To tax or not to tax: capital gains in New Zealand

By Justice Susan Glazebrook DNZM[1]

Introduction

The current tax system in New Zealand is underpinned by a framework known as "broad base, low rate".[2] Progressivity is largely delivered through transfers such as Working for Families tax credits.[3] New Zealand's tax and transfer system, however, reduces income inequality by slightly less than the OECD average.[4]

About 90 per cent of New Zealand's tax revenue comes from personal income tax, company income tax and GST. [5] Outside the national tax system, rates on property are the primary source of revenue for local government.[6]

There are few exceptions to the base on which income tax is levied. The main exception is that New Zealand does not have a general capital gains tax.[7] Nor does it levy tax on inheritances.[8] Progressivity is affected by the treatment of capital income as the inconsistent taxation of capital income from gains primarily benefits the wealthy.[9]

1 Judge of the Supreme Court of New Zealand. This paper was presented at Rise 2018, the Australian Bar Association/New South Wales Bar Association Biennial Conference, held in Sydney from 15 to 17 November 2018. My thanks to my clerk, Nichola Hodge, for her assistance with checking and footnoting this paper.

2 Tax Working Group *Future of Tax: Interim Report* (Tax Working Group, September 2018) ch 3 at 15, [2] [*Interim Report*].

3 Chapter 5 at 24, [16].

4 Chapter 3 at 16, [4]. The OECD average is 34 per cent of GDP whereas New Zealand's average is 32 per cent.

5 Chapter 3 at 15, [1]–[2].

6 Chapter 3 at 16, [9].

7 Some historical reasons why this might be so, such as the need for New Zealand to grow its capital base, are discussed in: Shelley Griffiths "New Zealand" in Michael Littlewood and Craig Elliffe *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Edward Elgar Publishing, 2017) 278 at 307–309. However, it has been pointed out that these reasons were not unique to New Zealand as other jurisdictions also relied on property and foreign investment. Other factors, such as the political economy, have been suggested as having played a role see: Chris Evans and Richard Krever "Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand" (2017) 23 NZJTLP 486 at 502–503.

8 Estate taxes, also known as death duties, were introduced in New Zealand in 1866 and abolished in 1992. Gift duty was abolished in 2011: see Michael Littlewood "The History of Death Duties and Gift Duty in New Zealand" (2012) 18 NZJTLP at 66.

9 *Interim Report*, ch 3 at 19, [18].

Not having a capital gains tax makes New Zealand unusual – 85 per cent of countries (187 out of 220) had some sort of regime for taxing capital gains in place in 2017. There were, however, only 114 countries with a capital gains regime in 2001 when South Africa introduced its regime.[10]

Our income tax legislation does, however, include in the definition of "income" many forms of gain that would generally be considered capital gains. Burman and White noted in their 2009 paper that at least 25 kinds of assets and transactions are defined as creating taxable income. Some gains are taxed on realisation, others on accrual or an equivalent, and still others based on imputed return. Their view was that the "current hybrid set of New Zealand tax rules is far from ideal" and that what has resulted is:[11]

> … a grab bag of income and deduction rules accumulated over more than 100 years. Some rules were developed by judges, often drawing on inappropriate trust law concepts. Others were hurried and unnecessarily complex responses by Parliament to economic events. And some were the result of more principled tax policy analysis and consultation by government. But even some of these latter provisions may not represent appropriate tax policy for a small, open economy in 2009 and in the medium-term.

Evans and Krever considered that these comments still held true in 2017, despite the bright-line changes (discussed below) that were introduced in 2015.[12]

Structure of paper

This paper first gives a brief overview of the current capital gains that are treated as income in New Zealand. It moves to a discussion of the legislative provisions and the main cases on capital gains and losses and a recent Supreme Court[13] case on feasibility expenditure.

It then turns to a history of attempts to introduce a capital gains tax in New Zealand. Finally, it discusses the interim report of the Tax Working Group which, among other things, discusses the options for a capital gains tax in New Zealand.

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10 Evans and Krever, above n 7, at 489.

11 Leonard E Burman and David I White "Taxing Capital Gains in New Zealand: Assessment and Recommendations" (paper presented to Victoria University Tax Working Group, Wellington, 2009) 1 at 3 (citations omitted).

12 Evans and Krever, above n 7, at 500.

13 The Supreme Court is the highest Court in New Zealand's hierarchy. Appeals are by leave only. See Senior Courts Act 2016, ss 73 and 74 for the criteria for leave to appeal.

Capital gains that are taxable as income

Gains on the sale of land are taxable for dealers in land[14] or if the land was bought with a purpose or intention of resale. Resale does not have to be the only or dominant purpose or intention.[15] Capital losses are generally not deductible unless the gain on the sale of the property would be taxable.[16]

In 2015 a bright-line test for residential property sales was introduced to aid enforcement.[17] This levies tax on the sale of any residential property within five years of purchase, subject to some exceptions. The most important exception is for the family home, which is generally excluded from that test.[18] However, the main home exclusion from the bright-line test can only be used twice in a two year period.[19] Owner-occupiers with a regular pattern of buying and selling residential land cannot use the main home exclusion for the bright-line rule.[20]

Evans and Krever say that this 2015 amendment represents yet another "'patch' on an increasingly motley set of patchwork provisions". In their view "provisions based on a specified (and relatively short-term) holding period are notoriously easy to circumvent and manipulate".[21]

Land affected by changes to zoning consents or other specific changes may be taxed on sale if the sale is within 10 years of acquisition.[22] If at least 20 per cent of the gain on disposal can be attributed to the change, the whole gain is taxable.[23] The taxable amount is reduced by 10 per cent for each year the taxpayer owns the land.[24]

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14 Income Tax Act, s CB 7.
15 Section CB 6.
16 *Interim Report*, above n 2, ch 5, at 24, [16]. See also Griffiths, above n 7, at 291–307.
17 Section CB 6A. The bright-line test was inserted into the Income Tax Act on the 1 October 2015 by the Taxation (Bright-line Test for Residential Land) Act 2015.
18 Section CB 16A(1). In the case of individuals, s 6A will not apply to the main home if the dwelling on the land was the main home for the person disposing of the property.
19 Section CB 16A(2)(a).
20 Section CB 16A(2)(b). *Interim Report*, above n 2, ch 5 at 24, [17]–[18].
21 Evans and Krever, above n 7, at 500.
22 See for example ss CB 10 and CB 11.
23 Section CB 14(1). This section serves as a catch all provision and applies to the amount an individual deprives from land sold within 10 years of acquiring it which is not covered by ss CB 6A to CB 12 of the Act.
24 For land that falls under s CB 14, along with the normal deduction of the cost of the land under s DB 23, the landowner can deduct the percentage of profits x years or $1000, whatever is greater. See also *Interim Report*, above n 2, ch 5, at 24, [19].

