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Dear Ms Burke

Financial Services Council of New Zealand ("FSC"): Submission on draft Interpretation Statement IS xx/xx: Income Tax – Deductibility of expenditure incurred in borrowing money – Sections DB 5 and DA 1

The Financial Services Council ("FSC") welcomes the opportunity to provide submissions on the draft interpretation statement ("IS"). As a general comment, we support Inland Revenue in providing further clarity around the deductibility of borrowing costs under section DB 5 of the Income Tax Act 2007 ("the Act"). However, we are concerned with certain aspects of the analysis outlined in the IS.

In particular, we do not agree with the analysis in the IS around the deductibility of life insurance premiums. In the alternative, we submit that Inland Revenue, at a minimum, issue a Revenue Alert that succinctly and clearly publicises the conclusions in the IS.

We submit on these and other issues below.

1 Summary of the draft IS

We briefly summarise the major conclusions contained in the IS:

- To be deductible under section DB 5, expenditure must be incurred in establishing or setting up a loan.
- Expenditure that is deductible under section DB 5 includes legal fees in connection with establishing the loan, valuation fees, guarantee fees, lenders mortgage insurance, loan procurement fees, survey fees, mortgage brokers' commissions, costs of arranging bank overdrafts and expenses arising from debenture issues (drafting, advertising and printing prospectuses).
- Expenditure considered not deductible under section DB 5 includes the repayment of the principal/interest and costs incurred over the term of the loan in relation to refinancing, extending, changing terms or "rolling over" the loan (unless it creates a new loan), discharging a mortgage and payments made to induce a lender to accept early repayment.
- Expenditure must relate solely to a loan, and must not be consideration for valuable benefits other than the loan to be deductible under section DB 5. The premium on a life insurance policy given as security for a loan is considered not to be deductible because it is considered to be capital expenditure incurred to acquire an asset (the policy) rather than expenditure incurred in borrowing money.

2 Proposed interpretation of “borrowing” is too narrow

Section DB 5 applies to expenditure incurred “in borrowing money”.

We submit that the IS has interpreted “in borrowing money” too narrowly by stating that only expenditure incurred in establishing or setting up a loan should be deductible under section DB 5. In coming to this conclusion, the Commissioner has provided some commentary around cases from foreign jurisdictions which consider provisions “equivalent” to section DB 5. However, we do not necessarily agree that consideration of foreign jurisdictions’ “equivalent” provisions is helpful in interpreting section DB 5 as those provisions will almost invariably be couched and articulated in different terms.

Furthermore, we submit that Inland Revenue has incorrectly articulated the test of whether expenditure is deductible under section DB 5. The test is not whether expenditure has been incurred in ***obtaining*** a loan, nor whether it is in connection with the ***establishment*** of a loan. The test in section DB 5 is whether expenditure has been incurred ***in borrowing money***; we see no need or requirement to read these words down in the manner in which the Commissioner has in the IS.

It is our view that the words “in borrowing money” clearly point to the ***entire process*** by which money is borrowed, including but not limited to the time prior to the time at which a loan is drawn down, throughout the term of the loan, to the point where the loan is discharged (and afterwards, depending on the facts).

Accordingly, we consider costs (excluding “cost of money” costs) incurred in relation to the refinancing of a loan, extending the term of a loan, altering the interest rate and discharging or novating a loan all have sufficient nexus with “borrowing money” and should be deductible under section DB 5.

Furthermore, we consider the old interest deductibility cases (such as *Pacific Rendezvous* and *Brierley*) provide a more appropriate guide to determining the proximate purpose of the borrowing. That is, the existence of another purpose is not a barrier to claiming a deduction under section DB 5.

3 Deductibility of life insurance premiums

3.1 Case law background

The Commissioner asserts at paragraph 79 of the IS that, to be deductible under section DB 5, expenditure must relate solely to a loan, and must not be consideration for valuable benefits other than the loan. The IS concludes that, as premiums paid under a life insurance policy are considered to be expenditure incurred to acquire a capital asset (the policy) rather than expenditure incurred in borrowing money, they are therefore non-deductible.

