assessable income under subsection CC 1(2)(a) and that subsection DD 1(1)(a) is specifically established to allow for deductions to be offset against the rental income.

The third issue to be considered is what has become known as “The Duke of Westminster Principle”, which resulted from *IRC v. Duke of Westminster*²¹ when Lord Tomlin said:

“Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”.

Anti-avoidance legislation must be considered with regard to this principle, to the extent that the current legislative provisions and case law interpretation permit. It is argued that the vet is merely ordering her tax affairs to enable a lesser amount of tax to be payable. Compare the TRA case involving rental properties. *Case N63*²² involved a claim for deductibility of interest under a mortgage. A \$30,000 mortgage loan was applied by a retired school teacher towards the purchase of the second flat in a two unit “own your own” flat building. This was so that she could move her residence from the first flat (which she had owned for some years previously) to the second flat and let the first flat. Her purpose in borrowing the \$30,000 mortgage loan can be regarded as to achieve ownership of an investment flat as well as a home flat. The use of the money can be regarded as to complete the purchase of the second flat as her new residence. Consequently the deduction was denied but Barber DCJ stated:²³

“As is so often the case, if the facts had been a little different then deductibility could have been achieved. For instance, if the objector had not decided to shift from one flat to the other as her own residence and had borrowed the money to purchase the second

²¹ *IRC v. Duke of Westminster* [1936] AC 1.

²² *Case N63* (1991) 13 NZTC 3,483.

²³ See n 22, para 19.

flat and let it, then the mortgage interest would have been deductible. This is because it would have been expenditure to acquire a capital asset to be used to obtain rental income, ie, as a base for that type of income earning process. However, as I have often said I must look at the facts as they are and not as they might have been. I have also often said that disputes about taxation liability must be confined to that liability aspect and cannot be decided on the basis of sympathy for the taxpayer's position or on the basis of fairness. It is well known that there is no fairness in tax other than entitlement to a fair hearing and a proper application of the law. Either the transaction procedure provides deductibility or it does not. It does not help that another procedure could have achieved deductibility for the interest expenditure.”

In the Privy Council decision in *Commissioner of IR v. Challenge Corporation Ltd*²⁴ the majority of the PC upheld the Commissioner’s appeal. Section 191 of the ITA 1976 was regarded as a provision intended to give effect to the reality of the group profits and losses, and not to be an instrument of tax avoidance, whereas the terms of section 99 ITA 1976 were of general application and should be applied in the absence of an express direction by the Parliament to exclude section 191 ITA 1976 from its ambit. In a majority judgement Lord Templeman²⁵ distinguished between *tax avoidance* and *tax mitigation*:

“Section 99 does not apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.

Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his tax liability to tax without involving him in the loss or expenditure which entitled him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had...

...Whatever the circumstances or complications, if a taxpayer asserts a reduction in assessable income, or if a taxpayer seeks tax relief, then tax avoidance is involved and the Commissioner is entitled and bound by section 99 to adjust the assessable income of the taxpayer so as to eliminate the tax advantage sought to be obtained.”

²⁴ *Commissioner of IR v. Challenge Corporation Ltd* (1986) 8 NZTC 5219 (PC).

²⁵ See n 24, pp 5226 – 5227.

In the case of *CIR v. Peterson*²⁶ Gault P in the Court of Appeal reinforced Richardson P in *BNZ Investments*,²⁷ and stated:

“The crucial challenge with this section and its predecessors has been to distinguish between arrangements by which taxpayers conduct their affairs legitimately taking advantage of the structure and operation of the tax system and arrangements that constitute tax avoidance as defined and are of a character incompatible with legitimate and credible tax planning.”

In the Privy Council the decisions of the majority and minority in *Peterson*,²⁸ in the light of the facts of the case and arguments advanced by the parties, add further confusion to the interpretation and application of s BG 1 in New Zealand, while we wait for the Supreme Court to comment specifically on s BG 1. The *Peterson* case further underlines the ability of taxpayers to conduct their affairs to enable them to take advantage of the tax system as in this vet’s case where there is a direct relationship between subsection CC 1(2)(a) and the expenditure allowed as a deduction under subsection DD 1(1)(a).

The fourth issue is that of the choice principle. Section BG 1 should not be interpreted as applying where the taxpayer is adopting a course of action anticipated by, and expressly incorporated within, the ITA 2004.

In *W P Keighery Pty Ltd v. FCT*,²⁹ the taxpayer sought to avoid being classified as a private company by issuing redeemable preference shares (which would have been subjected to the Australian undistributed profits tax). The Full High Court held that the equivalent provision to section 99 did not apply as the Income Tax Assessment Act 1936 (Cth) (ITAA 1936) had expressly stated the basis on which a company was to be characterised as “private”, and the taxpayer was entitled to choose whether or not it was taxed as such:

“Whatever difficulties there may be in interpreting s 260 one thing at least is clear; the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them...”

²⁶ *CIR v. Peterson* (2003) 21 NZTC 18060, para 36 (CA).

²⁷ *CIR v BNZ Investments Ltd* (2001) 20 NZTC 17,103 (CA).

²⁸ *Peterson v CIR* (2005) 22 NZTC 19,098; [2005] UKPC 5 (PC).

²⁹ *W P Keighery Pty Ltd v. FCT* (1959) 7 AITR 107, pp 124 – 125.