Disposals of land may also be taxed if there is an undertaking or scheme involving more than minor development or division of the land commenced within 10 years of the land being acquired.[25] Land disposals may also be taxed if there has been undertaking or scheme of division of development that involves significant expenditure on specified works but this is subject to a number of exclusions.[26]

Gains on shares in New Zealand companies are only taxable if they had been acquired for the dominant purpose of disposal or in the course of a person's share dealing business.[27] They are otherwise held on capital account and gains are not taxable.[28]

In terms of shares in foreign companies, the fair dividend rate method is usually used to tax portfolio investments and foreign shares other than in Australian-listed companies.[29] This means portfolio investments are generally taxed on a five per cent deemed return based on the opening value of the shares. The actual dividends and sale proceeds are not taxed. However, in any given year, taxpayers can choose to pay tax on the actual return if it is less than the deemed return.[30]

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25 Section CB 12(1).

26 Section CB 13. See also Griffiths, above n 7, at 294–298 for a discussion of the provisions relating to land. For a general discussion see Pam Davidson *Taxation of Property Transactions in New Zealand* (Thomson Reuters New Zealand, Wellington, 2016) and *New Zealand Income Tax and Practice* (Looseleaf ed, CCH). See also the *Interim Report*, above n 2, ch 5, at 24–25, [16]–[21] for a discussion on the position relating to capital gains on land.

27 Income Tax Act, ss CB 4 and CB 5. Section CB 4 states that the "amount that a person derives from disposing of personal property is income of the person if they acquired the property for the purpose of disposing of it". Section CB 5 deals with a person in the business of dealing in personal property.

28 *Interim Report*, above n 2, ch 5 at 25, [22].

29 Gains on Australasian shares held by a Portfolio Investment Entity (PIE) are generally not taxable. The PIE regime was introduced in 2007 to deal with a bias that would otherwise have existed against managed funds: see *Interim Report*, above n 2, ch 5 at 25, [25]. For more information on the position of PIEs see: Inland Revenue "Portfolio investment entities (PIE) for investors" (29 Jul 2009) <www.ird.govt.nz> which provides a variety of resources for the different type of PIE structures.

30 *Interim Report*, above n 2, ch 5 at 25, [25]–[27]. The regime for direct investments in foreign companies where a shareholder holds more than 10 per cent is summarised at 26, [28] of that chapter. See also Griffiths, above n 7, at 298–299 for a discussion on this point.

All returns, including capital gains, from financial arrangements are taxed on a full accrual basis.[31] Certain other receipts, such as lease inducements and payments for restrictive covenants are also treated as income.[32]

Legislative provisions

Income is dealt with in Part C of the Income Tax Act 2007.[33] There is no specific provision exempting capital income but it is accepted that income means income on revenue account or capital gains that are specifically treated under the legislation as taxable.[34]

Deductions are dealt with in Part D of the Income Tax Act 2007. The general provisions are set out in Subpart DA. Relevantly for our purposes section DA1(1), labelled the "General Permission", provides:

> **DA 1 General permission**
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> *Nexus with Income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
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> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income;[35] or
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> (iii) a combination of their assessable income and excluded income; or

31 See the Financial Arrangement rules set out in subpart EW. For a discussion on the tax position of financial arrangements in New Zealand: see Susan Glazebrook et al *The New Zealand Accrual Regime* (2nd ed, CCH New Zealand, Auckland, 1999). Note this was written before the current Act.

32 Many of the provisions dealing with these areas in the Income Tax Act were enacted in response to judicial decisions. For example, the cases of *Henwood v Commissioner of Inland Revenue* (1995) 17 NZTC 12,271 (CA) and *Commissioner of Inland Revenue v Fraser* (1996) 17 NZTC 12,607 (CA) which had held that restrictive covenants and inducement payments were capital were overturned by ss CE 9 and CE 10 of the Income Act. The Privy Council decision of *Commissioner of Inland Revenue v Wattie* [1999] 1 NZLR 529 (PC), which had held that lease inducements fall under capital, was also overturned by s CC 1B. A brief summary of these cases is provided in Appendix Two and for further discussion on the cases and subsequent reforms see Griffiths, above n 7, at 299–305 and: the Committee of Experts on Tax Compliance *Report to the Treasurer and Minister of Revenue – by a Committee of Experts on Tax Compliance* (19 December 1998).

33 The structure and history of the 2007 Act is discussed in Appendix One.

34 Chris Ohms "The tax base – A Framework and Overview" in Garth Harris and others (eds) *Income Tax In New Zealand* (Brookers, Wellington, 2004) 109 at 3.2.2. See also Timothy Plunkett "An Opportunity Missed: The Capital/Revenue Distinction, Feasibility Expenditure and *Trustpower Ltd v Commissioner of Inland Revenue*" (2018) 24 NZJTLP 33 at 36–39.

35 Excluded income is defined in s BD 1(3) and includes GST and fringe benefit tax.

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income

…

There are also general limitations on deductibility under s DA 2:

DA 2 General Limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

Private limitation

(2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

Exempt income limitation

(3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

Employment limitation

(4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.

Withholding tax limitation

(5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the **withholding tax limitation**.

Non-residents' foreign-sourced income limitation

(6) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the **non-residents' foreign-sourced income limitation**.

