Deductibility of interest: A Comparative Perspective: Conceptual issues

Chris Ohms and Karin Olesen

Abstract
Interest payable on borrowed funds or on amounts owing by reason of the operation of the law (for example interest that may be payable on statutory debts such as tax owing) in relation to an income earning activity is a significant (potential) deductible expense throughout the Commonwealth. The traditional “form” approach derived from the leading decision IRC v Duke of Westminster [1936] AC 1 requires that the underlying transaction giving rise to the interest, and the interest itself, be characterised according to the legal rights and obligations created evident from the objective intention of the parties. On the other hand, an “economic substance” approach allows for the same characterisation to arise having regard to the economic consequences that flow from the transaction. These issues have been considered and the movement towards the development of a conceptual framework which relies on commercial legal forms and absorbs this into its measurement and recognition basis.

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I. Introduction

Overview

1Professor Chris Ohms, BCom LLB LLM(Hons) PhD, Enrolled Barrister and Solicitor of the High Court of New Zealand, School of Law, Auckland University of Technology, Consultant to Coisory Partners Limited. Dr Karin Olesen, BCom (Accounting and Finance), MCom (Hons) MSIS PhD, Business School, Auckland University of Technology.
Interest payable on borrowed funds or on amounts owing by reason of the operation of the law (for example interest that may be payable on statutory debts such as taxes due) in relation to an income earning activity is a significant (potential) deductible expense throughout the Commonwealth. In the situation where public policy (or in Civil Law jurisdictions – *fraus legis or abus de droit*) – a priori – would lead to the conclusion that an interest deduction should be denied (for instance where it relates to a tax avoidance scheme or it might be used to pay a tax debt), two important issues arise. The first issue is how the taxpayer, the taxing authority and the Court may characterise the underlying transaction and interest as a question of law, prior to the application of the specific taxing legislation that may apply (“the characterisation issue”). The second issue is then of course how that specific taxing legislation (a deduction rule in the case of interest in the wide sense) is interpreted and applied by the taxpayer, the taxing authority and the Court (“the legislative issue”).

As noted above the reason why both of these issues are important is that it might be possible to argue that the initial characterisation of the transaction or the subsequent application of the specific interest deduction rule should be undertaken in such a way

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2 Australia: – interest is deductible under the general deduction rule, s 8-1 Income Tax Assessment Act 1997 (Cth Aust) herein “ITAA97”. See also *Ure v FCT* 81 ATC 4100, *FCT v Munro* (1926) 38 CLR 153 and *Ronpibon Tin NL and Tongkah Compound NL v FCT* (1949) 8 ATD 431; Canada: interest is deductible under a specific deduction rule, s 20(1)(c) Income Tax Act (Can) herein “ITA”). See *Shell Canada Ltd v Canada* 96 DTC 6121. New Zealand: - interest is deductible on largely the same basis as Australia, the combined effect of s DB 6(1) and s DA 1(1) Income Tax Act 2007 (NZ) herein “IT07” is essentially that the general deduction rule must be satisfied. See also *CIR v Banks* (1978) 3 NZTC 61, 236, *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271, *Public Trustee v COT* [1938] NZLR 436, *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146 and *CIR v Brierley* (1990) 12 NZTC 7,184. United Kingdom: - the advent of the Income Tax (Earnings and Pensions) Act 2003 (UK) herein “ITEPA 2003 and the Income Tax (Trading and Other Income) Act 2005 (UK) herein “ITTOIA 2005” saw the abandonment of the schedular system, except in so far as it was applicable to corporation tax. The main heads of charge are now: (a) trading income – ITTOIA 2005, Pt. 2; (b) property income – ITTOIA 2005, Pt. 3; (c) savings and investment income – ITTOIA 2005, Pt. 4; (d) miscellaneous income – ITTOIA 2005, Pt. 5; (e) employment income – ITEPA 2003, Pt. 2 and 3, 6 and 7; and (f) pension income – ITEPA 2003, Pt. 9; and ITEPA 2003, Pt. 10.r. As an example for trading income (ITTOIA 2005, Pt. 2) interest paid on loans to, or overdrafts of, a business is a deductible expense, provided the loan was made wholly and exclusively for business purposes Interest paid out is always a revenue rather than a capital expense, whatever the nature of the loan (ITTOIA 2005, s 29 also s 34). In *Scorer (HMIT) v Olin Energy Systems Ltd* (1985) TC 592, 611 Walton J approved the approach taken by the Special Commissioners regarding the payment of interest for the purposes of a trade, namely:

“… we take the view that the question whether interest was paid for the purposes of a trade must depend upon whether the loan, on which the interest was paid, was incurred for the purposes of that trade. It does not necessarily follow that the purposes of the loan can be ascertained by looking at the immediate use to which the borrower applies the money. The question is one of fact to be decided on the evidence available in each case.”

See generally CCH (UK), *Tax Reporter* para 215-000.

(generally by the taxing authority or the Court) that denies the deduction for policy reasons such as equity, adequacy or efficiency.

Here, an analogy is the situation of fines. Although a fine may be incurred as part of an income earning process and thus be an “outgoing incurred”, famous cases such as IRC v Alexander von Glehn and Co Ltd “re-characterise” fines factually as private expenditure to deny deductibility on no sensible conceptual or logical basis.

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4 See for instance United States Government Accountability Office, Understanding the Tax Reform Debate: Background, Criteria and Questions (September 2005) [28GAO-05-1009SP] pp 27-28. Horizontal equity requires that taxpayers who have similar ability to pay taxes receive similar tax treatment. Targeted tax expenditures, such as deductions and credits, could affect horizontal equity throughout the tax system because they may favor certain types of economic behavior over others by taxpayers with similar financial conditions. For example, two taxpayers with the same income and identical houses may be taxed differently if one owns his or her house and the other rents because mortgage interest on owner-occupied housing is tax deductible. Vertical equity deals with differences in ability to pay. Subjective judgments about vertical equity are reflected in debates about the overall fairness of the rate structures, where for this example, income is used as the measure of ability pay.

5 See Yorio E., “The President’s Tax Proposals: A major Step in the Right Direction” (1985) 53 Fordham L Rev 1255, at 1263. Yorio notes the final requisite of a sound tax system is that it provide revenues adequate to meet the needs of the public sector. Precisely how much revenue must be raised at any time to satisfy the adequacy criterion in this general sense will depend on factors such as society’s view of the proper balance between the public and private sectors, external threats posed to the society, and society’s judgment on the need or advisability of incurring debt or printing money rather than raising revenue as a means of financing government spending. In its narrower sense, the adequacy criterion refers to the aggregate revenue effect of a particular provision in the tax law. If a proposed change in the legislation will result in a significant loss in revenues, the criterion is badly served. If the proposal will generate additional revenues, the criterion is satisfied.

6 See the phraseology in the leading decision of the New Zealand Court of Appeal in CIR v Banks [1978] 2 NZLR 472, at 475 per Richardson J: “The statutory requirement is that the expenditure be “incurred in gaining or producing the assessable income”. That has to be judged as at the time that the taxpayer became definitively committed to the expenditure for which deduction is sought (F.C. of T. v Flood (1953) 88 C.L.R. 492; King v C. of I.R. (1973) 1 NZTC 61,107. Where the expenditure involves an element of volition and is itself of a revenue rather than a capital character, consideration of the object or purpose of the expenditure may, in many instances, be determinative of deductibility.”

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8 New Zealand Inland Revenue IS 09/01 FINES AND PENALTIES — INCOME TAX DEDUCTIBILITY [Interpretation Statement IS 09/01 (IS 09/01)] Date of issue: 15 October 2009: It followed the principles in the earlier English case of Strong v Woodfield (Surveyor of Taxes) 5 TC 215 (which it acknowledged was in a different context) and was also consistent with the decision in IRC v Warnes [1919] KB 444. Alexander von Glehn involved a company that carried on an exporting business and was fined £3,000 for exporting goods to Russia without taking appropriate precautions to ensure their ultimate destination was not enemy territory. The company’s claim to deduct that sum was rejected by the English Court of Appeal. In reaching its decision, the Court of Appeal considered that, because the fine was imposed on the company for breaking the law, the expense could not be connected with or arising out of the company’s trade. In Mann v Nash (1932) 16 TC 523, 529, Rowlatt J, referred to Alexander von Glehn, and observed that:
To guide us in these dangerous shoals a good “chart” is required. Like the Joint Conceptual Framework Project (International Financial Reporting Standards) for financial reporting, a conceptual framework for income tax system design and operation is needed within which the specific treatment of interest can be examined. This is the objective of this article.

The author’s conclusions

The conclusion reached in this article is that the current design of the Commonwealth income tax systems reviewed by the authors dictates that transactions are characterised according the their legal form (regardless of any public policy considerations) and that the subsequent application of the specific deduction regime is undertaken adhering also to the legal form of the transaction without any statutory recharacterisation.10

“the decision in the case was that payment of those penalties was nothing to do with the trade or business; it was not an expense for the earning of the profits, but it was an expense in the form of an inconvenience which supervenened later when the profits were made, because illegality had been committed in the course of earning them.”

The early United Kingdom decisions suggest that a deduction is denied on the basis that the required statutory connection or nexus between the fine or penalty and trading is absent – see paras 11, 12 and 12.

