Tax Treatment of Guarantee Payments - A Silver Lining to Business Failure?

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Tax Treatment of Guarantee Payments — A Silver-lining to Business Failure?

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This article examines the correct tax treatment of payments made under a guarantee. It considers how those payments are treated under both the traditional capital — revenue distinction and the specific financial arrangements rules. It considers the tax effect of both guarantee fees paid by the borrower to a guarantor to secure their guarantee and any ultimate payments made by the guarantor to the lender in honour of that guarantee. The article concludes that in many circumstances guarantee payments may be deductible to the guarantor.

1 Introduction

Like most of the world economy, New Zealand was buffeted by the Global Financial Crisis. Profits tumbled and the value of investments fell. The numbers of company liquidations and personal bankruptcies both climbed. The result of this financial mayhem was that many borrowers failed and lending institutions were obliged to call up personal guarantees given by individuals or related-entities who acted as sureties on loans. Not unexpectedly, having repaid the loan in honour of their personal guarantees, those taxpayers seek to mitigate their loss by claiming a tax write-off.

Surprisingly there is little case law and less IRD guidance on the correct tax treatment of payments made in honour of a guarantee. Given that information gap, it is conceivable taxpayers may claim a deduction for the payments. However, IRD have recently announced it will begin to actively audit the tax treatment of financial losses, including the deductibility of guarantee payments. Unfortunately, given the financial plight of taxpayers in this situation, many may be unable or unwilling to engage **[(2011) 17 NZBLQ 30, 31]** with IRD's statutory disputes procedure to determine the correct tax treatment. Accordingly, it may be some time before the correct position is determined.

2 Traditional tax treatment of guarantee payments

Tax law traditionally treated payments made in honour of a personal guarantee as entirely non-deductible on two distinct grounds.

2.1 Payment Considered Expenditure of Capital Nature

A payment made in honour of a guarantee was traditionally considered to be of a purely capital nature and therefore non-deductible under the General Limitation in s DA 2(1). An early authority on this point was *Meadowcroft v Commissioner of Inland Revenue* involving an investor who was required to make a payment under a guaranteed he had given in respect of one of his many commercial interests. The taxpayer claimed that payment as an expense but the Commissioner declined the deduction on the grounds it was capital. In the High Court Haslam J took the following approach:

> "When the scheme envisaged by the promoters came to grief so early after being launched, the appellant incurred the loss which he now seeks to deduct for taxation purposes… I think that the unfortunate sequence of events leading up to the appellant's loss flowed from a risk of his capital, followed by the occurrence of the contingency which required him, from such capital assets as a house and certain shares, to meet the demands of the bank, and left him with a diminished capital holding as a consequence."

His Honour considered the guarantee given to secure a loan to the venture should be viewed in the same way as the underlying loan:

> "I think that the appellant went further than chancing the daily uncertainties of trade in that he expressly risked his capital in this very enterprise just as much as if he had advanced the cash himself on loan to the company."

This approach applied whether the guarantor was an individual shareholder or another company within the corporate group. The same approach was applied to professional advisers who gave personal guarantees in respect of clients, on the grounds such payments were outside the normal scope of professional practice.

The reason for characterising guarantee payments as non-deductible capital expenditure was to ensure equal treatment with the situation of taxpayers that, instead of giving the guarantee, had **[(2011) 17 NZBLQ 30, 32]** advanced their own funds to the borrower (either by way of a loan or subscribing for additional share capital). This rationale was best expressed in *Garforth v Tankard Carpets Ltd* by Walton J:

> "I do not think that there is any real difference between giving a guarantee and the loan of money to the company concerned."

If the borrower needed funds the guarantor had a choice to either provide those funds itself or to facilitate the borrower to obtain those funds from the third party lender on the strength of the guarantor's promise. As explained in *Case F62*:

> "The guarantee transaction is normally looked on in the same light as if the surety had made a loan to the principal debtor instead of giving his guarantee. The transaction is therefore regarded as involving a loss of capital when the surety is called upon to honour his guarantee."

In both instances, the guarantor is risking its own capital in the event the borrower fails. This analysis was confirmed in *McElwee v Commissioner of Inland Revenue* by Robertson J:

> "I am of the view that taken in the broad what occurred must really be seen in the same light as if Mr McElwee had been persuaded to directly inject more capital into the partnership business. That is effectively what occurred in the long run. The bank provided the working capital in the first place and when there was a failure by the company Mr McElwee as a guarantor, was called on to make good the loss."

This position was summarised by an author of a leading text as follows:

> "In New Zealand at least, the Courts have analysed the loss as analogous to the loss incurred by a creditor who does not receive repayment of funds advanced."

2.2 Guarantee Has No Nexus with Deriving Income or Running a Business

Even if not treated as capital, the second hurdle taxpayers faced was that often the guarantee was given gratuitously on behalf of a related party. Unless the guarantor was in the business of charging for providing sureties or otherwise directly received some fee for its guarantee, any subsequent payment under a guarantee did not meet the general test for deductibility.

Where the parties are related, the guarantor invariably stands to gain from the success of the borrower, generally by way of distributions of profit or increased salary — but such benefit is too indirect. The guarantor does not actually receive the borrowed funds and does not directly generate any income from their use by the borrower. On that basis the Courts have generally concluded any payment by the guarantor lacks sufficient nexus with its own taxable income to warrant deductibility under the general

permission in s DA 1. The test requires that a deduction is only permitted if the facts demonstrate a sufficiently close relationship between the item of expenditure and the earning of the **[(2011) 17 NZBLQ 30, 33]** taxpayer's income. The application of this test was explained by the Court of Appeal in the leading decision of *Banks v Commissioner of Inland Revenue*:

> "The deduction is available only where expenditure has the necessary relationship, both with the taxpayer concerned and with the gaining or producing of his assessable income. Relationship with the taxpayer is not, in itself, sufficient, as the prohibition of a deduction for capital expenditure… makes clear. There must be the statutory nexus between the particular expenditure and the assessable income of the taxpayer claiming the deduction."

Likewise, in the contemporaneous decision in *Buckley & Young Ltd v Commissioner of Inland Revenue* the Court of Appeal considered the "heart of the inquiry" was whether there was sufficient nexus:

> "between the advantage gained or sought to be gained by the expenditure and the income earning process. That in turn requires determining the true character of the payment. It then becomes a matter of degree and so a question of fact to determine whether there is a sufficient relationship between the expenditure and what it provided or sought to provide on the one hand, and the income earning process on the other, to fall within the words of the section."

In the context of guarantee payments, the courts have generally found that payments in honour of a guarantee are simply one-step removed from the statutory nexus required for deductibility. While the courts acknowledge the guarantee given by a shareholder has put the borrower in funds, and therefore enhanced the prospects it would pay increased profits, distributions or salary to the guarantor, this has been insufficient to warrant deduction. For example, in *Case F62* the TRA reasoned the guarantor:

> "is one step removed from the income earning process which benefited from the guarantees of himself and his co shareholders… I appreciate that O derives his income from the company, as salary or dividends or both. However, I find that the guarantee which O gave supports the income earning process of the company rather than his own income earning process… there is also an insufficient relationship between the guarantee payment and the income that may have been earned by O as a shareholder employee of the company. The nexus between the expenditure and O's income is too remote for me to find that the expenditure was incurred in gaining or producing O's income."