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

Section DA 2 means that deductions for capital expenditure are generally not available. However, the Act does allow for some deductions for expenditure that would otherwise be on capital account. This includes deductions for depreciation. This initially only applied to tangible property but has been extended to apply for forms of depreciating intangible property such as computer software. Depreciation deductions for buildings were abolished in 2010.[36]

There follows a section providing essentially that specific rules override the general rules[37] and one stating that the capital limitation does not apply to depreciation loss merely because the property is capital in nature.[38] There are then multiple sub parts in Part D dealing with specific types of expenditure.[39]

Caselaw

The main caselaw on the capital/revenue distinction was summarised recently by the High Court[40] and the Court of Appeal[41] in the feasibility case discussed below.[42] There is not much point in repeating that in this paper, but I have set out a summary of recent cases in Appendix Two.

It is worth, however, setting out extracts from a case described by the Supreme Court as one of the leading cases in the area.[43] The case, *BP Australia v Commissioner of Taxation for the Commonwealth of Australia*,[44] a High Court of Australia decision on appeal to the Privy Council, has been endorsed in New Zealand, and was quoted from by both the High Court and Court of Appeal in *Trustpower*. The Court of Appeal cited this passage from Lord Pearce's judgment:[45]

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36 *Interim Report*, ch 5 at 26, [29]–[30].
37 Income tax Act 2007, s DA 3.
38 Section DA 4.
39 For example, s DB 6 provides that the capital limitation does not apply to interest expenses.
40 *Trustpower Ltd v Commissioner of Inland Revenue* [2013] NZHC 2970, [2014] 2 NZLR 502 at [44] – [56] per Andrews J [*Trustpower* (HC)].
41 *Commissioner of Inland Revenue v Trustpower Ltd* [2015] NZCA 253, [2015] 3 NZLR 658 at [51]–[84] per Ellen France P, White and Miller JJ [*Trustpower* (CA)].
42 The decision discussed below is that of the Supreme Court of New Zealand: *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91, [2017] 1 NZLR 155 (Elias CJ, William Young, Glazebrook, Arnold and O'Regan JJ) [*Trustpower* (SC)].
43 At [37].
44 *BP Australia v Commissioner of Taxation for the Commonwealth of Australia* [1966] AC 224 (PC) [*BP Australia*].
45 *Trustpower* (CA), above n 41, at [59]. For a discussion on the test advanced in *BP Australia* see *New Zealand Income Tax and Practice*, above n 26, at 256–200. See also *Sun Newspapers Ltd v Federal*

> A valuable guide to the traveller in these regions is to be found in the well-known judgment of Dixon J in *Sun Newspapers Ltd v Federal Commissioner of Taxation*, where he discussed the nature of certain sums spent in buying up the competition of a rival and concluded that they were capital. "There are, I think," he said,
>
>> three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.
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> And he said:
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>> the expenditure is to be considered of a revenue nature if its purpose brings it within the very wide class of things which in the aggregate form the constant demand which must be answered out of the returns of a trade or its circulating capital and that actual recurrence of the specific thing need not take place or be expected as likely.

The Court of Appeal also quoted another passage from Lord Pearce's advice, which noted the need not to adopt a rigid test:[46]

> The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
>
>> depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.
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> As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.

Commissioner of Taxation (1938) 61 CLR 337 at 363 and 362 respectively for passages cited by Lord Pearce.

46 *Trustpower* (CA), above n 41, at [60]. See also *Trustpower* (HC), above n 40, at [48]. The passage Lord Pearce cites is from *Hallstroms Proprietary Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648.

Trustpower in the Supreme Court

I now turn to consider the recent case in the Supreme Court where the issue was whether expenditure, which the taxpayer, Trustpower, labelled feasibility expenditure, was on revenue or capital account.[47]

Introduction

Trustpower earns its income from retail sales of electricity. It generates about half the electricity it sells and buys the rest from other generators. The issue in the case was the deductibility of the costs of applying for, and obtaining, resource consents in relation to four proposed electricity generation projects.

The consents were obtained by Trustpower on the basis that they would be material to Trustpower's assessment of the feasibility of its projects and thus whether they should be completed. Trustpower had not, however, decided whether it would complete any of the projects and any decisions to do so would be based on extensive additional investigation and market conditions at the time.

The High Court had held that the resource consents were on revenue account.[48] The Court of Appeal said they were on capital account.[49] The Supreme Court dismissed the appeal.[50]

At the time of the *Trustpower* case, the relevant Act was the Income Tax Act 2004. The General Permission[51] and the General Limitations sections were similar to those in the 2007 Act. Of relevance also is that s DB 13B of the 2004 Act gave a deduction for failed or withdrawn applications for resource consents.[52] This did not apply to Trustpower as the consent applications were successful. The Supreme Court nevertheless considered that the existence of

47 *Trustpower* (SC), above n 42.
48 *Trustpower* (HC), above n 40, at [154]–[157].
49 *Trustpower* (CA), above n 41, at [85]–[103].
50 *Trustpower* (SC), above n 42, at [2]–[3].
51 The Court of Appeal in *Trustpower* had indicated that the General Permission was not satisfied – above n 41, at [96]. The Supreme Court disagreed, saying that the expenditure had been incurred in the course of Trustpower's business for the purpose of deriving assessable income. See at [13](b) and [44] of the Supreme Court decision, above n 42. Indeed, the Commissioner had never argued to the contrary.
52 Section 28B contained a similar deduction for failed or withdrawn applications.

the section lent some support to the Commissioner's argument that resource consents were generally on capital account.[53]

The 2007 Act takes this further a step further. Section DB 19 now provides a deduction for costs relating to time limited resource consents, which are surrendered.[54]

Arguments in the Courts below

The arguments, at least in the High Court and the Court of Appeal, were very much focused on what was, at that stage, the Revenue's Interpretation Statement on the deductibility of feasibility expenditure.[55] In that statement feasibility expenditure incurred principally for the purpose of placing a taxpayer in a position to make an informed decision about the acquisition of an asset or other enduring advantage was said normally not to be on capital account. However, once the decision has been made to proceed, then any expenditure would be on capital account.

In the Courts below the Revenue had accepted that expenditure in relation to the four projects was on revenue account before the decision to apply for resource consent on the basis that it was, in terms of the Interpretation Statement, for the purpose of putting Trustpower in the position of making an informed decision. However, the stance taken was that the resource consents themselves were on capital account because they were identifiable, intangible assets in their own right.