10Per Richardson J in Mills v Dowdall [1983] 154 at 159-160:

“the legal principles governing the ascertainment of the true legal character of a transaction are now well settled and for recent discussions in this Court it is sufficient to refer to Re Securitibank Ltd (No 2) [1978] 2 NZLR 136; Buckley & Young Ltd v Commissioner of Inland Revenue [1978] 2 NZLR 485; Marac Finance Ltd v Virtue [1981] 1 NZLR 586; and Commissioner of Inland Revenue v Smythe [1981] 1 NZLR 673. It frequently happens that the same result in a business sense can be attained by two different legal transactions. The parties are free to choose whatever lawful arrangements will suit their purposes. The true nature of their transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. Not on an assessment of the broad substance of the transaction measured by the results intended and achieved; or of the overall economic consequences to the parties; or of the legal consequences which would follow from an alternative course which they could have adopted had they chosen to do so. The forms adopted cannot be dismissed as mere machinery for effecting the purposes of the parties. It is the legal character of the transaction that is actually entered into and the legal steps which are followed which are decisive. That requires consideration of the whole of the contractual arrangement and if the transaction is embodied in a series of inter-related agreements they must be considered together and one may be read to explain the others. In characterising the transaction regard is had to surrounding circumstances: not to deny or contradict the written agreement but in order to understand the setting in which it was made and to construe it against that factual background having regard to the genesis and objectively the aim of the transaction. The only exceptions to the principle that the legal consequences of a transaction turn on the terms of the legal arrangements actually entered into and carried out are: (i) where the essential genuineness of the transaction is challenged and sham is established; and (ii) where there is a statutory provision, such as s 99 of the Income Tax Act 1976, mandating a broader or different approach which applies in the circumstances of the particular case. A document may be brushed aside if and to the extent that it is a sham in two situations: (a) where the document does not reflect the true agreement between the parties in which case the cloak is removed and recognition given to their common intentions (as happened in Marac Finance Ltd v Virtue); and (b) where the document was bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.”
For example, if a taxpayer incurs a genuine liability for interest on a loan of money that is then used to fund an income earning activity that turns out to infringe the local town planning ordinance and is subject to a fine, the taxing authority and the Court may not deny that the loan of money has arisen according to its legal form and that any specific deduction rule for interest should not be applied by reason simply of the illegal nature of the income earning process.\footnote{See for example the deductibility of the legal cost of defending allegations of unethical and fraudulent building practices before a Royal Commission appointed by the Government of Western Australia on 28 January 1953 – \textit{FCT v Snowden & Willson Pty Ltd} (1958) 99 CLR 431. Taylor J at p 452 noted “The final observation which I wish to make is concerned with the argument that, as the expenditure was incurred in an endeavour to rebut the charges of fraud which were implicit in the allegations made by Mr. Oldfield, the company is not entitled to the deduction claimed. It was sought to support this argument by reference to cases concerned with legal costs and penalties incurred in criminal proceedings. It is, I think, sufficient to say that there is no analogy between the two classes of cases and, accordingly, that there is no substance in this submission. (See \textit{Inland Revenue Commissioners v. Warnes & Co.} (1919) 2 KB 444; \textit{Commissioners of Inland Revenue v. von Glehn & Co. Ltd.} (1920) 2 KB 553; \textit{Minister of Finance v. Smith} (1927) AC 193, at pp 197, 198).” See also Keesling F.M., “Illegal Transactions and the Income Tax” (1958) 5 UCLA L Rev 26 at 33. The author notes that “If receipts are to be included in gross income irrespective of the legality or illegality of their source, consistency requires that expenses, losses and other items should be deductible irrespective of the legality or illegality of the transaction in which it is incurred. If illegal income is to be taxed, illegal expenses should be deducted.” See \textit{Commissioner v Doyle} 231 F.2d 635 (7th Cir. 1956).}

The reason why form prevails at both the characterisation step and then the legislative step is that the scheme and purpose of the income tax systems reviewed is typically based on a transactional measurement system as compared with an economic comprehensive tax base model (Haig/Simons).\footnote{See infra n 20.}

The schema of this article

This article is divided into eight parts. After the introduction in Part One, Part Two examines some preliminary economic aspects of interest. Part Three then develops the conceptual framework. Part Four moves on to apply the conceptual framework by initially considering the tax administration cycle by which in practice the characterisation issue (Part Five) and then the interpretation issue (Part Six) arise. Part Seven looks at the same issue under IFRS while Part Eight presents the authors’ conclusions.

II. Economic aspects of interest

Interest in classical economic terms is described as “the payment for the use of funds employed in the production of capital, it is measured as a percent per year of the value of the funds tied up in the capital”.\footnote{Baumol W.J., Blinder A.S., 2011, \textit{Economics Principles and Policy} (Third Edition, Harcourt Brace Jovanovich International Edition p 403.} Keynes observed this to be the factor which brings the
demand for investment and the willingness to save into equilibrium with one another. Investment is considered to be “the flow of resources into the production of new capital. It is the labor, steel, and other inputs devoted to the construction of factories, warehouses, railroads, and other pieces of capital during some period of time”. The “rate of interest” is the price at which funds can be rented (borrowed). And like other factor prices, the rate of interest is determined by supply and demand. In business, loans are used primarily to finance investment. The business executive who “rents” (borrows) funds in order to finance an investment and pays interest in return, the funds really represent an intermediate step toward the acquisition of machines, buildings, inventories, and other forms of physical capital that the firm will purchase. The market determination of interest rates is done through the downward sloping demand curve for funds and the upward supply of funds. The downward-sloping demand curve for funds is considered as so “as the rate of interest on borrowing rises, more and more investment that previously looked profitable starts to look unprofitable. The demand for borrowing for investment purposes, therefore, is lower at higher rates of interest”. The supply of funds is considered using similar principles than the demand side where the lenders are consumers, banks and other businesses. “Funds are lent out are usually returned to the owner (with interest) only over a period of time. Loans will look better to lenders when they bear higher interest rates, so it is natural to think of the supply schedule for loans as being upward sloping – at higher rates of interest, lenders supply more funds”. Such a supply schedule is shown in the curve SS in Figure 1, where we also produce a demand curve DD.

15Baumol and Blinder, n 13, p 403.
16Baumol and Blinder, n 13, p 403.
17Baumol and Blinder, n 13, p 405.
18Baumol and Blinder, n 13, p 406.
III. Ectopia – the Haig-Simons concept of income and the need for the transactional approach

In Part Three the authors develop a conceptual framework which describes the basic structure of the Commonwealth tax systems that are reviewed. The analysis starts with the Haig/Simons comprehensive definition of income and then modifies that approach to illustrate how in practice the Commonwealth income tax systems operationalise this concept into a workable tax system. It is in fact the practical limitations of a pure Haig/Simons tax system that force tax policy makers to use a transactional approach in the measurement of income and also by necessity the reliance on a form approach.

The Haig-Simons comprehensive tax base

It is generally accepted that the “Haig/Simons” comprehensive definition of income is the paradigm that tax reformers move toward – particularly in the Commonwealth and the United States of America. The definition states:  

\[19\text{See Simons H., } Personal~Income~Taxation~(1938)~ pp~61-62,~206;~Haig~[Haig~R.,~(ed),~The~Federal~Income~Tax~(1921)~7]~defined~personal~income~as~the}~\text{“money~value~of~the~net~accretion~to~one’s~economic~power~between~two~points~of~time.”} \]
“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”

From a normative perspective it is well recognised that the “best” measure of income for tax reform purposes is that developed by Haig/Simons – commonly known as comprehensive income base or economic definition of income.\(^{20,21}\)

**The McIntyre formulation of an operational Haig/Simons tax base**

Broadly speaking economic or comprehensive income for a period represents the difference in wealth between the beginning and end of the period, together with consumption during the period. Under this approach income is measured as the sum of consumption and the net change in wealth during a period. Haig/Simons income (HSY) (as noted above) is usually defined as the algebraic sum of (1) the taxpayer’s personal consumption (C) and (2) the difference between their net worth at the end of the assessment period (\(NW_1\)) and their net worth at the start of the period (\(NW_0\)).\(^{22}\)

This may be represented in the following equation:\(^{23}\)

\[
(1) \text{HSY} = C + (NW_1 - NW_0)
\]

McIntyre notes that:\(^{24}\)

“Although commentators may occasionally indulge the fantasy that a tax department could measure the change in each taxpayer’s net worth, no one pretends that consumption could be measured directly. Instead, the assumption commonly made is that a tax department would compute consumption indirectly from presumably knowable information about a taxpayer’s income sources.”

Thus, the following formula more accurately presents a tax system that uses the HSY concept by resort to transactions and asset measurement:\(^{25}\)

\[
Y_t = rR_t + iK_t + wL_t
\]

where \(R\) is land, \(L\) is labour and \(K\) is capital. The earnings of these factors (of individuals) when added up for the entire population for a given time period \(t\) equates to the national income \(Y\) (where \(r\) is the return to land, \(i\) is the return to capital and \(w\) is the return to labour).


\(^{21}\) Commonwealth of Australia, n 21, p331. The project sets out the following formula:

\[
Y_t = rR_t + iK_t + wL_t
\]


\(^{24}\) at p 1087

\(^{25}\) at p 1087
(2) $HSY = S + (OA_1 - OA_0) + (NA - AC) - E - PD$

Under equation two:

$S$ = total realized income, including wages, investment income, realized gains, windfalls, and gifts;

$OA_1 - OA_0$ = the unrealized gains on assets held both at the start and the end of the taxable period, measured by subtracting the market value of old assets at the start of the period ($OA_0$) from the market value of these same assets at the end of the period ($OA_1$);

$NA - AC$ = the unrealized gain on assets obtained during the taxable period, measured by subtracting the acquisition costs of those assets ($AC$) from the market value as of the end of the period of the newly acquired assets ($NA$);

$E$ = the total of the taxpayer’s profit-seeking expenses (eg, payments that are intended to produce income and that do not either increase the value of an asset already owned by the taxpayer or produce an asset with utility that extends beyond the taxable period);

$PD$ = any personal deductions, such as the deduction for state and local income taxes, that are judged to fall outside a refined definition of consumption.

The McIntyre Haig/Simons model in operation

McIntyre, observes that all income tax systems impose tax only on realized income. An income tax based generally on Haig/Simons concepts which adopts a realization requirement for accrued gains would define its tax base as the sum of (1) realized income accruing in the current period and (2) income that accrued in prior periods but was realized in the current period less (3) depreciation, expenses relating to the earning of realized income and personal deductions.

This can be represented by our last equation:

(3) $RY = S + SA_0 - B_0 - D - Er - PD$

Under equation three:

$SA_0$ = the market value at the start of the period of assets on hand and sold during period;

$B_0$ = the taxpayer’s basis in assets sold during the taxable year, as of the start of the year;

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26 at p 1090, however, in some jurisdictions such as Australia there are examples as Division 16E relating to securities interest and now Division 230 ITAA 1977 relating to financial instruments in which the characterization of the transaction has been legislated via provisions of the Income Tax Act.

27 (RY)

28 at p 1090
D = the deduction for depreciation, representing the taxpayer’s estimated loss in value of wasting assets held at the end of the period;

\( E_r \) = that portion of the profit-seeking expenses (E) allocable to the earning of realized income; and

All other terms are as defined in equations (1) and (2).

**Expanding the McIntyre/Haig/Simons model in a Commonwealth context**

(4) \( RY_1 = (N + II + RG + W&G) + SA_0 - B_0 - D - E_r - PD \)

Under equation three:

\( N = \) wages during period;

\( II = \) Investment income during the taxable year not included in \( SA_0 \) and \( B_0 \);

\( RG = \) Realized gains during the taxable year which does not include assets included in \( SA_0 \) and \( B_0 \);

\( W&G = \) Windfalls and gifts received during the year; and

All other terms are as defined in equations (1), (2) and (3).