This reasoning was confirmed in *McElwee*. The High Court concluded any potential for increased future income resulting from the borrowing lacked sufficient nexus with the guarantee payment itself:

> "The required nexus must be between the payment and Mr McElwee's assessable income, not that of the company… his position was several steps removed from the income earning process to which the payment was related."

Crucially in *McElwee* the taxpayer had given his guarantee gratuitously. Accordingly the High Court concluded: **[(2011) 17 NZBLQ 30, 34]**

> "Mr McElwee did not receive any consideration for the *guarantee* and he is not in the business of providing *guarantees*. Although Mr Molloy is able through a tortuous labyrinth to demonstrate some connection between the payment which Mr McElwee eventually had to make and his own income earning process, I am of the view that it is too remote to meet the nexus test."

It was thus settled law that taxpayers were not entitled to claim a payment made in honour of a guarantee. However, the settled law in this area (along with many other principles) was swept away in 1987 by the introduction of the financial arrangements rules.

3 Whether guarantee is a financial arrangement

The extremely complex financial arrangements rules now found in Part EW of the Income Tax Act 2007 came into effect on 31 July 1986. Those rules entirely revolutionised the tax treatment of most kinds of financial instruments, including guarantees. One leading commentator explained the change effected by the financial arrangements rules as follows:

> “Whether any ‘gain’ or ‘loss’ can be categorised as capital or revenue assumes no relevance, the only issue is whether there is an overall gain or loss of wealth over the period for which the income is being measured.“The accrual regime can be interpreted as a fundamental shift from the rest of the income tax regime which operates on traditional legal/accounting principles. It is a move to a regime where the Act operates more on economic principles.”

The regime is notoriously complex and technical. It was described by another commentator thus:

> “The accruals regime was introduced in 1986 and it is probably fair to say still remains the most complex and least understood area of New Zealand’s tax legislation…“It seems that there is a perception among some taxpayers, practitioners and Inland Revenue Department (‘IRD’) staff that the [financial arrangement] rules do not apply to ‘simple, everyday’ transactions entered into by ‘your average taxpayer’, but only to those more complex transactions entered into by larger taxpayers such as the city based corporates. **This is a fallacy**. The accruals regime applies to all taxpayers. The provisions are far reaching and deal with anything that is a ‘financial arrangement’, a very widely defined term. Some would say that when confronted with an income tax issue, assume there are accruals rules implications until it can be shown otherwise.”

The principal effect of the financial arrangement regime is that the previous capital-revenue distinction no longer applies to payments under a guarantee. Instead, in accordance with s EW 1(3)(b), the new regime requires “the parties to a financial arrangement to disregard any distinction between capital and revenue amounts”. This consequence was recognised in IRD Rulings: **[(2011) 17 NZBLQ 30, 35]**

> “All returns on debt are now caught, whether in the form of capital or revenue gain. There is no longer a capital/revenue distinction with financial arrangements… instead the underlying cashflows are considered.”

As one commentator explained, “The regime has therefore effectively abolished the distinction between the tax status of capital gains v revenue gains arising on financial arrangements.” This understanding was confirmed by Richardson J in *Phillips v Foster*:

> “The broad purpose of that legislation is to dilute the capital/income distinction and to ensure that all returns on such financial arrangements whatever form they take are brought to tax on a progressive basis over the term of the financial arrangements concerned.”

The problem with the regime is its potentially wide application. The definition of “financial arrangement” catches any arrangement “under which a person receives money in consideration for that person, or another person, providing money to any person… at a future time or… on the occurrence or non-occurrence of a future event”. Obviously the giving of a guarantee to secure the payment of money from the lender to the borrower, with the promise to repay that loan in the event of the borrower’s default, comes within that wide definition.

Accordingly, if a guarantee comes within the financial arrangements rules, that regime operates as a code and superseded all prior case law on the (non)deductibility of guarantee payments. Cases such as *Shipbuilders Ltd* and the authorities cited in *McElwee* are no longer applicable. This new regime therefore opens the possibility that taxpayers previously denied a deduction for guarantee payments may now do so.

Unfortunately, given the complexity of the financial arrangement regime, the effect of the new rules regarding guarantees was uncertain. The authors of a leading text acknowledged the problem faced by guarantors:

> “It should be emphasised that the application of the very broadly drafted accrual rules to contracts such as guarantees (the

legal principles in relation to which can also be complex) involves some uncertainty. The following discussion attempts to state that which is clear and identify that which is not… There are numerous points on which alternative views could be taken. Definition resolution of the effect of the accruals rules on guarantees (if indeed they remain subject to the rules) will have to await a refinement of the statutory provisions or a ruling or other statement by the Commissioner."

The basic problem with treating guarantees under the regime is that they contain none of the usual features of other financial arrangements. That regime is premised on the spreading of income and expenditure from a financial arrangement over its entire life. However, the very nature of a guarantee is that no payments will be made until the borrower defaults and the guarantee is called up, at which time **[(2011) 17 NZBLQ 30, 36]** the guarantor must pay the debt in full. As noted by one commentator, the rationale for treating guarantees as financial arrangements at all was unclear:

"apart from the obvious practical connection between loans and guarantees, it is perhaps difficult to see anything in the inherent nature of guarantees themselves that means this should be so… It is not easy to see how the spreading mechanism methods should apply to a typical guarantee, where the contingent nature of the cash flows make any recognition income or expenditure problematic… Perhaps their inclusion was simply on the basis that payments under guarantees are often made in substitution for payments under financial arrangements, and therefore should be subject to the same rules."

Given that awkward fit, an independent report on reform of the financial arrangements rules in 1991 recommended guarantees be excluded from the scope of that regime on the grounds the boundary between a guarantee and contract of financial insurance or indemnity was too uncertain to justify treating them under separate regimes. However, that recommendation has never been taken up and guarantees are generally governed by the financial arrangements rules. This result is confirmed by IRD Policy, which states:

"Under the accruals rules, the definition of 'excepted financial arrangement' excludes contracts of insurance. Nevertheless, it is apparent that the rules do apply to contracts of guarantee (within the definition of 'security arrangement')."

Guarantees therefore continue to fall within that sub-category of financial arrangements called "security arrangements". These arrangements are defined as "a financial arrangement that secures a party against another person failing to perform the person's obligations under a secured arrangement." This conclusion was confirmed by IRD during a previous review of the scope and application of the financial arrangements rules in 1997:

"A *guarantee* or other *security arrangement* for which a fee is paid to the guarantor will fall squarely within the definition of a *financial arrangement* adopted by the accrual rules. It is an *arrangement* whereby a person (the surety) obtains money (the fee) in consideration for a promise by any other person (the surety) to provide money to any person (the creditor) at some future time or times, or upon the occurrence of some future event (default by the debtor)."