In the decision granting the leave to appeal against the Court of Appeal decision, the Supreme Court made it clear that it would be looking at the deductibility of feasibility expenditure generally and would not be constrained by the arguments that had been advanced the Courts below.[56] In particular, the Supreme Court said that it would not be constrained by the proposition that the Interpretation Statement was correct in treating "feasibility expenditure" as being on revenue account.

53 *Trustpower* (SC), above n 42, at [29].

54 Inserted in 2014. The same applies to patent expenditure under section DB 37. Section DB 40B introduced in 2012 provides a deduction for the unsuccessful development costs of software.

55 The High Court and Court of Appeal used: Inland Revenue *Interpretation Statement: Deductibility of Feasibility Expenditure* (ISO8/02, June 2008), see *Trustpower* (SC), above n 42, at [7]. The 2008 Interpretation was replaced in 2017 by a new statement that aligned the IRD's approach with the Supreme Court's decision in *Trustpower*: Inland Revenue *Interpretation Statement: Income Tax - Deductibility of Feasibility Expenditure* (IS17/01, February 2017).

56 *Trustpower Ltd v Commissioner of Inland Revenue* [2015] NZSC 134 at [1]–[2].

Decisions of the Courts below

The High Court concluded that the resource consents could not be regarded as standalone assets.[57] It followed that the expenditure was on revenue account. Even if this was wrong and the resource consents could be regarded as standalone assets, the expenditure would still be on revenue account.[58] This was because the consents were part of Trustpower's general business operation, they were not sufficient on their own to found a decision to proceed with the projects and had not generated income. They were thus part of a feasibility assessment and on revenue account.

The Court of Appeal, by contrast, considered that the expenditure had the purpose of acquiring assets that would be part of the profit making structure of the business.[59] There was thus a sufficient connection between the expenditure and the capital structure of the business, even if a final decision on whether the projects would go ahead had not been made.[60]

The Supreme Court decision

The Supreme Court noted[61] that the expression feasibility expenditure did not fully capture the significance of the resource consents. The consents amounted to tangible process towards eventual completion of the projects which could not be built without them.

The Supreme Court said that it was in general agreement on this point with the approach of Professor Prebble and Mr McIntosh[62] that everything that relates to a capital asset is non-deductible, even if a capital asset does not result.[63] There was some flexibility allowed by the Court, however, in respect of the initial stages of feasibility work seen as a normal incident of business.[64]

57 *Trustpower* (HC), above n 40, at 47.
58 *Trustpower* (SC), above n 42, discussed at [98]–[139].
59 *Trustpower* (CA), above n 41, at [87].
60 At [88]. Although considering the consents were standalone assets, this was not essential to the Court's conclusion, at [92].
61 *Trustpower* (SC), above n 42, at [2]–[3].
62 John Prebble and Hamish McIntosh, "Deducting Expenditure to Assess the Feasibility of Constructing Capital Assets: Opinions from Inland Revenue, the High Court and the Court of Appeal" 6 VUWLRP 24/2016 at 16-19.
63 *Trustpower* (SC), above n 42, at [4].
64 At [13](g) and [72].

The Supreme Court rejected the commitment approach argued for by Trustpower as it did not provide either a logical or principled approach to categorising expenditure.[65] The Court noted the subjectivity implicit in the commitment approach and said that this would give rise to a number of practical problems. These problems would arise as a decision on whether there was commitment would have to be made in a context where a taxpayer:[66]

(a) can be expected to defer commitment as long as possible to maximise the extent to which expenditure can be deducted; and

(b) has control of the contemporaneous records (board minutes and papers for example) which will form the basis of the later assessment whether there was a commitment.

Reaction to the Supreme Court's decision

In an article published this year, the Supreme Court's decision came under some criticism.[67] The author accepted that the decision is authoritative in that it settled the issue of the deductibility of expenditure incurred in the acquisition or construction of a capital asset, with only preliminary or early stage expenditure likely to be deductible. The author did however, criticise the decision, and argued that whether feasibility expenditure is preliminary or early stage may prove difficult to assess.[68]

I comment that the Supreme Court did recognise that the test it was proposing had some indeterminacy about it, but considered that this was in fact better than the indeterminacy that would arise if the commitment approach had been taken.[69]

The other aspect of the decision that was criticised in the article was that the Supreme Court did not take what was said to be a "rare opportunity" for the Court to discuss the leading cases on the capital revenue distinction and confirm the proper approach. It was said that leaving a fundamental and inherently difficult area of income tax law "undiscussed undermines the Supreme Court's role as New Zealand's highest Court".[70] The author does say that the

65 *Trustpower* (SC), above, at [47]–[67]. The Supreme Court did recognise that the commitment to a business was highly relevant in the case of whether a new business had started in fact: see at [13](a).
66 At [70].
67 Plunkett, above n 34.
68 At 62.
69 *Trustpower* (SC), above n 42, at [69].
70 Plunkett, above n 34, at 62.

principles governing the capital revenue distinction have been well established by the Court of Appeal but said that, even if complete clarity could not be provided by the Supreme Court, the Court could have at least provided greater certainty.[71]

I comment that it is a criticism often levelled at final courts that they fail to take the opportunity to deal with issues that have been concerning practitioners but which are of wider application than the case in front of them. In fact, the more uncertain the area of law is, the more cautious courts and final courts in particular, should be in writing, as one of my colleagues used to call it, a law review article on the topic. This is because courts are there to decide the case in front of them and in light of the facts of that particular case. The danger in going wider than this is that the law is being discussed in a vacuum and in the absence of particular facts. This can mean that the law is stated far too widely (or in some cases far too narrowly) and can therefore cause issues in future cases.[72]

Discussion paper

In May 2017 the then National Government issued a discussion document on black hole[73] and feasibility expenditure.[74] The discussion document set out two key proposals:[75]

> … the first proposal is that for expenditure that meets a new definition of "feasibility expenditure" businesses will be able to apply International Financial Reporting Standards (IFRS) to determine whether the expenditure is immediately deductible, or must be capitalised. The objective is to ensure that the tax treatment of "feasibility expenditure" is clearer, and to ensure that no expenditure that meets that definition will receive black hole treatment.
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> In addition, the second proposal is to allow taxpayers a deduction for expenditure that would have been deducted over time if the expenditure had been successful, but it is denied a deduction because the expenditure did not result in a successful asset. The Government believes this would resolve a lot of black hole tax treatment.