Australia, Canada and the United Kingdom have all introduced taxation systems designed to more or less implement the Haig/Simons model. New Zealand has also adopted the same broad conceptual framework for the design of its income tax system with the omission however, of a comprehensive capital gains tax. Nonetheless it is a valid proposition to say that the Haig/Simons comprehensive tax base is the conceptual framework upon which all four jurisdictions base tax design and policy.29 The major shortcoming however of the McIntyre/Haig/Simons model presented under equation three is that it fails to deal with the distinction between inflows from revenue producing activities (such as wages or salaries), capital gains (in the true sense of the term – inflows that arise from the realization of items that produce the framework from which revenue is made) and windfalls. For an example of the judicial recognition of this trichotomy, we find in the Australian Full Federal Court decision *FCT v La Rosa*30 Hely J notes (the issue was whether a stock of cash fell within one of the three categories):31

“Whether money is held as a revenue asset or as a capital asset or on private account depends on the circumstances of the holding. A taxpayer who stores money in the ground or in a safe or in the bank may hold the money as capital if it is part of the structure of the business, or if it is held for use when needed in the business and is in the nature of a capital reserve.”

30129 FCR 494.
31129 FCR 494 at 502-503.
In *La Rosa*\textsuperscript{32} Hely J cites with approval Professor Ross Parsons in his seminal treatise *Income Taxation in Australia*\textsuperscript{33} to support his reasoning. Although taken from another portion of Professor Parsons’s treatise, the following quotation outlines the proposition Justice Hely based his reasoning upon:\textsuperscript{34}

“(iii) An expense that is relevant to income derivation will be a working expense if it relates to the process by which income is derived. It will not be a working expense, and may be described as a capital expense, if it relates to the structure of the activity that produces income …

(iv) An expense which is not relevant to income derivation will not be a working expense, and may be described as a private or domestic expense.”

This same trichotomy as explained by Parsons logically applies both in the case of inflows as it does with outflows. In fact it would be absurd to suggest otherwise. Take for example the case of a taxpayer carrying on the business of banking or insurance. It has been held in a long established line of decisions that the realization of a security held by such a taxpayer when that security is part of its working capital or reserve fund will be itself on revenue account even though the lending of money at interest (or in the case of an insurance company the derivation of premiums) is the core activity. Any gain in such a case is revenue while a loss is deductible. In *Union Bank of Australia v CoT*\textsuperscript{35} Sim J observed:

“It is on the principle here stated that the question must be determined whether a loss made in realizing an investment is to be treated as a loss of capital or as a loss made in carrying on a business. …. The realization from time to time of these investments appears to be part of the ordinary business of a banker, just as much as the realization of a security given by a customer in connection with an advance. …. *It follows as a necessary result from this decision that if a loss had been made in the realization of the investment it could have been deducted from the gross profits as a loss incurred exclusively in the production of the assessable income of the company.*” (author’s emphasis).

The above discussion can usefully be shown in the following table:

<table>
<thead>
<tr>
<th>Transaction type</th>
<th>Revenue account</th>
<th>Capital account</th>
<th>Private account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflow</td>
<td><em>Income</em></td>
<td><em>Capital gain</em></td>
<td><em>Windfall gain</em></td>
</tr>
<tr>
<td>Outflow</td>
<td><em>Deduction</em></td>
<td><em>Capital cost</em></td>
<td><em>Private cost</em></td>
</tr>
</tbody>
</table>

Table One transaction type classification

**The phenomenon of Ectopia**

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\textsuperscript{32}129 FCR 494 at 503.


\textsuperscript{34}Parsons, n 32, para 5.13.

\textsuperscript{35}[1920] NZLR 649 at 656.
There is already a well received body of academic literature that confirms the authors’ general point. Professor John Prebble posits as one of the great problems of income tax law and policy the distinction between the treatment of a transaction under the pure Haig/Simons model and that we see under the modified McIntyre/Haig/Simons model that we present.

Professor Prebble observes that:

“As I have said, tax law generally taxes the results of legal transactions rather than their underlying economic effect. The courts are always telling us that tax law does not tax on the basis of economic equivalence. But the problem is deeper. In order to make income tax work at all, the law must make a number of assumptions that are not in fact correct, assumptions as to both the factual and the legal nature of the taxpayer’s income. The effect of these assumptions is that the base that the law taxes is removed even further from the facts of the case …. Which I call ‘ectopia’.”

In the domain of the revenue and capital distinction Professor Prebble illustrates ectopia by reference to the two leading decisions of the High Court of Australia in *Californian Oil Products Ltd v FCT* and *Heavy Minerals Pty Ltd v FCT*.

In *Californian Oil* by agreement dated 16th November 1927, adopting and ratifying an agreement of 30th June 1927, the Atlantic Union Oil Co Ltd (AUL) appointed the Californian Oil Products Ltd (CPL) sole agent for the sale of petroleum products and lubricating oils and greases from time to time manufactured or acquired or dealt in by the principal, during a period of five years from 1st April 1928 to 31st March 1933, in the territory of New South Wales, excepting certain specified areas. By a subsequent agreement dated 11th October 1928, between the parties, the initial agency agreement was terminated. In consideration of such termination, the AUL agreed to pay to the CPL the sum of £70,000, payable by ten equal half-yearly instalments, without interest, of £7,000 each, the first of such instalments to be paid on 1st May 1929, and the remaining instalments to be paid at successive intervals thereafter of six months each. CPL covenanted that, as from the date of the signing of the termination agreement, it would not directly or indirectly handle or deal in petroleum products of any kind. And each of the parties released the other from all claims of every kind other than those arising under and by virtue of the provisions of this agreement. The Commissioner of Taxation assessed CPL as agent to income tax in respect of the sum of £14,000 received by it under the agreement of 11th October 1928 during the year which ended on 30th June 1928.

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38Prebble, n 36, at 8-9.
39(1934) 52 CLR 28.
1931. The High Court held that the termination payments were on capital account. Dixon J for instance stating:41

“In the present case the sum in question was paid as the consideration for the termination of the agency which constituted the only business carried on by the taxpayer company. It was ‘truly compensation for not carrying on their business.’ It comes within the principles expressed by Rowlatt J in Chibbett v. Joseph Robinson & Sons [(1924) 9 TC at p 61] when he said: ‘A payment to make up for the cessation for the future of annual taxable profits is not itself an annual profit at all.’”

The reasoning being that the payments presented inflows from the disposition of the only capital asset of the taxpayer, the agency agreement, from which it earned its commissions and the like.

In Heavy Metals the taxpayer company had been formed in 1956 in New South Wales to undertake the operation of mining for a mineral known as “rutile”. To this end the taxpayer obtained a mining lease over an area of rutile rich land and installed plant and machinery. The capital structure in this case was clearly the lease, plant and machinery. The income earning operation was the extraction of rutile and sale to customers. The taxpayer entered into several long-term overseas contracts with users of rutile. Sadly the rutile market worldwide collapsed in 1957 and the various customers of the taxpayer negotiated an exit package in respect of their various contracts. The total compensation paid was £220,968 after expenses. This was not an insignificant sum in 1957 and the issue was whether this was trading income of the taxpayer. Windeyer J distinguished Californian Oil on the basis that in this case all that arose was receipt of trading profits from various customers in the form of compensation for future rutile sales and as cancellation of the supply agreements. By contrast in Californian Oil the entire structure (the agency) which earned the income (the commissions on AUL products sold to petrol stations and motor shops with New South Wales through the agency of CPL) had been disposed of. By contrast here the capital structure consisting of the leasehold, the plant and machinery remained intact. The Judge observed:42

“The appellant sought to liken the moneys which the buyers paid to be released from their contracts to a price received as a consideration for going out of business as in Californian Oil Products Ltd. v. Federal Commissioner of Taxation [1934] HCA 35; (1934) 52 CLR 28. But there is no analogy. The taxpayer’s business was mining rutile and dealing in rutile. Its capital assets were the mining lease and the plant. After the contracts were cancelled it still had these. It was free to mine its rutile and to sell it if it could find buyers: and it tried to do so. The taxpayer was not put out of business by the cancellation of its overseas contracts. It did not go out of business when they were cancelled. What happened is that because the price of rutile had drastically fallen it could not carry on its business at a profit.”

41(1934) 52 CLR 28 at 47.
42(1966) 115 CLR 512 at 517.
Having regard to the modified McIntyre/Haig/Simons model (on the assumption that capital gains are typically taxed at preferential rates and ring fenced) then clearly the effective rate of tax on the receipt in *Californian Oil* would be lower than that in *Heavy Metals* based on the distinction between the legal form of the two. This is Professor Prebble’s ectopia at work. Under a pure Haig/Simons tax base both receipts would be treated identically. Professor Prebble acknowledges however that because second best is what we use in practice then the two decisions were probably correctly decided:

“As I have explained, Windeyer J’s distinguishing of *Californian Oil Products* and his reasoning in *Heavy Minerals* were unexceptionable in law. The reason is that the High Court was not purporting to calculate Heavy Minerals’s tax liability on the basis of the profit from its actual economic business, but on the basis of the contracts that were used as the legal vehicle for that business and on the basis of the rights and duties that formed the legal context of the business. [Windeyer J] … was correct that from a legal point of view Heavy Minerals’s business remained intact, even though nobody wanted rutile at the price that they had to charge. On the other hand, Californian Oil Product’s business had depended on [one] … contractual right to buy products from the Union Oil Company. Once that right was gone there was no legal basis for their business.”

Criticism of the “gap” that arises between the treatment of a transaction under a Haig/Simons tax base and one under the modified McIntyre/Haig/Simons tax base that the authors present in the conceptual framework should not give rise to criticism of the later model per se. All of the Commonwealth systems reviewed are forced to use a realized transaction tax base and then to distinguish between revenue, capital and private inflows and outflows as a matter of equity, certainty and simplicity and administrative practicality.

**Implications**

Having derived the conceptual framework in Part Three the authors now go on to predict how the transactional and interpretational issue should be resolved having regard to the scheme and purpose of the model presented at formula 4. Our initial prediction is that the transactional measurement basis of the tax base dictates that transactions themselves are characterized according to “common law”44 legal form and that the application of any specific deduction rule for interest should preserve that form when considering whether the particular transaction falls within the rule.

**IV. The conceptual framework and the assessment process**

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43 Prebble, n 36, at 12.
44 This also includes rules equity, or statute where appropriate.
Preliminary

In Part Four the authors attempt to operationalise the conceptual framework by considering formula 4 within the context of the standard assessment process seen throughout the Commonwealth. In other words we attempt to show how formula 4 may be applied in practice having regard to the tax administration cycle.

The assessment function

In each of the jurisdictions reviewed by the authors a yearly assessment of income tax is undertaken. Whether it is the taxpayer or the taxing authority that undertakes the initial assessment, the same basic process applies. Indeed in many of the situations that are the focus of this article, the assessment at issue may well be a re-assessment of a taxpayer’s affairs after some form of audit had arisen.

A good description of the role of the assessment phase in the tax administration cycle was given by Lord Dunedin in *Whitney v IRC*:

> “Now, there are three stages in the imposition of a tax: there is the declaration of liability, that is the part of the statute which determines what persons in respect of what property are liable. Next, there is the assessment. Liability does not depend on assessment. That, ex hypothesi, has already been fixed. But assessment particularizes the exact sum which a person liable has to pay. Lastly, come the methods of recovery, if the person does not voluntarily pay.”