4 Payment of guarantee fee required

A crucial requirement is that some consideration "in money or money's worth" must have been given to the guarantor for its surety. Put simply, the guarantee must not have been given gratuitously. Guarantees for which no separate consideration was paid will not come within those rules and instead will be treated under the former rules, which effectively precluded deduction. Accordingly, the payment of a separate guarantee fee has become crucial to the tax treatment of guarantee payments. **[(2011) 17 NZBLQ 30, 37]**

This requirement was demonstrated in *McElwee v Commissioner of Inland Revenue*. There the guarantor (a shareholder/director in the borrower company) received no payment or other consideration for his guarantee but nevertheless sought to treat that guarantee as a financial arrangement. Robertson J rejected that approach:

"I am satisfied that a guarantee without consideration does not come within the general purview of the accrual regime… To hold that a guarantee given without consideration comes within the financial arrangements… places such a strained

interpretation on the words as to make it untenable in any event."

In reaching that decision, His Honour relied upon the commentary on the operation of the financial arrangements rules by a leading publisher, which stated:

> "the provision of some consideration for the guarantee is crucial in order for the financial arrangement provisions to apply. Where there is no specific fee or other consideration provided to a guarantor (such as where a natural person is guaranteed by a relative, or a subsidiary company's debts are guaranteed by its holding company), it seems likely that the accruals rules will not apply to the guarantee, as such. This is because the indirect benefit of facilitating the provision of credit (or whatever) to the relative or group company is arguably too amorphous to be accorded a value for the purposes of the accrual provisions."

Applying that reasoning, Robertson J accepted that only guarantees given in return for a fee come within the financial arrangements rules. By contrast, guarantees given gratuitously continue to be governed by the former rules (explained above).

Despite the conclusion reached in *McElwee*, arguments remain whether payment of a guarantee fee should be required before a guarantee becomes a financial arrangement. A guarantee given to support a loan to a third party prima facie falls within the almost exhaustively wide definition of "financial arrangement". The requirement for a separate consideration before the guarantee can be treated as a financial arrangement is therefore controversial. Certainly other types of bargains for which no separate consideration is paid are universally accepted to constitute financial arrangements, such as hedges, foreign exchange contracts and certain types of swaps. To single out and exclude guarantees from the regime on that ground is therefore inconsistent.

5 Whether fee was paid for guarantee

As the tax treatment of a guarantee differs depending upon whether a fee was paid, not surprisingly IRD are vigilant as to when and why that payment was made. In particular, IRD are alert to any back-dating or retrospective payment of a fee, especially when it became apparent the underlying guarantee was at risk of being called up. Clear contemporaneous proof of such payments will generally be required. In most instances, evidence of the payments will be found in the parties' previous tax returns. Where such a fee was paid it: **[(2011) 17 NZBLQ 30, 38]**

- must be returned by the guarantor as interest income, and
- may be claimed as a deduction by the borrower as *borrowing costs.*

The correct tax treatment of guarantee fees by the parties will provide prima facie proof that their guarantees falls within the financial arrangements rules. Absent that proof IRD are likely to question whether any guarantee payment, or at least the agreement for such a payment, was paid contemporaneously with the original loan advanced to the borrower. The belated payment of a guarantee fee, particularly if default by the borrower is impending, may indicate it does not truly constitute "consideration" for the original guarantee.

The definition of "financial arrangement" encompasses "an arrangement under which a person receives money in consideration for that person or another person, providing money to any person". The breadth of, and requirement for, "consideration" under the financial arrangements rules were explained by IRD:

> "The amount of cash or any non-cash items including services provided by one party to a contract as recompense or payment for any cash or non-cash items provided by the other party to the contract…The wording of section EW31(7) suggests that it is the actual money and other benefits passing that are to be taken into account for the base price adjustment calculation."

IRD's policy recognises that definition includes "*the actual money and other benefits passing*", which presumably includes all

amounts actual paid to the guarantor. Certainly such amounts must be included within the definition of "consideration" for the calculation of the Base Price Adjustment, which includes "all consideration that has been paid, and all consideration that is or will be payable to the person for or under the financial arrangement…".

In *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd* the Court of Appeal confirmed this wide definition of consideration should bear its ordinary meaning and therefore encompassed the respective promises exchanged by the parties to the agreement. This reasoning was subsequently applied in *Cooper v Commissioner of Inland Revenue* where Cartwright J referred to the notion of consideration and observed:

> "Consideration as traditionally conceived involves either some detriment to the promisee or some benefit to the promisor. An alternative and simpler definition, proposed by Sir Frederick Pollock and adopted by the House of Lords, is: 'The price for which the promise of the other is bought' [Pollock on Contracts (13th ed) p 133; *Dunlop v Selfridge*[1915] AC 847 at p 855 cited in Cheshire & Fifoot op cit at p 89]. **[(2011) 17 NZBLQ 30, 39]**

Courts have often concluded the definition of "consideration" adopted in various tax statutes should be given a much wider interpretation than the narrower requirements of Contract Law. Nevertheless, it is clear that *some* consideration is required in order to bring a guarantee under the financial arrangements rules. Taxpayers must ensure a fee is paid for the guarantee at the time it is given. Furthermore, that payment must relate to the guarantee and not be paid for some other service or to the guarantor in another capacity. If those requirements are not met, the guarantee will generally not come within the financial arrangements rules and be entirely non-deductible under the former rules.

5.1 Even if Fee Not Paid when Guarantee was Given, was it Contemplated?

Where no clear and contemporaneous payment was made for the guarantee, taxpayers may still be able to bring the guarantee under the financial arrangements rules if they can demonstrate the parties had agreed at the time that some payment would be made in the future. The onus of proving the existence of such an agreement falls on the taxpayer and IRD may naturally be sceptical. However, a short delay between giving the guarantee and payment being made by the borrower may be explicable in normal circumstances.

With many private enterprises the extent (if any) of payment to its proprietors is often not determined until after the end of each income year. Until the enterprise calculates its annual profit the amount of any payment to related parties its owners cannot be finalised. The Act itself includes a number of concessions permitting the proprietors of private companies extra time after the end of each year to determine what shareholder salary was paid. The same applies to the level of income allocated to beneficiaries each year by a Trust.

In line with that practice, it may be common for the amount or payment of the guarantee fee to be set when the enterprise prepares its financial accounts and tax returns for that year. This practice has been approved in a number of cases, even when the amount to be paid was not been determined at the time. For instance, in *AM Bisley & Co Ltd v Commissioner of Inland Revenue* Henry J concluded "that the expenditure is not payable until some future date does not of itself destroy its nature as an existing obligation". This approach was approved by the Privy Council in *Commissioner of Inland Revenue v Mitsubishi Motors NZ Ltd*.

A more explicit example regarding the deductibility of payments by an enterprise to related parties after the end of an income year is found in *Commissioner of Inland Revenue v Glen Eden Metal Spinners Ltd*. There Richardson J the Court of Appeal explained:

> "The legal principles are clear. An expenditure is incurred in an income year although there has been no actual disbursement if in that year the taxpayer is definitively committed to that expenditure **[(2011) 17 NZBLQ 30, 40]** (*King v C of IR*(1973) 1 NZTC 61,107; [1974] 2 NZLR 190). There must be an ascertained liability but it is not necessary to constitute a definitive commitment that that liability is indefeasible: the taxpayer is equally committed whether or not its present liability may subsequently be diminished or avoided by the action of others."