We note at the outset that section DB 5 is expressly not subject to the capital limitation contained in section DA 2(1). The predecessor to section DB 5 was introduced in the 1930’s to explicitly allow a deduction for the costs incurred in borrowing money which would otherwise have been denied because of the prohibition on the deductibility of capital expenditure. Accordingly, even if life insurance policies give rise to an asset, this of itself does not preclude deductibility under section DB 5.

Notwithstanding this, in the IS, the Commissioner quotes a number of cases which supposedly support his approach. We note that all cases cited in the IS concerning the deductibility of life insurance premiums are sourced from foreign jurisdictions and that there is no New Zealand authority directly on point.

Furthermore, we note that not all of the cases quoted are consistent in the view that life insurance premiums bring into existence an asset, and that in so doing those premiums are non-deductible when the life insurance policy is used as security for a loan.

For example, in the *Côté-Reco*, *Yonge-Eglinton* and *Economy Carriers* cases, it was held that expenditure incurred on policies as a condition of borrowing was deductible under sections equivalent to section DB 5. Indeed, in *Côté-Reco* the wording of the provision is substantially the same as in section DB 5, being "an expense incurred in the year ... in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property".

It is our submission the New Zealand courts would be likely to reach a conclusion consistent with the *Côté-Reco*, *Yonge-Eglinton* and *Economy Carriers* cases. This is on the basis that life insurance policies do not necessarily bring into existence an asset, and that the necessary nexus between the borrowing of money and expenditure incurred on life insurance premiums is satisfied for the period of time during which the policy is used as security for a loan. We submit further on these points below.

3.2 Life insurance policies not an asset

At paragraph 101, the IS states that:

> *"The essence of any life insurance contract is that in consideration for the payment of the premium or premiums, the policy holder acquires the right to be paid a specific sum."*

In the next paragraph, it states:

> *"Although the right to payment of the sum insured is a contingent right, that right is itself an asset."*

With respect, we cannot agree with this proposition in the case of all policies of life insurance. Whilst it may be argued that under certain policies such as Endowment, Whole of Life and Investment Linked policies, an asset may be created over the term of the policy (represented by the surrender value of the policy), this is not true of Term Insurance and Mortgage Repayment Insurance.

For completeness, in conceding that it is possible that assets accumulate under certain policies of life insurance (e.g. Whole of Life and Endowment), we are not conceding that this removes the ability to claim a tax deduction for premiums paid on policies which are used as security for borrowing. In the case of these policies, there is an apportionment of the premium between the risk component and the asset accumulation (savings) component as already acknowledged by the new income tax life insurance rules. Accordingly, the former component should constitute deductible expenditure (we expect this would be advised by the insurer and would be aligned with their own income tax treatment).

It is also worth noting that the insurance market has changed significantly since the original IS was issued. Term Insurance is now effectively the main type of new business that is issued by insurers as illustrated by the statistics collated by the FCS as at 31 December 2011 (refer Appendix).

Under Term Insurance and Mortgage Repayment Insurance policies, a premium is typically paid on a regular basis over a specified term in return for an agreement by the insurer to pay an amount on the occurrence of a specified event. At the end of that term (which may be as short as one month in the case of Term Insurance), if the specified event has not occurred, the contract comes to an end and the policyholder is entitled to nothing. Only if a claim can be made under the policy could it be said that the policyholder then has an asset.

Put another way, the expenditure incurred by the policyholder has utility only during the period to which it relates and creates no ongoing benefit. This seems to us to be the essence of the definition of "period" or "revenue" expenditure as no enduring benefit or identifiable asset has been created by reason of the expenditure.