As to the assessment itself this involves three important steps, the finding of fact, the characterisation of the legal rights and obligations of the parties and finally the application of the specific statutory provisions.

Another description of the assessment process is found in the leading decision of Richardson J in *CIR v Canterbury Frozen Meat Co Ltd* where his Honour observes:

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46 See for example *FCT v Riverside Road Pty Ltd (in liq)* 90 ATC 4567.

47 [1926] AC 37 at p 52.

48 *Craven v White; IRC v Bowater Property Developments Ltd; Baylis v Gregory* [1988] BTC 268 at 272 per Lord Keith “My Lords, in my opinion the nature of the principle to be derived from the three cases is this: the court must first construe the relevant enactment in order to ascertain its meaning; it must then analyse the series of transactions in question, regarded as a whole, so as to ascertain its true effect in law; and finally it must apply the enactment as construed to the true effect of the series of transactions and so decide whether or not the enactment was intended to cover it.”

“The making of an assessment determines the indebtedness of the subject to the Crown. That liability is unqualified. Sanctions are provided for failure to pay. It follows that a decision which is tentative or provisional or subject to adjustment or conditional does not reflect the statutory scheme. In short, to constitute an assessment for income tax purposes the decision of the Commissioner must be definitive as to the liability of the taxpayer at the time it is made and final subject only to challenge through the objection process.”

For instance in FCT v S Hoffnung & Co Ltd50 (a case from the High Court of Australia heavily relied upon by Richardson J in Canterbury Frozen Meats) the relevant “assessment” which was variously expressed to have been made “tentatively” or “subject to revision” or to be “finalized” was held not to be an assessment within the meaning of the legislation.

In making an assessment, a decision affecting tax liability may be challenged in that the Commissioner did not follow a proper process in arriving at that decision. This equally applies where a reassessment is involved or a statutory disputes procedure is used. For instance under the New Zealand TAA Part 4A any adjustment proposed by the Commissioner after an audit must be initiated through the use of the Notice of Proposed Adjustment51 and is a statutory power amenable to judicial review under the New Zealand Judicature Amendment Act 1972.52

“In making an assessment the Commissioner is required to exercise judgment. He or she is not entitled to act arbitrarily or in disregard of the law or facts known to the Commissioner (Lowe v Commissioner of Inland Revenue [1981] 1 NZLR 326, 348; Commissioner of Inland Revenue v Walker [1963] NZLR 339).”53 (authors’ emphasis).

To set the context for the ensuing discussion and to relate the assessment function to the conceptual framework the authors show this process by way of a diagram below:

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50(1928) 42 CLR 39.
51See s 89B 1 TAA.
52Section 4(1) states “(1) On an application which may be called an application for review, the [High Court] may, notwithstanding any right of appeal possessed by the applicant in relation to the subject-matter of the application, by order grant, in relation to the exercise, refusal to exercise, or proposed or purported exercise by any person of a statutory power, any relief that the applicant would be entitled to, in any one or more of the proceedings for a writ or order of or in the nature of mandamus, prohibition, or certiorari or for a declaration or injunction, against that person in any such proceedings.”
As a “preface” to the application of the conceptual framework via its operationalisation using the standard assessment cycle the authors note the important observations of Lord Wilberforce in *W T Ramsay v IRC*.\(^{54}\) Firstly, on our prediction that the structure of the current Commonwealth tax systems mandates a formal approach in construing legal relations, Lord Wilberforce presaged this conclusion when he opined:\(^{55}\)

“Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well-known principle of *Inland Revenue Commissioners v. Duke of Westminster* [1936] A.C. 1. This is a cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded. For this there is authority in the law relating to income tax and capital gains tax: see *Chinn v. Hochstrasser* [1981] A.C. 533 and *Inland Revenue Commissioners v. Plummer* [1980] A.C. 896.”

Secondly, Lord Wilberforce also confirmed that the duty of the Court was to apply the specific legislation giving accord to the transactional basis of the taxpayer’s legal rights and obligations unless a specific rule mandated a broader approach:\(^{56}\)

“A subject is entitled to arrange his affairs so as to reduce his liability to tax. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides. It must be considered according to its legal effect.”

It is the second step (the characterization issue) and the third step (the interpretation issue) which is the focus of the remainder of this article.

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\(^{54}\)[1982] AC 300

\(^{55}\)[1982] AC 300 at 323-324.

\(^{56}\)[1982] AC 300 at 323. His Lordship went on to note that “A subject is only to be taxed upon clear words, not upon ‘intendment’ or upon the ‘equity’ of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What are ‘clear words’ is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded: see *Inland Revenue Commissioners v. Wesleyan and General Assurance Society* (1946) 30 T.C.II, 16 per Lord Greene M.R. and *Mangin v. Inland Revenue Commissioner* [1971] A.C. 739, 746, per Lord Donovan. The relevant Act in these cases is the Finance Act 1965, the purpose of which is to impose a tax on gains less allowable losses, arising from disposals.”
V. Interest deductibility and the characterisation issue

In Part Five the authors move on to apply the conceptual framework to the characterisation of interest. *A priori* we predict that the taxing authority and the Court should adopt a form approach to this task as the basic scheme and purpose of the “generic” Commonwealth tax system uses a transactional measurement basis in place of a net accretions or comprehensive income base. Also it should be noted that at common law *stare decisis* dictates that a form approach is adopted.57

Form and substance – the issue stated

The issue of form and substance in the context of taxation is an extremely important issue. The particular characterisation adopted by the taxing authority may well give rise to a different incidence of tax to that proposed by the taxpayer. A good example of the issue is found in the leading decision of the New Zealand Court of Appeal in *Mills v Dowdall*,58 a case concerning the characterisation of transactions where a gift duty avoidance scheme had been undertaken. The background to the case was that the parties had been married in 1964 and had separated in 1977. The case involved the division of matrimonial property under the former Matrimonial Property Act 1976 (NZ).

As part of an asset planning structure (which also avoided the imposition of gift duty) the father and mother of the husband had transferred certain assets to their son being shares in a private company and a holiday home. On 24 August 1967 the husband’s father transferred 350 shares in a family company to the husband for a stated consideration of $2 per share. On the same day the father executed a deed of forgiveness of the whole debt. The husband’s mother, on 8 April 1975, executed a transfer of a house property to the husband for a consideration of $47,500, the whole of which was secured by a first mortgage back. On the same day the debt so secured was reduced by $4000 by gift and on 8 February 1977 a further $7500 was forgiven. The balance of $36,000 remained owing, but it was accepted by both spouses that at the time of the transfer it was the mother’s intention that the house would eventually become the husband’s property free of encumbrances without any payment being made by him; although there was no binding obligation on the mother to continue the gifting programme.

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57See the recent High Court affirmation of the objective form approach in *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 211 ALR 342 at para 40. “This Court, in *Pacific Carriers Ltd v BNP Paribas*[208 ALR 213], has recently reaffirmed the principle of objectivity by which the rights and liabilities of the parties to a contract are determined. It is not the subjective beliefs or understandings of the parties about their rights and liabilities that govern their contractual relations. What matters is what each party by words and conduct would have led a reasonable person in the position of the other party to believe. References to the common intention of the parties to a contract are to be understood as referring to what a reasonable person would understand by the language in which the parties have expressed their agreement. The meaning of the terms of a contractual document is to be determined by what a reasonable person would have understood them to mean. That, normally, requires consideration not only of the text, but also of the surrounding circumstances known to the parties, and the purpose and object of the transaction.”

The only issue before the Court of Appeal was whether these two items were excluded from the matrimonial property by s 10(1) of the Matrimonial Property Act 1976 as having been acquired by the husband “by gift from a third person”. There had been no intermingling with other matrimonial property.

The husband in effect chose to argue that both assets were acquired by way of gift by characterising the legal effect of each series of transactions based on their economic substance. Here, the end result of each series of transactions, was that the husband had acquired each asset without paying for them. Thus he argued it was a ‘gift” of the property in each case and excluded from the matrimonial pool.

By way of contrast the legal form of the series of transactions was that two separate transactions were effected in each case. First, there was a transfer of the asset for value (the debt). Second, part of the debt was gifted.

The Court of Appeal firmly rejected the argument advanced by the husband. Richardson J noted:

“On those facts the legal answer seems straightforward and obvious. The appellant acquired both the legal title and the equitable ownership of the shares in one case and the land in the other. He did so under the instrument of transfer. As property acquired by the appellant after the marriage it was brought within the matrimonial property net by s 8(e) unless excluded by any other provision of that legislation. The only such exclusion provision relied on is s 10(1). Giving the material words of that subsection their natural and ordinary meaning, the property in question acquired by the husband was not acquired by gift. It was acquired by purchase and the contractual obligation of the appellant to pay the agreed purchase price became the subject of the deed (or deeds) of forgiveness. On that analysis the gift in each case was of a monetary sum by way of forgiveness of that debt, not of the shares or the land.”

The Judge went on to observe that on the basis of this approach and the material before the Court it was not possible to warrant characterising the transaction in each case as involving a gift of the property the subject of the transfer (that is of the land and the shares). There was no evidence to suggest that the true bargain between father and son (and mother and son) was not fairly reflected in the legal arrangements that were entered into and carried out. The father could have executed a transfer of the shares by way of gift. The final position of the parties as between themselves at the end of the day would then have been the same as was achieved in the two steps that were employed. He elected not to do so but instead chose to sell the shares to his son and to forgive the resulting indebtedness. The mother, too, could have transferred the house property to the son by way of gift had she been prepared to incur a substantial liability for gift duty. She chose

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59 Per Richardson J in Mills v Dowdall [1983] 154 at 159.
not to do so and in terms of the legal arrangements entered into the appellant acquired the ownership of the land by purchase, not gift. 61

The traditional approach in tax cases

Traditionally, the Commonwealth courts have adopted a form approach in tax cases. 62 Such an approach was recognised by the decision of the House of Lords in IRC v Duke of Westminster although it was already a well accepted canon of legal construction in the context of the common law. 63 Why Westminster was important was that it applied the form approach in a tax case and was one that involved a deliberate scheme to minimise tax.