Accordingly, it may not be fatal if the guarantee payment was not made contemporaneously with the original loan. However, those authorities may not apply if the agreed future payment is not itself recorded in the parties' financial accounts. In particular, if the parties neither make the payment nor include a record of the future obligation to make that payment, it is logical for IRD to question whether any eventual payment for that guarantee truly constitutes consideration for the purposes of the financial arrangement regime. Instead, IRD may characterise such belated payment as "past consideration" for a guarantee already provided.

In those circumstances, the only hope for taxpayers is to establish that, despite the passage of time between when the guarantee was given and the eventual payment of a fee, it was always contemplated by both parties that a fee be charged — so the ultimate payment of that fee merely gives effect to that earlier agreement. This approach may be taken even if the taxpayers acknowledge that the precise amount and timing of this payment was not originally agreed between the parties. So long as, between the parties, it was always expected and understood that some payment or compensation would be provided to the guarantor, any subsequent payment will qualify as "consideration" for the guarantee under the financial arrangements rules.

This approach relies upon a line of cases confirming that not all apparently "voluntary payments" made after the other party has already performed its promise under an agreement will be excluded as past consideration. Unbelievably this line of cases dates back almost 500 years but it has been confirmed in New Zealand tax cases much more recently.

In *Casey v Commissioner of Inland Revenue* IRD attempted to impose gift duty in circumstances where it alleged the belated payment of interest under an existing loan, which was apparently interest-free, amounted to past consideration (and therefore purely voluntary), so constituted a gift by the borrower under the Estate and Gift Duty Act 1908. Based on the lack of agreement between the parties to charge interest at the time the loan was advanced, IRD argued the ultimate payment of interest by the borrower was unenforceable and did not constitute consideration for that earlier loan. Henry J dismissed IRD's arguments on the grounds the parties had always contemplated that some interest was to be charged, even if the precise rate and payment of that interest had not been specified at the outset:

> "The fact that the amount of such interest was not fixed at that point of time does not preclude the existence of a legal obligation to pay interest. The fixing of the amount of the interest at a later date may, if the proved circumstances warrant such a finding, be treated by the Court either as an admission which evidences, or as a positive bargain which fixes, the amount of interest which the parties had in contemplation at the time when the wife lent her money. The important matter is the fact that payment of interest was a material part of the transaction and in the contemplation of the parties when it was entered into. **[(2011) 17 NZBLQ 30, 41]**

This decision and the line of cases upon which it relies are discussed in a leading text, which explains that:

> "where the plaintiff has performed services for the defendant without any agreement for payment the defendant subsequently promised to pay for them.. [consideration] will lie if, but only if, the services were originally performed at the defendant's request… The previous request and the subsequent promise were thus to be treated as part of the same transaction."

These cases confirm that any payment, including the quantum of any such payment, need not be agreed between the parties at the time the services were performed. All that is required is that the parties have "*a contemplation*" that such a payment will ultimately be made.

Applied to guarantees, provided the taxpayers always expected that some payment for the guarantees would be made, any subsequent payment may still constitute consideration for the prior guarantee. Accordingly, the failure to pay a contemporaneous guarantee fee may not be fatal to the treatment of the guarantee under the financial arrangements rules. While obviously a question of fact in each instance, this line of cases provides some authority for the belated payment of a guarantee fee, and the subsequent tax consequences should be determined by the application of the financial arrangements rules in Part EW.

6 Correct tax treatment of payment under financial arrangements rules

Surprisingly given how common the issue must be in practice, there is little guidance on how payments made under a guarantee should be treated under the financial arrangements rules. For instance, as long ago as 1991 experts warned IRD the correct tax treatment of guarantee payments was uncertain:

> "There is a lack of clarity as to when expenditure or income under a *security arrangement* should be recognised on an accrual basis prior to base price adjustment. The general view is that such income or expenditure is not recognised unless, and until, crystallisation of the *security* agreement seems highly probable. However, there is no statutory guidance on this point and it is an area of considerable uncertainty. This emphasises the inappropriateness of applying the accrual treatment

to contracts of a very contingent nature"

Unfortunately, this lack of clarity has never been corrected. Instead, a number of commentators have expressed different views on the correct tax treatment of payments made in honour of a guarantee. It is not even clear what steps must be applied by the parties to determine their tax position.

The most likely requirement is that, upon payment by the guarantor, both it and the lender (but not the borrower, as discussed below) must undertake a base price adjustment calculation to determine the amount of income or expenditure that arises under the security arrangement. The amount recovered by the lender under the guarantee is treated as income (which is offset against a corresponding **[(2011) 17 NZBLQ 30, 42]** deduction for the loss suffered under the original loan). The amount paid by the guarantor is treated as expenditure.

One commentator attempted to explain how the base price adjustment rules apply to guarantee payments:

> "**Base price adjustment and deductibility**"When the financial arrangement (ie the guarantee or indemnity) 'matures' (ie when all the payments under the guarantee or indemnity have been made), the base price adjustment ('BPA') must be calculated. This will generally result in deemed expenditure being incurred by the issuer/guarantor, and assessable income arising to the holder/lender. The deductibility of the deemed expenditure by the issuer/guarantor will be determined under the interest deductibility rules [now contained in s DB 6]."

That conclusion is confirmed by another commentator, which provides an example of how the BPA formula should be calculated on payments made under a hypothetical guarantee:

> "When an amount is paid out under a guarantee that amount will, through the application of the base price adjustment, generally constitute expenditure to the guarantor and gross income to the party whose loss has been the subject of the guarantee. Assuming a guarantee payment of $100 this will arise as follows:"***For the guarantor (issuer):***"a # (b + c)
>
> "a = *consideration payable by issuer ($100)*
>
> "b = *acquisition price = 0 (assuming nothing is paid for the guarantee)*
>
> "c = *income/expenditure in previous years (assume 0)*
>
> "*So $100 # $0 = $100*'*positive $100 = $100 expenditure to the issuer*"***For the holder of the guarantee:***"a # (b + c)
>
> "a = *consideration payable to holder ($100)*
>
> "b = *acquisition price = 0*
>
> "c = *income/expenditure in previous years = 0*
>
> "*So $100 # $0 = $100*'*positive $100 = $100 gross income to the holder"*

Based on that example the amount of any payment made in honour of a guarantee will give rise to a negative amount under the BPA and therefore constitute "financial arrangement expenditure" (i.e., an interest expense) for the purpose of s DB 6. While not all agree, that is the conclusion reached by most **[(2011) 17 NZBLQ 30, 43]** commentators. For example, the leading text on the scope and application of the financial arrangements rules confirms:

> "The loss of a surety under a guarantee payment is, when the base price adjustment is performed, deemed to be expenditure incurred by the guarantor in the year. Under [s DB6], expenditure deemed to be incurred pursuant to the accrual rules is deemed to be interest payable. If that interest is payable either in gaining or producing assessable income or producing gross income, for any income year, it will be deductible without regard to the capital / revenue distinction."