71 At 62.
72 Justice Susan Glazebrook "Intermediate and Final Courts of Appeal: Chalk and Cheese?" (2017) JJA 98 at 116–117; and more generally Susan Glazebrook "What Makes a Leading Case? The Narrow Lens of the Law or a Wider Perspective?" (2010) 41 VUWLR 339.
73 Lui and Elliffe define black hole expenditure as relating to "expenditure which has been incurred by the business and that, for some reason or another, cannot be deducted. In other words, the expenditure has "disappeared" because it cannot be deducted or capitalised to an asset. It is effectively lost from the balance sheet.": Peggy Lui and Craig Elliffe "The Problem with 'Black Hole' and Feasibility Expenditure: Some Suggestions for Reform" (2011) 17 NZJTLP 67.
74 Steven Joyce and Judith Collins *Black hole and feasibility expenditure* (Inland Revenue, Wellington, 2017).
75 At [1.3] and [1.4].

These proposals however, have been overtaken by the Tax Working Group established by the new government after the recent general election.

History of consideration of capital gains tax

A number of reviews of the tax system have considered the extent to which New Zealand should tax capital gains,[76] but such a tax has never eventuated, despite strong recommendations from the OECD and some expert groups.

Professor Griffiths says that, at least by the 1920s, the categorisation of income and capital as separate was "endemic in thinking about the income tax system".[77] No consideration was given to a capital gains tax in any of the reviews conducted in the 1920s. There was some consideration given to the issue in a review of the taxation system conducted in 1951 but it was concluded that it was not possible to levy an equal, just and proportionate tax on capital. A young country like New Zealand needed to build up its capital base and there were practical problems with both the levying and payment of such a tax.[78]

In 1966 the Government established a committee of independent experts (the Ross Committee) to undertake a review of taxation in New Zealand. In its report the following year, the Committee noted that, while there was justification for taxing realised capital gains on equity grounds, there were administrative problems among other issues, such as the fact that gains due to inflation were illusory. It considered the issue of whether to tax capital gains needed further study but this was not a priority.[79]

In 1982 a task force on tax reform reported (the McCaw Committee). This Committee recommended a broad base, low rate taxation model and a value-added tax. The Committee concluded that, although there was no reason in principle not to tax capital gains, it did not recommend the introduction of a capital gains tax at that time. The task force's recommendation seemed to have been be influenced by its view that introducing a capital gains tax during a period of high inflation, as then prevailed, would create more problems than it would cure.

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76 This history of reform efforts is taken from Griffiths, above n 7, at 278–309 and Robin Oliver "Capital Gains Tax - The New Zealand case" (a paper prepared for the Fraser Institute 2000 Symposium, on Capital Gains Taxation held in Vancouver BC, Canada, September 2000).

77 Griffiths, above n 7, at 279.

78 At 280–281.

79 At 280–281.

Following the election of a Labour government in 1984, there were radical reforms of the tax system in New Zealand, directed to base broadening and rate reduction. Many exemptions and incentives were removed and GST was introduced. In the course of the reform process a number of advisory committees had recommended the introduction of a capital gains tax.[80]

A committee was set up to examine that issue in 1989. The committee's report concluded that the current exemption of capital income had been the work of judges, rather than arising from the legislation and that there was no inherent justification for the distinction between income and capital. Another committee, set up the following year, concluded that the priority should be to address anomalies in the legislative framework. The Minister of Finance announced that only once that was done would the issue of capital gains be examined again.[81] Any plans were, however, shelved when the Labour Government was defeated in the 1990 general election.

In 1998 a committee of experts on tax compliance concluded that, although not having a capital gains tax was a cause of some complexity in the system, on balance the lack of a comprehensive capital gains tax enhanced simplicity.[82]

In 2000 the OECD reported that New Zealand had one of the most broadly based, neutral and efficient tax systems in the OECD but that one of its main weaknesses was the lack of a capital gains tax. The issues raised included that "the income tax base is narrowed; the allocation of savings and investment is distorted; tax-shifting behaviour is encouraged, in particular among high-income earners and wealthy individuals; and a non-level playing field is created among different financial instruments".[83]

In 2001, the Fifth Labour Government appointed an expert committee to undertake a general review of the New Zealand tax system. The Tax Review 2001, known as the McLeod Committee, concluded that New Zealand should not adopt a general capital gains tax on realised gains because it believed that this:[84]

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80 For example, the Consultative Committee on Full Imputation *Report of the Consultative Committee on Full Imputation* (Government Printer, 1988) at [6.2.3.] and the Royal Commission on Social Policy *The April Report (Report of the Royal Commission on Social Policy)* (Vol III, pt 2, The Commisson, 1989). For more, see Griffiths, above n 7, at 282–283.

81 Griffiths, above n 7, at 283–285.

82 At 285–286.

83 OECD *OECD Economic Surveys: New Zealand* (OECD Publishing, 2000) at 144.

84 *Tax Review 2001: Final Report* (October, 2001) at [3.14].

> … would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower rates. Instead, any such tax would be more likely to increase the complexity and costs of our tax system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion.