Westminster has subsequently been accepted and endorsed by the Appellant courts in both Australia, 64 Canada 65 and New Zealand. 66 For instance it was applied in New Zealand by the decision of the Privy Council in CIR v Europa Oil (NZ) Ltd 67 and the Court of Appeal in Re Securitibank Ltd (No 2). 68 In Finnigan v CIR 69 Richardson J observed:

“The legal principles governing the characterisation of transactions and payments made under transactions are well settled. Parties are free to choose whatever lawful arrangements will suit their purpose. The true nature of their transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. That does not turn on an assessment of the broad substance of the transaction or of the overall economic consequences to the parties or of legal consequences which would follow from an alternative course which they could have adopted but chose not to do. It is the legal character of the transactions that is actually entered into and the legal steps which are followed which are decisive. The only exceptions to those principles are where the essential genuineness of the transaction is challenged and sham is established and where there is a statutory provision such as a s [BG 1] of the Income Tax Act

61 Mills v Dowdall [1983] 154 at 161. Per Richardson J at 161 “The reason why the Courts have adopted the approach I have been discussing is obvious enough. Commercial men are entitled to order their affairs to achieve the legal and lawful results which they intend. If they deliberately enter into a genuine transaction intended to operate according to its tenor, those intentions should be recognised. It is what they choose to do that counts and their rights and obligations should be determined on that basis except where the legislation has itself directed otherwise.”


63 See Lord Wright MR in IRC v Ramsay (1935) 20 TC 79 at 94.

64 Cecil Bros Pty Ltd v FCT (1962–1964) 111 CLR 430.


69 (1995) 17 NZTC 12,170 at p 12,173
mandating a broader or different approach which applies in the circumstances of the particular case”.

While the traditional position on form and substance was fairly well settled the advent of the doctrine of “fiscal nullity” in the United Kingdom starting in the early 1980’s did cause many commentators to question whether a “new” approach in taxation cases was afoot. This is indeed a key issue in the substantive parts of this article in the specific context of interest payments but the authors briefly consider the point next.

The new awakening?

In *W T Ramsay Ltd v IRC* many commentators argue that a new substance approach to tax cases (in particular those involving tax avoidance) was developed by the House of Lords. The normal claim is that the House of Lords developed a “judicial general anti-avoidance rule” that allowed transactions (or a series thereof) that had been undertaken for no bona fide purpose other than to minimise tax to be disregarded – in other words – a “fiscal nullity”. The searing intelligence behind such observations failed however to provide any juridical basis for such a doctrine unless of course these fiscal pundits were wholly unaware of the rule of law and the doctrine of parliamentary sovereignty. Indeed in *Westmoreland Investments Ltd v MacNiven (HMIT)* Lord Hoffmann expressly made this point on the subject of fiscal nullity:

“My Lords, I am bound to say that this does not look to me like a principle of construction at all. There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. All other ‘principles of construction’ can be no more than guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation. But Mr McCall’s formulation looks like an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose

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70 A general anti-avoidance income tax rule otherwise known as a GAAR.
71 See *W T Ramsay Ltd v IRC* [1982] AC 300.
73 [1982] AC 300.
76 See a real life application of this point in the famous case *Fitzgerald v Muldoon and Others* [1976] 2 NZLR 615. A purported suspension of the New Zealand Superannuation Act 1974 by the then Prime Minister, the Hon R D Muldoon was held to be illegal within the meaning of s 1 of the Bill of Rights (1688) (Eng) by Chief Justice Wild who noted at 620: “I am bound to hold that in so doing he was purporting to suspend the law without consent of Parliament. Parliament had made the law. Therefore the law could be amended or suspended only by Parliament or with the authority of Parliament. ’The principle of Parliamentary sovereignty means neither more nor less than this, namely, that Parliament thus defined has, under the English constitution, the right to make or unmake any law whatever; and, further, that no person or body is recognised by the law of England as having a right to override or set aside the legislation of Parliament’ *Dicey's Law of the Constitution* (10th ed.) 39.”
77 [2001] BTC 44 at 51.
of any particular provision, save for the possibility of rebuttal by language which can be brought within his final parenthesis. This cannot be called a principle of construction except in the sense of some paramount provision subject to which everything else must be read, like s. 2(2) of the European Communities Act 1972. But the courts have no constitutional authority to impose such an overlay upon the tax legislation and, as I hope to demonstrate, they have not attempted to do so.” (authors’ emphasis).

Despite all the rhetoric the House of Lords in one of the more recent decisions on the subject - Barclays Mercantile Business Finance Ltd v Mawson (HM Inspector of Taxes) 78 observed in a joint judgment:

“Cases such as these gave rise to a view that, in the application of any taxing statute, transactions or elements of transactions which had no commercial purpose were to be disregarded. But that is going too far. It elides the two steps which are necessary in the application of any statutory provision: first, to decide, on a purposive construction, exactly what transaction will answer to the statutory description and secondly, to decide whether the transaction in question does so.”

In other words, in Barclays Mercantile, the House of Lords confirmed that in the absence of an avoidance provision, a court did not have the power to nullify a transaction for tax purposes simply because of an underlying tax avoidance purpose (or in the wider context of this article some other aspect of public policy), when considering whether another specific provision of the taxing legislation applied to the same transaction.

The true effect of “fiscal nullity”

As stated in other contexts by the authors 79 it is preferable to rationalise the doctrine of “fiscal nullity” on purely orthodox grounds having regard to the three component steps of the assessment process, the finding of fact, the construction of the legal arrangements and the application of the taxing legislation. It is submitted that the ambit of the W T Ramsay Ltd was thus confined by the House of Lords in Barclays Mercantile to ensuring that the interpretation of taxing legislation was approached on a “purposive basis”  and that in construing legal transactions, while the form approach still applied, closer scrutiny would be made of the “legal transactions” to see what the their true effect in law was. There was also it is further submitted much more emphasis placed on objective findings of fact relying on circumstantial evidence. 80 This is evident in the following observation in the same case: 81

80See for instance in another context which could easily be termed “fiscal nullity” the decision of the High Court of Australia in FCT v Myer Emporium Ltd 163 CLR 199 at 209 per Mason ACJ, Wilson, Brennan, Deane and Dawson JJ “But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances[ objective facts] of the case.” (authors’ emphasis).
81[2004] BTC 414 at 422.
“The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of statute, upon its true construction, applies to the facts as found.”

We now move on to consider the characterization of interest and to show that the form approach is indeed appropriate.

**The legal nature of interest and its characterisation**

When analysed correctly, “interest” is in fact a generic term that includes both the traditional payment as consideration for a loan of money and compensation for money had and received. In *Colonial Mutual Life Assurance Society Ltd v CIR*82 Richardson P recognized this point:

“interest is not a technical word. It is not confined to payment for the use of money lent. The word is commonly used to describe compensation for delay in payment of amounts due in respect of late payment, for example, of trade debts. Where it relates to delay in making a payment of a particular character, it may readily be ascribed that same character”

From a taxation perspective both forms of “interest” may be potentially deductible.

**Interest as compensation**

The first type of “interest” the authors examine is broadly what may be termed “compensatory interest” – this arises as compensation for monies payable on a debt which arises otherwise than from money lent. As an example under the Companies Act 1993 (NZ), s 301 confers on the High Court the right to order repayment or restoration of money, and *interest* on that money, in the liquidation of companies. It should be noted that under the common law or equity there was historically no right to compensation for the time value of money in respect of a debt arising by operation of law. In the leading decision of Lord Denning MR in the English Court of Appeal - *Jefford and another v Gee*83 his Lordship notes:84

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83 [1970] 1 All ER 1202 at 1205.
“The rule of the common law of England was that, in the absence of express agreement, interest could not be recovered on a debt or damages and equity in this respect followed the law.”

A similar position was reached in relation to the New Zealand taxing legislation in *Chatswood Estate Limited v CIR*.85

**Characterisation of compensatory interest**

While these cases consider whether interest may be awarded as part of a claim in common law or equity the alternate situation recognized in *Jefford* was where there was an express agreement by the parties. The critical point here is that it is still a matter of contractual interpretation or of identifying the statutory basis of the particular charge to decide the exact juridical nature of the interest obligation. An economic equivalence approach is totally inappropriate.

Conclusive authority on this point is the decision of the Privy Council in *Fahey v MSD Speirs Ltd*.86 In *MSD Speirs Ltd* the respondent, a supplier of building materials, allowed a discount for prompt payment, but if an account was overdue for a period of three months interest was added at the rate of one percent per month. On 1 December 1968 the Fahey Construction Co Ltd was indebted to the respondent in the sum of $10,070.06 and faced with a refusal by the respondent to supply further materials unless the account was paid or security given. On 2 December 1968 the appellant signed a personal guarantee that he would “pay for any materials which are purchased from MSD Speirs Ltd by Fahey Construction Co Ltd in the event of Fahey Construction Co Ltd not being in a position to do so.” Fahey Construction went into liquidation and the appellant sought to avoid the personal guarantee (*inter alia*) by reason of the fact that the respondent’s terms of business included the provisions as to interest and thus the company was a money lender within the meaning of the former Moneylenders Act 1908 (NZ) and was not registered. Section 2 of that Act held that with certain exceptions the term “moneylender” included every person (whether an individual, a firm, a society or a corporate body) whose business was that of moneylending or who advertised or announced himself or held himself out in any way as carrying on that business.

Lord Morris delivering the judgment of the Privy Council observed:87

“Their Lordships see no evidence at all that the respondent was carrying on the ‘business’ of moneylending. The respondent’s letter to its customers in April 1967 showed that its genuine concern and desire was that accounts should be paid and should not be

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84 Lord Denning also referred to the comments of Best CJ in *Arnott v Redfern* (1826) 3 Bing 353 (at p 359) to support his conclusion.
86 [1975] 1 NZLR 240.
87[1975] 1 NZLR 240 at 246.
outstanding. The reason why interest was to be charged on overdue amounts was so that prompt payment would be encouraged. There were none of the elements of a disguised loan transaction. The transactions were genuine sale transactions. To regard purchasers who were dilatory in their payments to a vendor as being borrowers from a moneylender would be wholly irrational.”