The authors then work through an example before concluding that the amount of the guarantee payment, less any guarantee fee received "will be expenditure to C Company [the guarantor]. This will be deductible if the test in s DD1 [now s DB 6] is met…".

So most commentators conclude the full amount of the guarantee payment, less any guarantee fee received, is a deductible expense to the guarantor. Only one commentator appears to question that conclusion, on the grounds the base price adjustment ought to include both payments made under the guarantee and the corresponding entitlement to receive future repayment of that amount from the borrower.

7 Should the guarantor include the value of the underlying loan in its BPA?

The worked examples of the BPA for all parties to the guarantee (above) do not include the value of the underlying loan. While the precise legal mechanism is complex, when the guarantor pays the lender in honour of its guarantee it thereby gains the right to recover that amount from the borrower. In effect the guarantor steps into the shoes of the lender, including the ability to enforce any other security given by the borrower. Depending upon the financial standing of the borrower the prospects of the guarantor recovering anything under these rights will obviously vary greatly. While some guarantees may expect to make a full recovery others will face total loss. Because of this uncertainty commentators cannot agree whether the value of these rights against the borrower must be taken into account when calculating the guarantor's BPA.

Most commentators consider that these recovery rights should only be included in the BPA when they arise (i.e., as and when the borrower actually makes payment to the guarantor) and therefore the amount to be included will vary depending upon the facts in each case. Until any repayment by the borrower is received, it need not be taken into account by the guarantor. **[(2011) 17 NZBLQ 30, 44]**

By contrast, at least one commentator has suggested the full value of the underlying recovery rights assumed by the guarantor may be included in the BPA regardless of the actual prospects of recovery. This approach requires that the value of any rights obtained by the guarantor should be included immediately by the guarantor's BPA.

If correct, that approach would mean the guarantor's BPA will almost never give rise to a negative amount of expenditure because the amount paid to the lender under the guarantee will automatically be matched by its right to recover that amount from the lender. The actual recovery against the borrower should then be treated as a separate financial arrangement. Any shortfall will then simply become a bad debt of the guarantor in its new role as lender and therefore be deductible or not according to the general rules.

Such an approach appears to ignore the economic reality of the parties' positions. While arguably some value may be attributed to the rights acquired by the guarantor, there appears to be no basis for simply including the theoretical value of those rights in the BPA without regard to their actual worth. Even proponents of this approach acknowledge the correct BPA required to be undertaken by guarantors remains uncertain:

> "If [the guarantor] is required to include such amounts, then a guarantee will never give rise to expenditure under the accruals rules, since the amounts paid by the guarantor will never exceed the total of the amounts it is entitled to be indemnified for. It seems, generally, to have been assumed, that this is not the case and that a guarantor may have expenditure under the accrual rules in relation to its guarantee."

Accordingly, it seems the better view is that any right by the guarantor to recover against the borrower for amounts paid under the guarantee should be calculated separately.

8 Tax treatment of the underlying loan

One of the few issues upon which most commentators agree is that the financial arrangement represented by the guarantee (i.e., the "security arrangement") is between the lender and the guarantor — not between the guarantor and the borrowers whose debts are being guaranteed. Unless and until the guarantee has been called up and honoured by the guarantors, there is no financial arrangement between the borrower and the guarantor. Only once payment under the guarantee has been made will the guarantor assume the lender's position by subrogation. This understanding is confirmed by one commentator:

> "Applying the financial arrangement provisions to a guarantee, a holder of a financial arrangement is defined as 'a person who, if the amount or amounts payable under the financial arrangement were **[(2011) 17 NZBLQ 30, 45]** due and payable at that time would be entitled to receive… payment of the amount or amounts so payable…'. The guarantor to a security arrangement will be the issuer as he or she cannot be the holder."As issuer, the acquisition price of the financial

arrangement to the guarantor is ‘the value of all consideration provided to the issuer in relation to the financial arrangement’. This will generally be the amount of any guarantee fee paid.”

The separate and distinction nature of the guarantee and the underlying loan is important for the treatment of both the guarantor and the borrower. For instance, Glazebrook and others conclude, “It is easier to treat the loan and guarantee as separate financial arrangements rather than as a composite financial arrangement.” Likewise, the TEO consider, “The ‘security arrangement’ (ie the guarantee) and the ‘secured arrangement’ (for example, the loan which has been guaranteed) are separate (financial) arrangements”.

The consequence of this separate treatment is that a different base price adjustment must be made in respect of the guarantee and the underlying loan. Mr Judge explains this requirement:

> “If the rights under the loan are subrogated to G Ltd, no BPA is required to be performed by the issuer (D Ltd) or the new holder (G Ltd), in relation to the loan, until the loan matures or is remitted, sold or otherwise transferred.”

Assignment of the underlying loan to the guarantor in return for its payment under the guarantee does not cancel or otherwise affect the underlying loan and therefore does not rise to a base price adjustment for that loan. Instead, that loan remains extant unless or until it is repaid, defaulted or remitted by the parties. Accordingly, the tax treatment of that loan is either:

- interest income to the guarantor/lender if the loan is eventually repaid; or
- remission income to the borrower if the loan is ultimately cancelled or forgiven.

Furthermore if the parties are associated at the time of this remission, the guarantor/lender is not entitled to claim a deduction for the amount of the loan written off, by virtue of the bad debt exclusion in s DJ 31. This prevents the guarantor from gaining a double deduction in respect of that loan — once when it first made payment under the guarantee and again when the debt it then acquired was eventually written off as a bad debt.

9 Limit on deduction of guarantee payments by guarantor or “associated person”

Unfortunately for taxpayers, even when the guarantor has properly incurred interest expenditure under the BPA calculation, that expense may still not be deductible by virtue of s DB 15. That section provides the payment under the guarantee may not be deductible if the expenditure or loss was due to **[(2011) 17 NZBLQ 30, 46]** “actions of the surety or an associated person” or “the occurrence… or the no-occurrence of an event influenced by the surety or an associated person”.

Superficially, the operation of that exclusion would prevent deductibility of guarantee payments in most circumstances. In most instances guarantees are provided by taxpayers who are associated with the borrower. For example, a shareholder/director of a private company will invariably be required to give a guarantee in respect of borrowings by the company. If the shareholder’s direct or indirect ownership interest in that borrower company is 25 per cent or more, the parties are “associated persons”. The same would apply to a guarantee provided on behalf of any close family member, two companies under 50 per cent the same control or partners in a partnership. If any of those associated borrowers default as a result of their action or inaction (presumably including poor business decisions that resulted in declining profitability), the exclusion in s DB 15 would apply to preclude the guarantor from claiming a deduction.

However, there are two separate aspects to this exclusion that must be considered.

9.1 Whether Surety and Borrower are Associated Persons

Section DB 15 applies only where the guarantor and borrower (or other party that caused the failure of the loan) are “associated persons”, by virtue of s YB 5(1). That definition catches most types of ownership interests that may exist between a borrower and guarantor.