Although the Committee did accept that the lack of a capital gains tax did cause "tensions and problems in specific areas",[85] it favoured a continuation of the ad hoc New Zealand approach of dealing with capital gains issues as they arose. To address the problems caused by the disparate taxation of different savings entities at that time, it proposed the risk-free return method of taxation.[86]

In 2009 Victoria University, in conjunction with the Treasury and the Inland Revenue Department, established a tax working group. It reported in early 2010. Two options for a capital gains tax were suggested – a hybrid approach which used an accrual basis for listed shares and unit trusts and a risk-free return method for other assets. The other option was a realisation based capital gains tax on all property. Agreement between the members of the committee was not, however, reached.[87]

In 2011 the New Zealand Labour Party included a capital gains tax in the policies it put to the electorate for the election campaign that year. The Labour Party did not get elected, although it has been suggested that this was not because of its proposal for a capital gains tax.[88]

In 2013 the OECD Economic Survey recommended that New Zealand "[i]mplement a capital gains tax and boost environmental and property or land taxes to facilitate a more efficient and equitable tax structure".[89] It was said that "New Zealand belongs to a group of five OECD countries with particularly high pre-tax capital-income inequality … [and that,] as much of this income, especially at the top levels, takes the form of capital gains, the lack of a capital gains tax in New Zealand exacerbates inequality (by reducing the redistributive power of taxation). It also reinforces a bias toward speculative housing investments and undermines housing affordability".[90]

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85 At [3.15].
86 At 286–288.
87 At 288–289.
88 Andrew Maples "A Comprehensive Capital Gains Tax in New Zealand – No Longer Political Hare-kari? A consideration of the Labour Party proposal" (2014) 20 NZJLP 144.
89 OECD *OECD Economic Surveys New Zealand: Overview* (June 2013) at 3.
90 At 22.

There were comprehensive proposals in the 2014 general election put forward by both the Labour Party and the Green Party but again these parties were not successful in the election.[91] In the 2017 election, a capital gains tax was not part of Labour's policies and it was promised one would not be introduced in the first term. A committee would, however, be set up to examine the tax system.[92]

Tax Working Group

In fulfilment of that policy, in 2017 the New Zealand Government created the Tax Working Group to consider the future of tax. Chaired by former Finance Minister Hon Sir Michael Cullen, its task is to provide recommendations to Government that would improve the fairness, balance and structure of the tax system over the next 10 years. The Group sought input from a diverse and wide range of New Zealanders and ran a two-month public consultation between 1 March and 30 April 2018. In September 2018, the Group released an interim report.[93] Final recommendations will be issued in February 2019.

The interim report notes that Inland Revenue and the Treasury did an analysis which shows that some industries appear to pay a low amount of tax relative to their accounting profits. The Group commented that there may be valid reasons for this. For example, some companies may be earning foreign income that is not taxed in New Zealand. There are also areas where tax laws differ from accounting rules. The most significant cause for effective tax rates, however, appears to result from untaxed income on form of gains from capital assets.[94]

Overall, the Group concluded that there are inconsistencies in the treatment of some forms of capital income, which raise a number of concerns.[95] The first is fairness. The Group noted that:[96]

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91 See Griffiths, above n 7, at 289–290.

92 The New Zealand Labour Party set out a proposed timeline for the Working Group, starting in December 2017 with any resulting legislation introduced to Parliament in September 2019 and not coming into force until 2021. See "Labour's Tax Plan" *Labour* <www.labour.org,nz>; Henry Cooke "Election: Labour backs down on tax, will not introduce anything from working group until after 2020 election" *Stuff* (New Zealand, 14 September 2017).

93 *Interim Report*, above n 2. For a summary of the *Interim Report*'s key findings and standout issues see Barney Cumberland, Stuart Hutchinson and Paul Windeatt "Tax Working Group: The Future Is Not What It Used To Be" (2018) 122 Taxation Today 4.

94 *Interim Report*, above n 2, ch 5 at 27, [38]–[40].

95 Chapter 5 at 26, [49] and ch 6 at [13]–[18].

96 Chapter 5 at 28, [47].

> The inconsistent treatment of capital income is unfair. This unfairness will only increase if the economy becomes more capital-intensive through a greater use of technology replacing labour.

The second concern was the distributional impact of the inconsistent tax system. The Group said:[97]

> It is the wealthiest members of society who benefit the most from the inconsistent taxation of capital income. There is a risk that this regressive outcome erodes the social capital that sustains public acceptance of the tax system.

The third concern is revenue sustainability.[98] The concern here is that, as the population ages, a greater proportion of the population will live off capital income in retirement. The economy is thus likely to became increasingly capital-intensive. The tax base needs to be sustainable over time and fair in an intergenerational sense.

In particular, taxing more capital income from land has the advantage that it is an immobile tax base unlike financial capital and labour which are increasingly mobile. Broadening the tax base to include more income from land helps to diversify and provide some more flexibility in the system to respond to future changes.[99]

The Group noted that the 2017 OECD Economic Survey of New Zealand recommended that New Zealand adopt a broad-based capital gains tax. The advantages were said to be that such a tax increases progressivity of the tax system, improves horizontal equity by taxing income, whether it is earned on capital gains or otherwise and improves efficiencies through reducing tax-driven incentives to make investments and assets that provide capital gains rather than income and, in particular, housing. It also reduces the incentive to shelter income from tax by transformation ordinary income into capital gain.

The disadvantages are that there is inefficient lock-in due to an incentive to hold onto assets to avoid paying capital gains tax. Taxes accrue on nominal as well as real gains and this, in the absence of other tax changes, can discourage saving and investment through reducing post-tax return, particularly if there are strict limits around relief for capital losses. Taxing gains on

97 Chapter 5 at 28, [47].
98 Chapter 5 at 28, [47].
99 Chapter 6 at 33, [11].

shares has the potential for some double taxation of retained profits on which company tax has already been paid.[100]

The Group noted that there could be economic inefficiency outcomes but it would depend on the detail, design and who actually bears the cost of the tax. One of the advantages of taxing capital income is the ability to deduct capital expenditure such as black hole expenditure or building depreciation into the tax base. This would improve the neutrality of the tax system.[101]

The view of the Group was that tax has not played a large role in the current state of New Zealand's housing market and will be unlikely to play a large role in fixing it.[102] The Group acknowledges that the extension of capital income taxation will significantly increase compliance and administration costs. On the hand, virtually every other country in the OECD has been able to deal with extending their tax base in this way.[103]

The Group is considering two main options for extending the taxation of capital income. The first is to tax realised gains and the second is to tax certain assets on deemed return basis (for example, a risk-free rate of return method). Whichever option is chosen, the effectiveness will be dependent on its design. As the design has not yet been decided, the Group is not in a position to make specific recommendations as to whether a capital gains tax should be introduced but is intending to do so in its final report. One question will be whether the fairness, integrity, revenue and efficiency benefits from reform outweigh the administrative complexity, compliance costs and efficiency costs that would arise from any proposed additional capital income taxation.[104]

Conclusion

At the recent Charted Accountants Australia and New Zealand Tax Conference, the Chair of the Tax Working Group, Dr Cullen said that any legislation to introduce a capital gains tax would be prospective only but he recommended that, if a decision was made to tax capital gains, the legislation should be introduced before the 2020 general election, even if it would

100 Chapter 6 at 42–43, [7]–[88].
101 Chapter 6 at 32–33, [19]–[20].
102 Chapter 6 at 33, [27].
103 Chapter 6 at 34, [34].
104 Chapter 6 at 30, [2]–[4] and 35–42, [43]–[95]. The Group decided not to recommend land or wealth taxes: see ch 6 at [96]–[108].

not come into force until after the election.[105] This would be to ensure that the final form of the tax is known before the election.