Hence the Privy Council were quite prepared to conclude “interest” was properly chargeable as regards an overdue debt but at the same time not prepared to characterise the underlying transaction as a “loan of money”. This approach was amplified by the New Zealand Court of Appeal in Re Securitibank where Richardson J notes “It is the legal character of the transaction which is decisive, not the overall economic consequences to the parties …”. If a statutory provision giving rise to an interest charge is at issue, then, the normal purposive approach to statutory interpretation is mandated. For instance in New Zealand - formerly s 5(j) Acts Interpretation Act 1924 (NZ) and now s 5(1) Interpretation Act 1999 (NZ) mandates a purposive approach. Under such an approach the words used in an enactment are to be considered in light of the objects which the statute and the part of the legislation at issue is intended to achieve. In the leading decision Challenge Corp Ltd v CIR Richardson J (as he then was) notes:

“In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and s 99 under the statute and of the relation between them. That

89[1978] 2 NZLR 136 at 167. Richardson J went on to observe (at 169) that the legal rights and obligations were not to be determined conclusively by the nomenclature used by the parties. Consideration must be given to the whole of the contract in order to determine the true nature of the relationship. If the transaction was embodied in a number of interrelated agreements, all the agreements must be considered together and one may be read to explain the others. The first question then in this class of case was: what is the substance of the bargain as disclosed by the documents before the Court (Re George Inglefield [1933] Ch 1, at 24). In arriving at the answer to that question, the circumstances surrounding the entering into the transactions may be taken into account. This did not mean that evidence is admissible to vary or contradict the written agreement; only that before you construe the agreement you are entitled to understand the setting in which it was made and that you construe it against that background. While then it was legitimate to take into account surrounding circumstances and to look at the documents as a whole, the documents themselves might be brushed aside only if and to the extent that the parties had a common intention that they were not to create the legal rights and obligations which they gave the appearance of creating and in that sense were shams. Finally, the concern was with the legal arrangements actually carried out. It was what the parties eventually did that counts, not what they may initially have agreed to do. In some cases the parties may have departed from the initial agreement, in which event questions of a new agreement or variation of the original agreement, or estoppel, or sham in operation may arise. But that was not in question here and required no further consideration. It was also unnecessary on the facts of this case to consider further the two qualifications to the principle that the rights and obligations of the parties to an agreement are determined according to the terms of the agreement which have been adverted to: first, where the essential genuineness of the documentation of the arrangements is challenged and sham is alleged; and second, where there is a statutory provision directing a broader or different approach designed to prevent the erosion of the policy of the legislation by refusing recognition to attempts to structure arrangements so as to take them outside or bring them within the statutory provision as the case may be, or by directing attention to the end result or economic purpose of the transaction.
90 See the excellent discussion by Somers J in the leading New Zealand Court of Appeal case Donselaar v Donsellar [1982] 1 NZLR 97 at 114.
91 [1986] 2 NZLR 513 at 549 (CA).
is a matter of statutory construction and the twin pillars on which the approach to statutes mandated by s 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in 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."

The High Court of Australia in Cooper Brookes (Wollongong) Pty Ltd v FCT\(^{92}\), the Supreme Court of Canada in Stubart Investments v The Queen\(^{93}\) and the House of Lords in WT Ramsay v IRC\(^{94}\) have all approved of purposive interpretation in the context of taxation legislation of whatever description.

**Interest as a return for money lent**

The second type of “interest” covered by the principle discussed by Lord Denning in Jefford was where the underlying transaction was a “loan of money” with the consideration being the payment of interest by the debtor to the creditor.\(^{95}\) In this situation the correct characterisation of the underlying loan is critical. In Re Securitibank Ltd the Court of Appeal analyses the nature of a “loan of money”. Richardson J states:\(^{96}\)

“The third is that the essence of a loan of money is the payment of a sum of money on condition that at some future time an equivalent amount will be repaid. In this case it was accepted by the respondent that the payment of the acceptance fee could not be characterised as a loan …”

A similar approach is also found in the leading decision Chow Yoong Hong v Choong Fah Rubber Manufactory\(^{97}\) where Lord Devlin, delivering the judgment of the Privy Council states:

“There are many ways of raising cash besides borrowing. One is by selling book-debts and another by selling unmatured bills, in each case for less than their face value. Another might be to buy goods on credit or against a post-dated cheque and immediately sell them in the market for cash. Their Lordships are, of course, aware, as was Branson J [in Olds Discount Co Ltd v John Playfair Ltd [1938] 3 All ER 275], that transactions of this sort can easily be used as a cloak for moneylending.”

The critical point to take from Chow Yoong Hong is that at common law, the “task of the court in such cases is clear. It must first look at the nature of the transaction which the

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\(^{93}\) (1984) 10 DLR (4th) 1 at 32.
\(^{94}\) [1982] AC 300 at 323.
\(^{95}\) Re National Bank of Wales Ltd [1899] 2 Ch 629.
\(^{96}\) 1978] 2 NZLR 136 at 167.
parties have agreed. If in form it is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money.”

Characterisation of interest on money lent

As has already been noted above, the characterisation of a transaction as one of a loan of money with interest is governed by the normal rules of contractual interpretation – clearly following a form basis. In the leading decisions of the Court of Appeal in Buckley & Young, Finnegan and Boat Park Ltd v Hutchinson a series of guidelines have been established:

1. In deciding the character of the payments and benefits provided in an agreement it is necessary to determine the true nature of the legal arrangements pursuant to which the payments were made and the benefits provided;
2. It is well established that the true nature of a transaction must be ascertained by reference to the legal arrangements actually entered into and carried out.
3. It is the legal character of the transaction actually entered into determined by the contractual arrangements which is decisive, not the overall economic consequences to the parties.

98[1961] 3 All ER 1163 at 1167. In Olds Discount Co Ltd v John Playfair Ltd [1938] 3 All ER 275 at 279. Branson J pithily put the argument raised by the defendants that the legal form of the particular transactions could be ignored despite having executed the proper documentation in these terms: “However, it is said on behalf of the defendants: ‘In spite of the fact that we have entered into the agreements which are before the court, and which in express terms are agreements for the purchase and payment of book debts, we ask the court to say that that does not represent the real transaction between the parties, and that the real transaction between the parties was not a transaction of purchase and sale, but a mere moneylending transaction to be repaid by monthly payments secured by bills of exchange.’ No evidence has been called by the defendants of anybody who was a party to these agreements who has dared to come into the witness-box and say that that was the fact of the case. That is not surprising, because, when people of sound understanding and business experience put their hands to an agreement which expressly says that it is an agreement for the absolute sale and purchase of book debts, it is asking a good deal for those persons to come before the court and to say: ‘Notwithstanding that we entered into that agreement, it is quite untrue to recite, as we have recited, that the fact was that we were entering into an ordinary transaction of loan, and the reason why we want the court to believe us when we say that is that we shall be able to take advantage of the Moneylenders Act and repudiate the agreement into which we have entered.’”

100(1995) 17 NZTC 12,170.
102Per Richardson J in Buckley & Young Ltd v CIR [1978] 2 NZLR 485at 489 - the starting point is to consider the documentation embodying the transaction. In IRC v Ramsay (1935) 20 TC 79 at 94 Lord Wright MR observed: “The decision in any particular case can only be arrived at by considering what is the substance of the transaction in question, and what is the substance of that transaction can only be ascertained by a careful consideration of the contract which embodies the transaction.”
103Commissioners of Inland Revenue v Wesleyan and General Assurance Society (1946) 30 TC 11. See also Nicholls v CIR [1965] NZLR 836 at 845.
104In this context see IRC v Duke of Wesminister [1936] AC 1 at 25 Lord Russell of Killowen said: “If all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or non-taxability in accordance with the
4. While the nomenclature used by the parties is not decisive, it is the legal rights and duties created by the transaction into which the parties entered and as ascertained by ordinary legal principles, taking into account surrounding circumstances, that must be determined. Following Lord Hoffmann’s careful remarks in the decision of the House of Lords in *Investors Compensation Scheme Ltd v West Bromwich Building Society* several points on contractual interpretation are now part of the jurisprudence.105

5. Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.106

6. The background was famously referred to by Lord Wilberforce in *Prenn v Simmonds*107 as the “matrix of fact”, but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.108

7. Thus, while it is legitimate to take into account surrounding circumstances and to refuse to be blinded by terms employed in documents, the documents themselves may be brushed aside only if and to the extent that they are shams, in the sense of not being bona fide in inception or of not having been acted upon, and are only used in whole or in part as a cloak to conceal a different transaction or if required by a provision such as s BG 1 Income Tax Act 2007.109

8. The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them110.

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legal rights, well and good .... If, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine”.

106[1998] 1 All ER 98 at 114.
107[1971] 3 All ER 237 at 239-240. Lord Wilberforce notes: “In order for the agreement of 6 July 1960 to be understood, it must be placed in its context. The time has long passed when agreements, even those under seal, were isolated from the matrix of facts in which they were set and interpreted purely on internal linguistic considerations. There is no need to appeal here to any modern, anti-literal, tendencies, for Lord Blackburn’s well-known judgment in *River Wear Comrs v Adamson* ((1877) 2 A Cas 743 at 763, [1874–80] All ER Rep 1 at 11) provides ample warrant for a liberal approach. We must, as he said, enquire beyond the language and see what the circumstances were with reference to which the words were used, and the object, appearing from those circumstances, which the person using them had in view.” (authors emphasis).
108[1998] 1 All ER 98 at 114.
9. The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax.\textsuperscript{111}

10. The “rule” that words should be given their “natural and ordinary meaning” reflects the commonsense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had.\textsuperscript{112}

“The conclusion to which I have already come about the meaning of “$6.50 per GJ” is merely reinforced if reference is made to the negotiations between the parties which led to the letter of 15 October 2004. The traditional view has been that it is impermissible to have regard to negotiations when interpreting a contract. The House of Lords has recently confirmed that view in Chartbrook and it continues to hold sway in Australia.\textsuperscript{7} It is not, however, an absolute rule of exception. It has no application when the negotiations are considered “not in order to provide a gloss on the terms of the contract, but rather to establish the parties’ knowledge of the circumstances with reference to which they use the words in the contract”.\textsuperscript{8} Those circumstances include, just as much as “the genesis of the transaction, the background, the context, the market in which the parties are operating”,\textsuperscript{9} the subject matter of the intended contract as Mason J made clear in Codelfa Construction Pty Ltd v State Rail Authority (NSW):\textsuperscript{10} Obviously the prior negotiations will tend to establish objective background facts which were known to both parties and the subject matter of the contract. To the extent to which they have this tendency they are admissible.

The scope of the subject matter in part defines “the commercial or business object of the transaction objectively ascertained”, which Lord Wilberforce himself in Prenn v Simmonds\textsuperscript{11} considered to be a surrounding fact to which reference could be made. Differing in this respect from the view McGrath J takes as to the extent of what he calls the “subject matter exception”,\textsuperscript{12} I see no reason why it can be called in aid, if necessary, for the purpose of ascertaining that the contract was concerned with a gas supply but not to learn that it dealt with gas only. If there is, as I think, a subject matter exception, there cannot sensibly be degrees of subject matter. There is of course an important qualification that any material which is simply declarative of the subjective intentions of one party must be disregarded. But there is no reason in principle why the Court should not have regard to communications between the parties for the light they may throw upon the objective commercial purpose and, in particular, what ground the contract was to cover. The question of how much further the courts of this country should go towards admitting evidence of negotiations for the light they may shed on the objective intention of the parties can be left for another day.”

\textsuperscript{111}[1998] 1 All ER 98 at 115 (see Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd [1997] 3 All ER 352, [1997] 2 WLR 945).