Importantly, s DB 15 specifies that it applies only to “*the surety or a person with whom the surety was an associated person* <u>*over*</u>

the arrangement's term" (emphasis added). Under that requirement, changes in ownership interests by the guarantor between the time the guarantee was given and when it was ultimately called up for payment must be considered. For instance, in *McElwee* the High Court held that a guarantor who had sold down his interest in the borrower company immediately prior to its failure so that he then fell below the statutory threshold for "association" was not precluded under s DB 15 from deducting the payment made under his guarantee. It appears that, as the guarantor was not associated with the borrower at the time it defaulted on the principal debt, the restriction ceased to apply.

It will therefore be crucial to determine whether the parties are associated at any and all times over the period in which the guarantee was in effect, and particularly at the time immediately prior to the borrower's default. The decision in *McElwee* suggests that proper planning by a guarantor so that divests itself of its ownership interest prior to the borrower's default or when the guarantee is called upon may circumvent the restriction. However, unless there is some commercial justification for this divestment, and depending upon the financial position of the borrower at the time, any last minute sale may attract the attention of IRD as "contrived" or "artificial", and therefore potentially a tax avoidance arrangement under s BG 1 and/or the specific anti-avoidance provision regarding financial arrangements in s GB 21. **[(2011) 17 NZBLQ 30, 47]**

9.2 Whether Failure Caused by Actions of the Borrower or Associated Person

Even if the borrower and guarantor are associated over the term of the arrangement, s DB 15 will not necessarily apply to preclude deductibility. Instead, under s DB 15 something more is required, being where the expenditure or loss was due to "actions of the surety… the occurrence… or the no-occurrence of an event influenced by the surety". So that section applies only where the surety or the associated person has in some way caused or influenced the events that gave rise to the call under the guarantee. It is significant that s DB 15 does not simply exclude deductions by all associated persons, but specifies the circumstances in which those associated persons may not claim those deductions.

This narrow prohibition contrasts directly with the approach taken under the financial arrangement regime to the deduction of bad debts under s DB 31(3)(c), which simply precludes any deduction unless (along with other specified requirements) "the person is not associated with the person owing the amount written off". This provision is a blanket prohibition on the deduction of bad debts by any lender who is associated with the borrower. While s DB 15 could easily have been similarly drafted to exclude deductibility for taxpayers who are associated with the borrower they have guaranteed, it does not do so. Rather, it appears to permit:

- full deductibility for sureties that are not associated with the borrower, and
- at least partial deductibility for sureties that are associated with the borrower provided that surety (or any other person/s associated with them) did not cause or influence the borrower's loss.

This appears to be the view expressed by IRD in its only policy addressing the application of s DB 15, which states:

> "In this case, the taxpayer holds more than 25% of the shares in the company, and so she and the company are associated persons. Under section EH 4 (8), no deduction can be claimed for the loss if the expenditure or loss results from the actions of the taxpayer or an associated person."If the expenditure or loss did not result from the actions of the taxpayer or an associated person, a full deduction for the expenditure or loss can be claimed."

This narrower interpretation of s DB 15 is supported by one commentator who concluded s DB 15:

> "arguably only applies where the expenditure or loss has arisen as a consequence of events that the guarantor/surety or an associated person brought about, and does not apply where the expenditure or loss arose as a result of events outside the control of the parties."

Likewise, another commentator concludes the fact that a borrower and guarantor are associated "could potentially" render the guarantee payment non-deductible, but only "if the loss can be said to be due to the actions of the guarantor or the borrower." **[(2011) 17 NZBLQ 30, 48]**

The exclusion in s DB 15 was considered necessary to prevent possible manipulation of the underlying loan by borrowers (who remain liable for that debt) and associated guarantors (who received assignment of the debt following payment under the guarantor). A number of commentators have questioned the reality of that concern. Rather, in practice, it appears that exclusion is a designed to ensure parity of treatment between:

- amounts lent directly by the taxpayer to an associated person (which cannot claim a deduction for any loss by virtue of the exclusion for deduction of bad debts by associates under s DB 31 bad debt rules); and
- amounts loaned by a third party to an associated person that had been guaranteed by the taxpayer (which would be fully deductible if not for the operation of s DB 15).

However, as noted above, the requirement in s DB 15 for the default to be caused by the guarantor (or the associated borrower), means that section is much narrower than the blanket prohibition in s DB 31. Instead, the Commissioner may only deny deductibility of a guarantee payment if there is some basis to conclude the borrower's failure was caused or influenced by the guarantor. This was the interpretation adopted in *McElwee* where the taxpayer had recently resigned his directorship and had no active role in the company's financial affairs, and therefore could not be personally blamed and was not responsible for its failure. Robertson J stated:

> "I am satisfied that had the sum claimed been deductible on either of the first two grounds then the Commissioner could not have refused it in reliance upon the influence provision in [s DB 15]. Mr McElwee resigned his offices in the company and transferred his interests in the company after the sale of the Tiller Mine shares to Starline before the default which caused his loss occurred… During the times which were critical, Mr McElwee lacked the required influence and in my judgment could not have altered the course of events."

This approach to the application of s DB 15 has been adopted by most commentators. For instance, in TEO Newsletter, No 146, the authors concluded whether the borrowers default was caused by it or the guarantor "will depend on the facts." Likewise, that view is also endorsed by Glazebrook and others:

> "*McElwee v CIR* seems to imply that the exclusion can apply only where there is actual control and perhaps actual influence over the result. Where the debtor merely has financial problems, a direct link may be difficult to establish. In such cases, deductibility would be judged under normal deductibility criteria without regard to any association between the parties."

On that approach, guarantors that are not directly involved in the operation of the borrower's failed venture, or can otherwise establish that its failure was not caused or influenced by their own conduct, should fall outside the exclusion in s DB 15. In particular, according to Roberston J, the taxpayers merely need to establish that "at the critical time… they could not have altered the course of events" giving rise to that failure. His Honour considered that such factors as whether the guarantor "had good **[(2011) 17 NZBLQ 30, 49]** reason to believe" the borrower was "solvent" and "not in default of any of its commitments" are relevant. As in the *McElwee* case itself, this test may be satisfied if it can be shown that the guarantor believed its business was solvent, could trade its way into profitability, or was being readied for sale.

Importantly, s DB 15 is not an all-or-nothing test but expressly permits an apportionment of the deduction where the guarantor or associated borrower is only partially responsible for the default. It precludes deduction only "to the extent to which" the guarantor is responsible — thereby permitting a partial deduction where that default was caused both by the guarantor and other, unrelated factors.

This wording and approach to apportionment of expenditure mirrors the general permission and general limitation in sections DA 1 and DA 2. Cases explaining how such an apportionment should be undertaken include *Ronpibon Tin NL v Federal Commissioner of Taxation* and *New Zealand Co-operative Dairy Co Ltd v Commissioner of Inland Revenue* and *Buckley and Young Ltd v Commissioner of Inland Revenue*. Those cases demonstrate that apportionment of a single item of expenditure between deductible and non-deductible items is largely a question of fact, with the onus of proof falling on the taxpayer. In some instances the taxpayers will be unable to satisfy that onus. Some positive proof will be required to establish the default was due to factors unrelated to the actions or inactions of the borrower or guarantee. Such proof may best be provided by an independent expert who can attest to the reason/s for the default.