It remains to be seen whether the Working Tax Group will be able to agree on a proposal for a capital gains tax and,[106] if so, whether the Government will be prepared to commit to introducing one. Without cross-party agreement (which would be unlikely),[107] it would become an election issue and one on which there are very entrenched and passionately held[108] views (on both sides of the debate).[109]

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105 Patrick Smellie "Michael Cullen says legislate capital gains tax before election" *New Zealand Herald* (Online ed, New Zealand, 18 October 2018). This is in line with the New Zealand Labour Party's proposed timeline for tax reform with intended reforms, if any, put before the House in September 2019, this is discussed above at n 92. The structure of the MMP government however means that the Labour Party would require the support of its coalition partners: the Green Party and New Zealand First. While the Green Party has indicated support for a capital gains tax (excluding the family home), the position is less certain for New Zealand First; see Green "Economic Policy" <www.greens.org.nz>; New Zealand First "About New Zealand First" <www.nzfirst.org.nz>. See also: Audrey Young "Audrey Young: Winston Peters holds veto on any capital gains tax after Michael Cullen's Tax Working Group Reports back" *New Zealand Herald* (online ed, New Zealand, 20 September 2018); Audrey Young "Audrey Young: Capital gains tax defining issue for Labour, NZ First" *New Zealand Herald* (online ed, New Zealand, 22 September 2018). It is also unlikely that the Labour Party will have support from the main opposition party: The New Zealand National Party.

106 Tom Pullar-Strecker "Capital gains tax gets tick from most – but not all – Tax Working Group members" *Stuff* (28 November 2018).

107 See for example the article by Judith Collins, Opposition MP and a former National Minister of Revenue, who argues that a capital gains tax will cause a rental crisis and rent increases: Judith Collins "Judith Collins: Capital gains tax will hit the vulnerable" *New Zealand Herald* (online ed, New Zealand, 11 September 2018).

108 Kreve and Brooks have said that among "small business persons, homeowners and farmers" there is a "deeply-felt, visceral reaction to the taxation of the gain on the sale of their assets": Richard Kreve and Neil Brooks *A Capital Gains Tax for New Zealand* (Victoria University Press, 1990) at 6 as cited in Griffiths, above n 7, at 285.

109 See, for example, Vaughn Gunson "Take the GST off petrol" *New Zealand Herald* (online ed, New Zealand, 10 October 2018), arguing that the tax cuts that were the trade off for GST favoured the wealthy who have the means to invest for tax-free capital gains and that taxing necessities (with GST) is "an undeniable injustice". And on the other side of the debate, Troy Bowker "Tax Working Group plan for baches [holiday homes] a wealth tax that will rob Kiwis of their dream" *Stuff* (New Zealand, 19 October 2018). For a response to Bowker's article see Pattrick Smellie "A bach tax in New Zealand? Don't count on it" *Stuff* (New Zealand, 1 November 2018). See also Lyn Webster "Capital gains tax punishes hard work" *Stuff* (New Zealand, 23 October 2018). The actual recommendations that will be made by the Tax Working Group are however, unclear and the Labour Party has, as an article noted, given the Group a "prod" to examine measures, such as a broad-based capital gains tax system, to address issues of inequality, see Tom Pullar "Ministers issue fresh request to Tax Working Group to 'consider inequality'" *Stuff* (New Zealand, 20 September 2018). See also Tom Pullar-Strecker "Capital gains tax debate not over Grant Robinson suggests" *Stuff* (New Zealand, 10 September 2018).

Appendix One: Structure of income tax legislation in New Zealand

[1] The current income tax legislation, the Income Tax Act 2007, is the culmination of a project to rewrite tax legislation to ensure that it has a logical structure, is written in plain English and that it outlines the scheme for the calculation of income tax liabilities.[110] The primary aim was to produce legislation that clearly states the underlying policy. This was seen as integral to reducing compliance and administration costs and increasing voluntary compliance with tax law. The principles used in the rewrite were:[111]

(a) organising the material from the general to the specific, and using general rules to perform a pivotal role to provide links to the core provisions;

(b) starting parts, subparts and sections with more widely used rules and concluding with less widely used rules;

(c) grouping provisions performing similar functions or having similar subject matter to provide the reader with the relevant context;

(d) reducing repetition by applying common sets of rules to minimise overlap;

(e) limiting the subject matter of each section to a single concept;

(f) adopting a plain language approach; and

(g) using a consistent format to aid accessibility by improving the flow of text.

The rewrite project's first stage was the re-ordering and renumbering of the Income Tax Act 1976, and the subsequent enactment of the 1994 Act and the Tax Administration Act 1994. The 1994 Act organised the legislation into parts that were structured around a set of core

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110 The need to rewrite tax legislation had been signalled by a number of committees, including the Consultative Committee on the Taxation of Income from Capital (commonly called the Valabh Committee after its chair), the Working Party on the Reorganisation of the Income Tax Act 1976; and the Organisational Review of the Inland Revenue Department. See also the article by Ivor Richardson, "Simplicity in Legislative Drafting and Rewriting Tax Legislation" (2012) 43 VUWLR 517.

111 Tax Information Bulletin issued 3 March 2008, "Income Tax Act 2007: Introduction and summary of the act". This bulletin also summarises the history of the rewrite project and the function of the various parts of the Act as outlined below.

provisions, using an alphanumeric system. There was some consolidation of material by topic, and the definitions were brought together in one section.