\textsuperscript{112}[1998] 1 All ER 98 at 114. Lord Diplock made this point more vigorously when he said in Antaiox Cia Naviera SA v Salen Reederierna AB, The Antaiox [1984] 3 All ER 229 at 233, [1985] AC 191 at 201 “if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense.”
11. A deed or other instrument must be construed as a whole and, if the transaction is embodied in a number or complex of interrelated agreements, then all the agreements must be considered together and one may be read to explain the others.\textsuperscript{113}

Possibly the rule at point eleven is one of the most overlooked yet important when it comes to taxation issues regarding a “loan of money”. More than once a taxing authority in at least one of the jurisdictions reviewed has indeed tried to “amalgamate” several quite separate legal contracts to re-characterise that series of contracts as one “economically equivalent” arrangement or transaction.\textsuperscript{114}

Conclusion

Our preliminary view is that the predicted result from applying the conceptual framework \textit{a priori} to the issue of the characterisation of interest is proven \textit{a posteriori} having regard to the manner in which the Commonwealth Courts construe legal obligations generally and specifically which concern money lending and forms of debt giving rise to interest. This is a logical extension of the fact that the modified Haig/Simons tax base we present uses transactions as the basic unit of measurement. We also note that in other areas of commercial law where legislation is superimposed over common law contractual forms the same policy process may been seen. In \textit{Re Securitibank Ltd} Richardson J made a similar point concerning the application of the Bills of Exchange Act 1908 (NZ), s 55(1). His Honour noted that the apparent “legislative policy” reflected in the bills of exchange legislation. Richardson J observed.\textsuperscript{115}

\textsuperscript{113}See \textit{Manks v Whitely} [1912] 1 Ch 735.
\textsuperscript{114}See \textit{Shell Canada Ltd v Canada} [1999] 3 SCR 622. In 1988, Shell required approximately US$100 million for general corporate purposes. To get the money at the lowest possible after-tax cost, first, it entered into debenture agreements with three foreign lenders borrowing NZ$150 million at the market rate of 15.4 percent per annum. Shell was required to make 10 semi-annual interest payments of NZ$11.55 million. The principal was to be returned to the lenders in 1993. Second, Shell entered into a forward exchange contract with a foreign bank, pursuant to which it used the NZ$150 million to purchase approximately US$100 million. The forward exchange contract also allowed Shell to exchange a specified amount of US dollars for NZ$11.55 million on each day that a semi-annual payment to the lenders was due, and to exchange another specified amount of US dollars for NZ$150 million when the time came to repay the principal to the lenders. The exchange rates in the forward exchange contract were established by reference to the forward exchange rates for NZ dollars for the period of the loan. When computing its income for tax purposes, Shell relied on s. 20(1)(c) of the ITA and deducted the interest, calculated at the rate of 15.4 percent per annum, that it had paid under the debenture agreements. For its 1993 taxation year, Shell reported a capital gain of approximately US$21 million. The Minister of National Revenue reassessed Shell for the 1992 and 1993 taxation years on the basis that it was only permitted to deduct interest at the rate it would have paid had it borrowed US dollars, i.e., 9.1 percent per annum. The claimed capital gain for the 1993 taxation year was also reassessed as being on income account. The Tax Court of Canada set aside the Minister’s reassessment. The Federal Court of Appeal allowed the Minister’s appeal but held that Shell could claim the net foreign exchange gain on capital account. Shell appealed to the Supreme Court on the interest rate issue and the Minister cross-appealed on the capital gain issue. McLachlin J at para 39 rejected the notion the separate contracts could be amalgamated as one.
\textsuperscript{115}[1978] 2 NZLR 136 at 173.
“By drawing a bill the drawer engages that on due presentation it will be accepted and paid according to its tenor (Bills of Exchange Act 1908 [(NZ)], s 55(1)). And it is basic to the law of negotiable instruments that negotiation transfers title: and it does not operate as a charge or mortgage. It derogates from the commercial principles inherent in bills of exchange legislation not to allow genuine documents, which are in form bills and which are assigned in accordance with legal requirements, to take effect according to their terms. That may be required in some cases. For example, where bills of exchange are made or given in relation to transactions which are governed by regulatory legislation, the acquisition or transfer of rights by the use of bills may in turn be qualified or controlled by the terms of that legislation.”

Richardson J concluded that the policy of the bills of exchange legislation reinforced the importance of determining the true nature of a transaction involving the use of bills in accordance with the terms of the documents and agreements actually entered into and carried out. This is directly analogous with the approach advocated here by the authors.

**VI. The interpretation issue**

In Part Six the authors apply the conceptual framework to the issue of the application of statutory deduction provisions in the Commonwealth (the interpretation issue). To be clear our focus in this article is to consider whether the same approach seen in *Re Securitibank Ltd* applies in the case of interest. In other words does the generic policy of the Commonwealth income tax systems we have reviewed (and that admittedly adopt a transactional measurement basis) make as paramount the importance of determining the true nature of a transaction involving the interest contracts in accordance with the terms of the documents and agreements actually entered into and carried out? *A priori* we would conclude that this is indeed the case and the concept of ectopia illustrates this point.

**Schema of Part Six**

*A priori* we predict that the taxing authority and the Court should adopt a form approach to this task as the basic scheme and purpose of the “generic” Commonwealth tax system uses a transactional measurement basis in place of a net accretions or comprehensive income base. However as noted in cases such as *Usher’s Wiltshire Brewery Ltd v Bruce*116 by Earl Loreburn this is subject to the caveat that the specific legislation may modify such an approach:

“The reasons given were that profits and gains must be estimated on ordinary principles of commercial trading by setting against the income earned the cost of earning it, subject to the *limitations prescribed by the Act.*” (authors’emphasis).

116[1915] AC 433 at 444.
We briefly review the substantive nature of the specific deduction rules in the jurisdictions under consideration to provide context to our main point as described above.

**Introduction to statutory deduction provisions**

While it is clearly beyond the scope of this article to provide a detailed analysis of the statutory deduction regimes of Australia, Canada, New Zealand and the United Kingdom the authors may make some general observations about the broad approach seen in these jurisdictions.

**Global vs scheduler systems**

In the schedular system, each of the major income flows, salaries and wages, dividends, rent, and profits, is subject to a different tax base and rate. The global income tax is imposed on income aggregated from all sources, after personal exemptions, deductions, and so forth, on the basis of a single rate or graduate rates.

**Global systems**

Under a global income tax system all receipts subject to tax are aggregated and allowable deductions subtracted. After any allowances the rate schedule is applied appropriate to the entity concerned. In the case of a jurisdiction that also has a capital gains tax the net capital gain (or loss) is ring fenced and taxed at a preferential rate if a gain or carried forward separately as a capital loss.

In so far as Australia and New Zealand are concerned the “general deduction rule” governs the deductibility of most interest incurred in relation to an income earning activity. In Canada because of the development of the jurisprudence in relation to the deductibility of interest under the Canadian general deduction rule, a specific provision was enacted.

As a broad statement all three jurisdictions (in the case of money lent at interest) look to the “use” of the interest in the year of deduction rather than the original purpose of the loan or indebtedness. For instance in the leading decision of the High Court of Australia in *Steele v DFCT* the majority consisting of Gleeson CJ, Gaudron and Gummow JJ observed that the “principal issue in this appeal concerns the deductibility, for income tax

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117 forthcoming
119 See n 2.
120 See n 2.
121 99 ATC 4242.
purposes, of interest where the borrowed money has been used to purchase and hold a capital asset intended to be developed for income-producing purposes.”

Their Honours went on to state:

“However, in the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited term of loan funds, then it is proper to regard the interest as a revenue item, and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset.”

In the same vein McLachlin J Shell Canada Ltd v Canada observed that the correct approach to the “nexus” requirement to gain deductibility of interest under s 20(1)(c)(i):

“focuse[d] not on the purpose of the borrowing per se, but rather on the taxpayer’s purpose in using the borrowed money. As Dickson C.J. stated in Bronfman Trust, supra, at p. 46, ‘the focus of the inquiry must be centered on the use to which the taxpayer put the borrowed funds’”.

It is submitted a similar chain of reasoning was employed by the New Zealand Court of Appeal in the early leading decision - Public Trustee v C of T. In that case the issue before the Court of Appeal was whether interest paid on borrowed monies used to pay estate or death duties was deductible. The Public Trust (acting on behalf of the estate) would have been forced to sell income producing assets to pay the debt if borrowing had not arisen. Myers CJ considered that there was a sufficient connection between the interest and the Public Trust’s income earning assets. Myers CJ considered that the borrowing “left the money so borrowed or its equivalent in capital assets”.

In the narrower case of interest paid as compensation for a debt otherwise arising than by borrowing it is submitted that the issue will simply be a matter of whether the particular item has a sufficient nexus with an income earning activity – clearly when no loan of money has arisen at law then the interest (such as interest payable to the Crown for overdue tax debt) will have to be examined under different principles other than a “use” test.

More correctly, the question should be whether the involuntary expense (such as compensatory interest) arises as a “working expense” of the taxpayer’s income earning process.

For instance in the specific New Zealand context in relation to legal costs, in the leading Text CCH, New Zealand Income Tax Law and Practice it is noted there is no provision

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123 ATC 4242 at 4244.
125 ATC 4242 at 4248.
127 [1938] NZLR 436.
128 CCH, New Zealand Income Tax Law and Practice at para 316-800.
of the New Zealand legislation which specifically deals with the deductibility of legal expenses. This means that the deductibility of legal expenses is determined by the fact that the character of those expenses is such that they are to be recognised as deductible under the general deduction provision of the s DA 1(1)(a).

In this way, the fact that the expenses are “legal expenses” is not, on its own, sufficient to justify deduction. Authority for that view may be found in Hallstroms Pty Ltd v FCT where Dixon J said: 129

“The claim is to deduct legal expenses, and legal expenses, we may assume, take the quality of an outgoing of a capital nature or of an outgoing on account of revenue from the cause or the purpose of incurring the expenditure. We are, therefore, remitted to a consideration of the object in view when the legal proceedings were undertaken, or of the situation which impelled the taxpayer to undertake them.”

The author submits that the deduction of compensatory interest should be governed, by the same broad concept. The author terms this the “working expense” approach. In the leading decision of the High Court of Australia in John Fairfax & Sons Pty Ltd v FCT Menzies J opined: 130

“To make a payment to acquire or to defend the acquisition of a favourable position from which to earn income or to enter into arrangements that will yield income is not in general an outlay incurred either in gaining or in carrying on business for the purpose of gaining assessable income; such a payment in the case of a trading company, occurs at a stage too remote from the receipt of income to be so regarded. To be deductible an outlay must be part of the cost of trading operations to produce income, i.e., it must have the character of a working expense.”

So too for compensatory interest. The question to ask thus is whether the particular payment of compensatory interest (possibly interest paid on overdue trade debts or as a penalty under a long-term construction contract) is “… part of the cost of trading operations to produce income, i.e., it must have the character of a working expense.”