In that regard, the current economic climate may actually assist taxpayers in establishing the default was due to causes beyond their control, thereby taking themselves outside the exclusion in s DB 15. Given the current economic climate many taxpayers can persuasively claim their failure resulted from the unfavourable state of the entire New Zealand economy caused by the unforeseen (and unforeseeable) consequences of the world-wide financial crisis. Certainly this is the view taken by our financial press. Based on that view, a case could be made that the failure of any New Zealand businesses was caused, at least partially, by the general deterioration of the global financial crisis and the general economic downturn that resulted. Many business failures over the past two years may therefore be attributable not to the actions or inactions of the taxpayers but causes beyond their control.

10 Conclusion

The law regarding the correct tax treatment of payments in honour of a guarantee remains uncertain. Where a fee was paid for that guarantee, it will constitute a “security payment” under the financial arrangements rules and any payment by the guarantor will give rise to interest expenditure or loss, which is ordinarily deductible to the taxpayers. Likewise, unless the parties are associated or it can be shown the failure was due to some action or inaction of the guarantor (or borrower, if the parties are associated), s DB 15 will not apply to restrict that deduction. In those circumstances the taxpayers should be entitled to full deductibility of that loss as “interest”, under s DB 6(1). This tax treatment **[(2011) 17 NZBLQ 30, 50]** may then provide some small consolation for a guarantor who has been obliged to honour a guarantee given in respect of a failed investment.

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FOOTNOTES

1 Andrea Milner “Little to Give but a Lot of Receiving to be had” *The New Zealand Herald* (New Zealand, 4 January 2009) at <http://www.nzherald.co.nz>.

2 Jared Savage “Insolvencies Sour as Credit Crunch Hits” *The New Zealand Herald* (New Zealand, 18 January 2009) at <http://www.nzherald.co.nz>.

3 Maria Slade “Company Failures Soar by 40pc” *The New Zealand Herald* (New Zealand, 10 March 2009) at <http://www.nzherald.co.nz>.

4 Diana Clement “Recession Puts the Squeeze on Trusts” *The New Zealand Herald* (New Zealand, 8 August 2009) at <http://www.nzherald.co.nz>.

5 See IR504 Inland Revenue “Inland Revenue’s Compliance Focus 2009 — 2010”, June 2009, at <http://www.ird.govt.nz>.

6 The prohibitive cost and inherent delays of the statutory tax disputes procedure in Part IVA of the Tax Administration Act 1994 has been widely criticised. For example, see Taxation Committee of NZLS and National Tax Committee of NZICA, “Joint Submission: The Disputes Resolution Procedures in Part IVA of the Tax Administration Act 1994 and the Challenge Procedures in Part VIIIA of the Tax Administration Act 1994” (Wellington, August 2008); and M Keating “Tax Disputes Procedure — Time for a Change” (2008) 14 NZJTLP 425.

7 *Meadowcroft v Commissioner of Inland Revenue*[1964] NZLR 108 (SC).

8 Ibid at 112.

9 See *Commissioner of Inland Revenue v Shipbuilders Ltd*[1968] NZLR 885 (CA) and *Knightsbridge Carpets Ltd v Commissioner of Inland Revenue*(1970) 2 ATR 78 (SC) which found that unless the lender or guarantor was in the business of making loans or providing guarantees, advances to support a subsidiary were non-deductible capital advances.

10 *Case 40* 2 NZTBR and *Case 13* 3 NZTBR.

11 See *Case L37*9 ATC 14 and *Case 17* 8 CTBR (NS).

12 *Garforth v Tankard Carpets Ltd*[1980] STC 251 at 258.

13 *Case F62*(1983) 6 NZTC 59,870 at 59,873.

14 *McElwee v Commissioner of Inland Revenue*(1997) 18 NZTC 13,288 (HC) at 13,293.

15 Casey Plunket; "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) at [15.10.2].

16 The application of the nexus test was explained in *Commissioner of Inland Revenue v Banks*(1978) 3 NZTC 61,236 (CA) at 61,241.

17 *Buckley & Young Ltd v Commissioner of Inland Revenue*(1978) 3 NZTC 61,271 (CA).

18 Ibid, at 61,274.

19 *Case F62*(1983) 6 NZTC 59,870 at 59,874 (TRA).

20 *McElwee v Commissioner of Inland Revenue*(1997) 18 NZTC 13,288 (HC).

21 Ibid, at 13,291.

22 Ibid, at 13,292-3.

23 The regime was enacted as ss 64B-64M of the Income Tax Act 1976 and subsequently became Part EH of the Income Tax Act 1994.

24 See the full description and explanation for the financial arrangements rules in Casey Plunket; "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) at ch 15.

25 Glazebrook and others *The New Zealand Accruals Regime: A Practical Guide* (2nd ed, CCH, Wellington, 1999) at 301.This understanding of the regime was endorsed by their Lordships in *Commissioner of Inland Revenue v Auckland Harbour Board*(2001) 20 NZTC 17,008 (PC) at [2].

26 TEO Newsletter 105, 20 July 1995.

27 IRD *Technical Rulings Manual* (Inland Revenue, Wellington, 1998) at ch 14.1.

28 TEO Newsletter 105, 20 July 1995.

29 *Phillips v Foster*[1991] 3 NZLR 263 (CA) at 269.

30 See s EW 3 of the Income Tax Act 2007.

31 That guarantees would come within the regime was acknowledged in the Supplementary Report on the Consultative Committee on Accrual Tax Treatment of Income and Expenditure (the "Brash Committee") at [2.6]-[2.7].

32 *Commissioner of Inland Revenue v Shipbuilders Ltd*[1968] NZLR 885 (CA).

33 Casey Plunket; "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) at [15.10.2].

34 Ibid.

35 See Supplementary Report of the Consultative Committee on Accrual Tax Treatment and Expenditure (known as "The Brash Committee") June 1987 at 2.6-2.7.

36 This is the conclusion reached by Casey Plunket; in "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) at [15.10.2].

37 See PU3801(r), September 1998.

38 Section YA 1 of the Income Tax Act 2007.

39 IRD "The Taxation of Financial Arrangements" Discussion Document (IRD, Wellington, 1997) at 13.1.

40 *McElwee v Commissioner of Inland Revenue*(1997) 18 NZTC 13,288 (HC).

41 Ibid, at 13,295-6.

42 CCH, *New Zealand Income Tax Law and Practice* at [418-150].

43 The various counter-arguments are considered in Casey Plunket; “Tax Accounting: Accruals” in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) at [15.10.3].

44
Under s CC 4 of the Income Tax Act 2007.

45
Under s DB 5 of the Income Tax Act 2007.

46 See s EW 3(1) of the Income Tax Act 2007.

47 See IRD Rulings Manual, Accruals, 1998, at ch 14.2.

48 See s EW 31(7) of the Income Tax Act 2007.

49 *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd*(1994) 16 NZTC 11,048 (CA).

50 *Cooper v Commissioner of Inland Revenue*(1995) 17 NZTC 12,216 (HC).