This is true of general insurance premiums also, although if the Commissioner is right that premiums paid in respect of life insurance policies create assets, then so must premiums paid in respect of general insurance products. One need go no further than a set of financial statements to see that no asset is recognised for accounting purposes for either life or general insurance policies. Furthermore, the fact that premiums paid in respect of general insurance policies are deductible for tax purposes by those in business exposes an unjustifiable difference in treatment for life insurance premiums proposed by the Commissioner in the IS.

Similarly, we can see no difference in principle between expenditure incurred on life insurance premiums and, say, expenditure incurred on obtaining a valuation for the purposes of borrowing or guarantee fees paid to a loan guarantor. These costs are clearly "period" expenditure and have explicitly been given the seal of approval for deductibility in the draft IS. Accordingly, we can see no principled reason to treat life insurance premiums differently for tax purposes.

For the reasons given above, it is our submission that no asset is created merely by the payment of premiums for life insurance policies.

3.3 Nexus between premiums and borrowing money

Having submitted that premiums paid in respect of life insurance policies do not create an asset, we believe it then follows that where insurance policies are used as security for a loan, there is a sufficient nexus between the premium expenditure and the borrowing of money.

This principle was established in the *Côté-Reco*, *Yonge-Eglinton* and *Economy Carriers* cases.

Furthermore, to restate the test in *Buckley & Young* (noted in the IS at paragraph 100), to determine the character of expenditure, it is necessary to consider the legal arrangements entered into and carried out under which expenditure is incurred. In terms of this test, we submit that whilst used as security for a loan used to derive income, the expenditure incurred on life insurance premiums is clearly incurred in borrowing money. Therefore, during the period so used as security, that expenditure should be deductible under section DB 5.

This is similar to the position whereby expenditure incurred on a property (such as repairs, rates, interest, etc) will be non-deductible whilst that property is used for private or domestic purposes. However, where the use of that property changes, and is subsequently used to derive income from rent, the very same expenditure will become deductible for tax purposes.

This is not to argue that the cost of a piece of land, or depreciable property will be deductible under section DB 5 if those assets were applied as security for a loan. Consistent with our submissions above, we do not believe that such expenditure has a sufficient nexus with the borrowing of money. In this regard, we are in agreement with the IS (see para 105).

This is because those assets will have been acquired for other purposes which will in all likelihood continue to hold true regardless of the fact that they are ***also*** being used as security for the borrowing of money. This can be distinguished from the use of a policy of life insurance as security, as the sole purpose of that policy is to provide security for the period during which it is so used.

3.4 Impact of non-deductibility on economic growth

If the interpretation in the draft IS stands, this will increase the effective cost of doing business in New Zealand. We believe that this may then have an impact on the desire of businesses to seek growth opportunities as the cost of that opportunity will increase. In some cases, we expect those growth opportunities may not be pursued. This would also seem to go against the general theme of current policy initiatives of the Government which is trying to transform the New Zealand economy to enhance economic growth.

4 Practical solution for insurers

If the Commissioner's conclusions do not change, in the alternative, we submit that Inland Revenue should succinctly and clearly publicise the conclusions in the IS, particularly those relating to the non-deductibility of life insurance premiums.

Our concern is that financial advisors will not have read or be familiar with the views outlined in the IS and take the position that deductions for premiums paid on insurance policies used to secure borrowings are available.

Accordingly, Inland Revenue should issue a Revenue Alert that clearly and succinctly states the IS's conclusion that insurance premiums are not a deductible borrowing cost. The Revenue Alert can refer to the IS as technical support. It does need to traverse the technical issues. In this way financial advisors and insurance companies can readily find Inland Revenue's views.

5 Application date

We also consider that the Commissioner should state the IS applies prospectively to expenditure incurred, at least, one quarter after it is finalised. This will allow taxpayers time to consider the final IS and apply it.

6 Further information

Please do not hesitate to contact us if you would like to discuss our submission in greater detail.

Yours sincerely,

Deborah Keating
EXECUTIVE OFFICER