**Schedular system**

Under the United Kingdom legislation and despite the simplification process a schedular system still remains for all practical purposes. It is beyond the scope of this article to consider the breadth of the United Kingdom deduction provisions save to concentrate on the most relevant statutory provision in terms of this discussion, s 34(1) ITTOIA 2005 (Part 2) which relates to trading income. Under s 5 of that legislation “Income tax is charged on the profits of a trade, profession or vocation.” Then the more specific deduction rule holds in s 34(1) “In calculating the profits of a trade, no deduction is

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129 72 CLR 634 at 647.
130 (1959) 101 CLR 30 at 48.
allowed for … expenses not incurred wholly and exclusively for the purposes of the trade …” (authors’ emphasis). In *Scorer (HMIT) v Olin Energy Systems Ltd*[^131^] Walton J observed about the deduction of interest under s 34(1), namely:[^132^]

“… we take the view that the question whether interest was paid for the purposes of a trade must depend upon whether the loan, on which the interest was paid, was incurred for the purposes of that trade. It does not necessarily follow that the purposes of the loan can be ascertained by looking at the immediate use to which the borrower applies the money. The question is one of fact to be decided on the evidence available in each case.”

It is submitted that the same use test seen in the other Commonwealth jurisdictions is employed in the United Kingdom context.

### The legislative policy of form in interest transactions

Turning to our particular issue of concern in Part Six of this article we consider whether the same approach seen in *Re Securitibank Ltd* applies in the case of interest. In other words does the generic policy of the Commonwealth income tax systems we have reviewed (and that admittedly adopt a transactional measurement basis) make as paramount the importance of determining the true nature of a transaction involving the interest contracts in accordance with the terms of the documents and agreements actually entered into and carried out? *A priori* we would conclude that this is indeed the case and the concept of ectopia illustrates this point.

In Australia *Steele v DFCT*[^133^] directly confirms the authors’ point. The High Court concluded that:[^134^]

“As was explained in *Australian National Hotels Ltd v FC of T*, [(1988) 19 FCR 234 at 239-241] interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the *use of borrowed money during the term of the loan*. According to the criteria noted by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd v FC of T* [(1938) 61 CLR 337 at 359-363] it is therefore ordinarily a revenue item.” (author’s emphasis).

The High Court clearly applied the deduction provision (now s 8-1ITAA97) to the legal form of the transaction by reference to the “use of the borrowed money during the term of the loan.”[^135^]

In Canada *Shell Canada Ltd v Canada*[^136^] rejects outright the notion that separate loan or financing contracts could be amalgamated. McLachlin J concluded:[^137^]

[^131^](1985) TC 592.
[^132^](1985) TC 592 at 611.
[^133^]99 ATC 4242.
[^134^]99 ATC 4242 at 4248.
[^135^]99 ATC 4242 at 4248.
“However, this Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts’ role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way.”

In New Zealand the general point was also confirmed in *Finnigan v CIR*. This same point was applied by the New Zealand Supreme Court in the recent Supreme Court decision in *Ben Nevis Forestry Ventures Ltd v CIR*. Although speaking of a forestry licence the same concept applied. Tipping, McGrath and Gault JJ noted:

“Under the legislation the licence premium is deductible if it is for ‘a right to use land’. Whether that is the legal character of the payment of $2,050,518 per plantable hectare which is to be made in 2048 requires an analysis of the nature of the arrangements actually entered into. The Court must construe the relevant documents, in their commercial context, to ascertain the parties’ obligations to each other, as if it were determining a dispute between them over the meaning and effect of their contractual arrangements.”

Their Honours also went on to observe:

“On the other hand, it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it. The label ‘licence premium’ is accordingly not what is important in the present case, but rather the true contractual nature of the legal rights for which payment is to be made and the effect of applying the tax legislation to a payment of that character. Once the nature of the contractual rights and obligations has been determined in this way, the specific provision can be applied.”

Finally in the United Kingdom in *Westmoreland* Lord Hoffmann recognized that “there are many terms in tax legislation which cannot be construed in this way. They refer to purely legal concepts which have no broader commercial meaning.” (authors’ emphasis).

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137[1999] 3 SCR 622 at para 45.
139(2009) 24 NZTC 23,188.
140Both a loan of money and the use of land are conceptually equivalent in economic terms as they are the use of a factor of production for a stipulated return and embodied in a bi-lateral contract concluded under normal contractual law concepts of offer, acceptance, consideration and intention to create legal relations.
141(2009) 24 NZTC 23,188 at 23,201.
143[2001] BTC 44 at 57.
VII: Accounting treatment

Introduction

In part Seven the authors consider the treatment of interest and debt instruments from an accounting perspective. The scope of the paper only allows the New Zealand treatment to be considered but as New Zealand now adopts the International Financial Reporting Standards (IFRS) this discussion is also illustrative of the other jurisdictions we review.

Accounting treatment can be useful circumstantial evidence in tax cases although ultimately it is only one factor that the Court may take into account144.

Accounting treatment of “interest” in New Zealand is related to “financial instruments” as interest is a cost of borrowed funds. IFRS apply in New Zealand as New Zealand Generally Accepted Accounting Practices. The main coverage of interest and financial instruments is found in the Framework for the Presentation and Preparation of Financial Statements (IASB) which covers in paragraph 4.33 what is determined to be expenses. Financial instruments are currently accounted for using IFRS New Zealand Equivalent to International Accounting Standard 32 (Financial Instruments: Presentation: NZIAS32), New Zealand Equivalent to International Accounting Standard 39 (Financial Instruments: Recognition and Measurement: NZIAS39) and New Zealand Equivalent to International Financial Reporting Standard 7 (Financial Instruments: Disclosures: NZ IFRS 7).

NZIAS32 Financial Instruments: Presentation, defines what a financial instrument is whether it is financial asset, financial liability or equity instrument. Once you have identified a financial instrument, NZIAS 39 Financial Instruments: Recognition and Measurement, addresses how to recognize and measure them in the financial statements of the entity. NZIFRS 7 Financial Instruments: Disclosures, provides detailed disclosure requirements for the financial instruments.

A new standard on financial instruments - New Zealand Equivalent to International Financial Reporting Standard 9 (Financial instruments: NZ IFRS 9) (2010) will apply as mandatory adoption for any accounting periods starting after 1 January 2013. However,

144 Gallagher v Jones [1993] STC 537 in para123B Sir Thomas Bingham MR discusses “the dependence of taxable profits on accounting profits as a beginning point. The object is to determine, as accurately as possible, the profits or losses of the taxpayers’ businesses for the accounting periods in question. Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which the legislation requires to be answered. As Pennycuick V.-C. pointed out in Odeon Associated Theatres Ltd. v Jones1 WLR 442, different considerations arise where there is no accounting evidence or where there are two or more principles either or any of which is generally accepted. But those considerations do not apply here”.
some organization’s will choose to adopt early and therefore entities will be applying a mixture of models over the next few years.

If we use the current standards to identify financial assets, liabilities and equity instruments we use NZIAS32. This does not change between the old and new regime. In the old regime, NZIAS32 and its contents were developed prior to the contents of NZIAS39. The reason for this was there was less debate about the presentation and disclosure of financial instruments than there was with the recognition and measurement. Therefore NZIAS32 concentrates on disclosure issues.

**The operation of NZIAS32**

Under NZIAS32 firstly, financial instruments, financial assets, financial liabilities and equity instruments are defined. Secondly, specified criteria relate to their amount, timing and certainty of future cash flows are given in the standard.

**The concept of a financial instrument**

For the purposes of the NZIAS32 a financial instrument is defined as “any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument to another”. Therefore, there must be a contract which gives rise to one party having a financial asset and the other financial liability or equity instrument.\(^\text{145}\)

**The concept of a financial asset**

A financial asset according to NZIAS32 paragraph 11\(^\text{146}\) is:

1. Cash; or

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\(^\text{145}\)NZ IAS 32 paragraph 11: A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

\(^\text{146}\)A financial asset is any asset that is:

(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
   (i) to receive cash or another financial asset from another entity;
   or
   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
(d) a contract that will or may be settled in the entity’s own equity instruments and is:
   (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity’s own equity instruments; or
   (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments.
2. A contractual right to receive cash or another financial asset from another entity; or
3. A contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or
4. An equity instrument of another entity.

Examples of items that satisfy these definitions are given in paragraphs AG3-AG23. A contractual right to exchange financial instruments with another entity under conditions that are potentially favourable relates to derivatives.

The concept of a financial liability

A financial liability is defined by NZIAS32 paragraph 11\footnote{A financial liability is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity’s own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity’s own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.} to be:
1. Any liability that is a contractual obligation:
2. To deliver cash or another financial asset to another entity; or
3. To exchange financial assets or liabilities with another entity; or
4. A contract that is a derivative; or
5. A non-derivative.

The concept of an equity instrument

Finally an equity instrument is defined by NZIAS32 paragraph 11\footnote{An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.} as “any contract that evidences a residual interest in the assets of another entity after deduction of all its liabilities.”
Other observations

All financial assets and liabilities should be recognized in the balance sheet when the entity becomes party to the contractual provisions of the instrument.

NZIFRS9 (2010) uses the same definitions for financial instruments, financial assets, financial liabilities and equity instruments. However, one of the reasons for the changes to NZIFRS9 (2010) is the recognition and measurement in NZIAS39. Under NZIAS39 how you measured the financial instrument depended on the classification of the financial asset or liability. There were various classifications such as held to maturity, loans and receivables, available for sale financial assets. This classification determined how they were to be measured. Generally financial instruments are recognized initially at fair value of consideration given. Fair value is defined in IAS32 (paragraph 11) ‘Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction’ (exact definition).

One of the issues with this is that management determined how they were classified initially according to their objective intention and could change the classification in later accounting periods and hence the measurement of the financial instrument at a later date. This could be an area of income smoothing. NZIFRS9 addresses this issue and makes an irrevocable designation to a classification at initial recognition.

VIII Conclusion

The main issue the authors explore in this article is the question of whether the tax laws reviewed follow the common law legal form of money lending transactions giving rise to an interest expense and whether the scheme and purpose of the jurisdictions reviewed utilize the same common law forms to apply scientific interest deduction rules. The answer is yes. Haig/Simons is not a practical, thus we use transaction based measurement. This in turn relies on commercial legal forms and the legislation absorbs this into its measurement and recognition basis. Treatment of the actual deductibility of the interest expense is not looked at here (forthcoming). Accounting IFRS (International Financial Reporting Standards) are recognized by the Inland Revenue Department also focuses on contractual rights. This adds to the complexity as there is a relationship between accounting and profit calculations. Since the tax calculations are making reference to accounting standards, having an awareness of the accounting standards given the harmonization of accounting standards is important. The final direction that this mutual awareness and cross referencing takes is not yet clear.

References