51 Ibid, at 12,225.

52 For instance, see *Cooper v Commissioner of Inland Revenue*(1995) 17 NZTC 12,216 (HC); *Baigent v Commissioner of Inland Revenue*(1979) 4 NZTC 61,628 (CA); and *Taupo Ika Nui Body Corporate v Commissioner of Inland Revenue*(1997) 18 NZTC 13,147 (HC).

53 See s 149A(2) of the Tax Administration Act 1994.

54 Section EA 4(3).

55 See the definition of “beneficiary income” in s HC 6 applying to the distribution of beneficiary income in s HC 14.

56 *A M Bisley & Co Ltd v Commissioner of Inland Revenue*(1985) 7 NZTC 5,082 (HC) at 5,096.

57 *Commissioner of Inland Revenue v Mitsubishi Motors NZ Ltd*(1995) 17 NZTC 12,351 (PC).

58 *Commissioner of Inland Revenue v Glen Eden Metal Spinners Ltd*(1990) 12 NZTC 7,270 (CA).

59 Ibid, at 7,271.

60 *Casey v Commissioner of Inland Revenue*[1959] NZLR 1052 (SC).

61 Ibid, at 1056.

62 Burrows and others *Law of Contract in New Zealand* (3rd ed, LexisNexis Butterworths, Wellington, 2007) at [4.2.2].

63 Consultative Committee on the Taxation of Income from Capital (“The Valabh Committee”) *Operational Aspects of the Accruals Regime* (October 1991) at [2.7(d)(ii)].

64 See TEO Newsletter 71, 25 June 1993 and TEO Newsletter 107, 16 August 1995.

65 By virtue of s EW 29 of the Income Tax Act 2007.

66 By virtue of s DB 14 of the Income Tax Act 2007.

67 TEO Newsletter 107, 16 August 1995. In particular see the full worked “Example 18” appended to that Newsletter.

68 CCH *Income Tax Law and Practice* (online ed) at [418-150].

69 Glazebrook and others *The New Zealand Accruals Regime: A Practical Guide* (2nd ed, CCH, Wellington, 1999) at 215.

70 Ibid, at 218.

71 See the similar conclusion reached in Tax Education Office Newsletter No 107, 16 August 1995, “Example 18”, and Alan Judge “The Accrual Rules” (ICANZ Tax Conference, Rotorua, November 1997) at 81.

72 Casey Plunket; “Tax Accounting: Accruals” in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004)

at [15.10.2].

73 See Glazebrook and others *The New Zealand Accruals Regime: A Practical Guide* (2nd ed, CCH, Wellington, 1999) at 219-220. The authors provide two worked examples, where the guarantor is able and then unable to recover any of the underlying loan from the original borrower, to show the different BPA calculations.

74 See Casey Plunket; "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) at [15.10.2].

75 Deductibility of bad debts is governed by s DB 31 of the Income Tax Act 2007.

76 Casey Plunket; "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004), at [15.10.4], referring to the conclusion reached by the authors of Glazebrook and others *The New Zealand Accruals Regime: A Practical Guide* (2nd ed, CCH, Wellington, 1999).

77 See the detailed discussion on the legal rights obtained by a guarantor against the borrower following its payment of the principal debt by Casey Plunket; in "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004), at [15.10.4].

78 Alan Judge "The Accrual Rules" (ICANZ Tax Conference, Rotorua, November 1997) at 61 and 62.

79 Glazebrook and others *The New Zealand Accruals Regime: A Practical Guide* (2nd ed, CCH, Wellington, 1999) at 217.

80 TEO Newsletter 107, 16 August 1995.

81 By virtue of s EW 31 of the Income Tax Act 2007.

82 Alan Judge "The Accrual Rules" (ICANZ Tax Conference, Rotorua, November 1997) at 81.

83 See the circumstances in which the borrower would be obliged to undertake a BPA in respect of the loan, as stipulated in s EW 29(1)-(12) of the Income Tax Act 2007.

84

By virtue of the base price adjustment calculated under s EW 31 of the Income Tax Act 2007.

85 As decided by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*[2009] NZSC 40, (2009) 24 NZTC 23,188 and *Glenharrow Holdings Ltd v Commissioner of Inland Revenue*[2008] NZSC 116, (2008) 24 NZTC 23,236. See the discussion of these cases and the widened scope of the general anti-avoidance provision in C Elliffe and M Keating "Tax Avoidance – Still Waiting for Godot?" (2009) 23 NZULR 368.

86 However, see the limitations in scope and application of s GB 21 in *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] UKPC 1, (2001) 20 NZTC 17,008.

87 One commentator suggests that, in addition to satisfying the requirements for the deduction of a security payment, the taxpayer must also meet the rules for deduction under the bad debt provisions in s DB 31: see Casey Plunket; "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004), at [15.10.4(1)]. However, even Mr Plunket concedes that the separate ground for deductibility in s DB 15 "allows an inference to be drawn that the drafters of the accrual rules did not contemplate that a guarantor would have to seek a deduction for any loss under [the bad debt provisions in s DB31], as it contains a somewhat similar set of restrictions". It would appear contradictory for the Act to restrict guarantors who are associated with the borrower from claiming deductions for losses caused by their own action or inaction under s DB 15, only to then require them to meet the separate bad debts requirements of s DB 31, which impose an absolute ban on deductions by associated persons. Such an interpretation would make s DB 15 entirely redundant.

88 Inland Revenue "Loan guarantor's loss when guarantee is called on – deductibility" (1995) 7(2) Tax Information Bulletin 29 at 29.

89 See TEO Newsletter 107, 16 August 1995.

90 Alan Judge "The Accrual Rules" (ICANZ Tax Conference, Rotorua, November 1997) at 83 and 88.

91 Ibid, at 84.

92 "The Taxation of Financial Arrangements" Inland Revenue Discussion Document (1997) at [13.9-15].

93 *McElwee v Commissioner of Inland Revenue*(1997) 18 NZTC 13,288 (HC) at 13,297.

94 TEO Newsletter 146, 25 May 1998.

95 Glazebrook and others *The New Zealand Accruals Regime: A Practical Guide* (2nd ed, CCH, Wellington, 1999) at 215-216.

96 *Ronpibon Tin NL v Commissioner of Taxation*(1949) 78 CLR 47 (HCA).

97 *New Zealand Co-operative Dairy Co Ltd v Commissioner of Inland Revenue*(1988) 10 NZTC 5,215 (HC).

98 *Buckley and Young Ltd v Commissioner of Inland Revenue*(1978) 3 NZTC 61,271 (CA).

99 See for example, Adam Bennett "NZ Super Hit By Global Crunch" *The New Zealand Herald* (New Zealand, 25 September 2008), see <http://www.nzherald.co.nz>; Tamsyn Parker "How the Financial Dominos Tumbled" *The New Zealand Herald*, (New Zealand, 20 September 2008), see <http://www.nzherald.co.nz>; "NZ, Global Markets in Tailspin After Wall St Plunge" *The New Zealand Herald* (New Zealand, 19 September 2008), see <http://www.nzherald.co.nz>; and Adam Bennett "Economy at Threat as Crisis Deepens" *The New Zealand Herald* (New Zealand, 17 September 2008), see <http://www.nzherald.co.nz>.