It is the outstanding feature of Division 7 that it makes a company's liability to be assessed for additional tax depend upon the company's possessing certain characteristics on a particular day, the characteristics being such that whether the company possesses them on that day is a matter within the antecedent control of shareholders or other persons interested...If they so alter the relevant facts that, when the last day of the year of income arrives, the company will not be a "private company", their action cannot be regarded as tending to defeat a liability imposed by the Act; it is one which the Act contemplates and allows.

Because this is so, an attempt by the Commissioner to rely on s. 260 in the present case in order to avoid only the applications for and the allotments of the redeemable preference shares would be an attempt to deny to the appellant company the benefit arising from an exercise which was made of a choice offered by the Act itself. The very purpose or policy of Division 7 is to present the choice."

The courts in NZ have not departed from this more limited *choice principle*; refer to the decision in *CIR v. Challenge Corporation Ltd*³⁰, where Cooke J stated:

"Where a particular section conferring tax concessions or rights has its own anti-avoidance provision (and there are other instances in the Income Tax Act) the preferable inference seems to me to be that the special provision is exhaustive in its own field. Within that field a taxpayer is entitled to assume that he has the right to order his affairs to take advantage of the benefits conferred by the section, provided only that he does not fall foul of the special provision. Outside that field there may still be room for section 99 to operate".

Richardson J³¹ added that:

"the legislature could not have intended that section 99 should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself".

However the Privy Council held that the general anti avoidance section must be applied unless Parliament gave direction against this view.³²

³⁰ *CIR v. Challenge Corporation Ltd* (1986) 8 NZTC 5001, p 5015 (CA).

³¹ See n 30, pp 5019-5021.

³² *Commissioner of IR v. Challenge Corporation Ltd* (1986) 8 NZTC 5219 (PC).

Lord Hoffman (approving of Richardson J's comments) stated in *O'Neil v. CIR*³³ that:

“On the other hand, the adoption of a course of action which avoids tax should not fall within s 99 if the legislation, upon its true construction, was intended to give the taxpayer choice of avoiding it in that way.”

In *CIR v. BNZ Investments Ltd*³⁴ Richardson P stated:

“For the reasons discussed in the cases (e.g. *Challenge Corporation v. CIR...*), s 99 as the expanded successor of the old s 108 of the Land and Income Tax Act 1954 is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to a particular defined situation, the legislature through section 99 has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn

Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice ...

The function of s 99 is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the legislature could not have intended that s 99 over-ride all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti-avoidance provision cannot be subordinated to all specific provisions of the tax legislation. It, too, is specific in the sense of being specifically directed against tax avoidance; and it is inherent in the section that, but for its provisions, the impugned arrangements would meet all the specific requirements of

³³ *O'Neil v. CIR* (2001) 20 NZTC 17,051.

³⁴ *CIR v. BNZ Investments Ltd* (2001) 20 NZTC 17013 (CA).

the income tax legislation. The general anti-avoidance section thus represents an uneasy compromise in the income tax legislation.”

The choice principle is relevant to the scenario since the structure of the ITA 2004 is to treat income from land as assessable income and to treat the expenditure that has a nexus to deriving this income as deductible.

The choice principle basically holds (and probably even goes beyond the Westminster principle) that a taxpayer can legitimately reduce his liability to tax by "choosing" to bring his actions within the express terms of some provision in a taxing Act that thereby results in a reduced tax liability. The principle came from an Australian case way back in 1932 of *Clarke v FCT* (1932) 48 CLR 56. In this case it was held that where circumstances exist so that a choice is presented to a prospective taxpayer between two courses, and of which one will and the other will not, expose the taxpayer to liability for taxation, then the taxpayer's deliberate choice of the second course (ie not to be exposed to tax) cannot be made a ground for the application of an anti-avoidance section.

In New Zealand the O’Neil case was referred to in the TRA case X1³⁵:

"If, as a matter of commercial reality, a taxpayer has a number of choices in the way a transaction is structured which would result in some permitted outcome, such as here the deducting of interest, then the transaction does not become impermissible tax avoidance merely because one of the choices results in tax savings."

Therefore as long as the objectives of the income tax legislation are not defeated then the choice of the taxpayer should not be affected by anti-avoidance legislation, refer comments by Tom Delaney³⁶

If a taxpayer chooses to lease the lifestyle block as opposed to fattening a few head of beef cattle, then this is surely the most efficient return on the lifestyle block.

6. CONCLUSION

The ITA 2004 has been set up to assess the rental income from the leased property and to allow deductions for the expenditure that have a close link to deriving that income. Taxpayers

³⁵ X1 (2005) 22 NZTC p 12052, para 373

³⁶ New Zealand Journal of Taxation Law and policy Volume 11:2 June 2005

who lease (and/or who are not in the business of renting) their property are entitled to offset the expenditure to the extent that it relates to deriving the rental income and if there is a loss from this process, then this loss is deductible against the taxpayer's other income for that income year.

If a taxpayer changes the use of the land; that is, the taxpayer changes from running a few head of livestock to leasing the land, then tax avoidance could be an issue. Nevertheless, the reasons for the change and determining whether tax avoidance is more than "merely incidental" are very relevant issues. The reason for the course of action (leasing the property) when viewed objectively could be that the person is seeking a better cash flow from the property and this has not been done to achieve a manufactured tax advantage. However this would have to be looked at on a case by case basis and considered in the context of the amount of tax saved.³⁷

³⁷ See for example the decision of Barber DCJ in *Case W33* (2004) 21 NZTC 11,321.

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