The alphanumeric referencing system does not number the whole Act consecutively from the first section. Instead parts and subparts are lettered in separate series. A reference to each section of the Act begins with an alphabetical reference, first to the part, and secondly to the subpart, followed by a number. So a reference to a specific section could take the form CB 3. This system allows new subparts and provisions to be inserted over time, without resulting in complex section identifiers. It also gives a better sense of structure.[112]

The next stage in the rewrite process was the reworking of the core provisions, which led to the enactment of the Taxation (Core Provisions) Act 1996. The rewritten core provisions contained a clear conceptual scheme for the Act, based on a transactional approach to taxation. This scheme was integrated with the assessment rules in the Tax Administration Act 1994.

The 2004 Act contained the rewritten Parts C to E. The main objective was to integrate the income, deduction and timing rules with the framework set out in the core provisions. Some minor adjustments were made to the core provisions to clarify some aspects of those rules, for example, the development of a structure for the concept of "assessable income".

The 2007 Act rewrote Parts F to Y of the 2004 Act as well as the schedules to that Act. It also made consequential amendments to Parts A to E to highlight the relationship between provisions in Parts F to Y with the core provisions, and to move income rules to Part C, deduction rules to Part D and timing rules to Part E.

Part A of the 2007 Act deals with purpose and interpretation. The purpose provision is not likely to be of much assistance in interpretation as it effectively states the obvious. It says:[113]

> The main purposes of this Act are—
>
> (a) to define, and impose tax on, net income:
>
> (b) to impose obligations concerning tax:
>
> (c) to set out rules for calculating tax and for satisfying the obligations imposed.

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112 Law Commission *Legislation Manual Structure and Style* (NZLC R35, 1996) at 60, [253].
113 Income Tax Act, s AA1.

Section AA 2(1) provides that diagrams, flow charts and reader's notes and lists of defined terms following the sections are interpretational aids. If there is a conflict with the terms of the Act then the Act prevails. Definitions are included in Part Y, as well as the general Interpretation Act 1999.[114]

Part B contains the core provisions, providing a list of taxes and other obligations imposed on a person and the procedures to be followed for calculating and satisfying the obligations under the Act.

Part C sets out the circumstances in which a transaction or other event gives rise to income. Part D contains provisions relating to deductions for expenditure or loss, including a loss in value, arising from a transaction or event. Part E contains rules related to the timing and in some cases the quantification of the derivation of income or the incurrence of expenditure or loss.

Part F recharacterizes the outcome of certain transactions for income tax purposes. Part G deals with avoidance and valuation matters. Part H deals with how certain entities must determine and account for their tax obligations. Part I deals with how tax losses may be used and the loss grouping rules for groups of companies. Part L deals with how a tax credit is used to satisfy a person's income tax liability. Part M deals with how tax credits are paid to persons entitled to particular tax credits. Part O contains rules for credit and debit accounts

Part R Rules related to the payment, collection, and refunds of taxes and other payment obligations. Part Y contains defined terms that apply across the Act. Part Z contains transitional provisions and some savings provisions.

In general, the drafting approach has been to use subpart A in each Part to provide a link to the core provisions if the Part as a whole supports the operation of the core provisions.

114 The Interpretation Act 1999, s 5 provides that "[t]he meaning of an enactment must be ascertained from its text and in the light of its purpose."

Appendix Two: Recent cases

Easy Park Limited v Commissioner of Inland Revenue [2018] NZCA 296; (2018) 28 NZTC 23-066

Easy Park was a company that was formed for the sole purpose of undertaking commercial rental property investments. It agreed to an early termination of a tenant's lease in return for a lease surrender payment of $1.1 m.

In the High Court,[115] Ellis J concluded that the lease surrender payment received by Easy Park was on revenue and not capital account, upholding the Revenues' classification of the lease surrender payment as taxable income. The Court of Appeal agreed that the lease surrender payment in the hands of Easy Park was on revenue account and dismissed the appeal.

The Court of Appeal held that Easy Park's sole business was leasing commercial properties. The lease surrender payment essentially had the same character as the rents Easy Park received when leasing those commercial properties. It was a lump sum made on account of the rent forgone, meaning that, from a practical business point of view, the lease surrender payment was income in its hands.

Commissioner of Inland Revenue v Vector Limited [2016] NZCA 396, (2016) NZTC 22-065

Vector sold certain access rights to the national grid operator, Transpower New Zealand Ltd, for around $53 m. At issue was s CC 1 of the Act and in particular s CC 1(2)(g). Section CC 1 provides:

> **CC 1 Land**
>
> *Income*
>
> (1) An amount described in subsection (2) is income of the owner of land if they derive the amount from—
>
> (a) a lease, licence, or easement affecting the land; or
>
> (b) the grant of a right to take the profits of the land.
>
> *Amounts*
>
> (2) The amounts are—

115 *Easy Park Ltd v Commissioner of Inland Revenue* [2017] NZHC 1893; (2017) 28 NZTC 23-024.

(a) rent:

(b) a fine:

(c) a premium:

(d) a payment for the goodwill of a business:

(e) a payment for the benefit of a statutory licence:

(f) a payment for the benefit of a statutory privilege:

(g) other revenues.

…

The High Court held that the amount received by Vector for the access rights was a non-taxable capital receipt.[116] The Court of Appeal dismissed the appeal. The Court concluded that there has never been a coherent, overarching scheme in s CC 1 that all amounts derived by a landowner for letting another use its land is taxable. The Court held that the High Court was correct in finding that the term "other revenues" used in s CC 1(2)(g) does not include amounts of a capital nature.[117] In this case the consideration received was on capital account because there had been an effectively permanent disposition of Vector's property interest.

Section CC 1B, inserted in 2015,[118] may, however, be relevant in a future case. This provides:

Consideration relating to grant, renewal, extension, or transfer of leasehold estate or licence

When this section applies

(1) This section applies when a person (the **payee**) derives an amount—

(a) in relation to a right (the **land right**) that is

(i) a leasehold estate not including a perpetual right of renewal:

(ii) a licence to use land; and

(b) as consideration for—

(i) the agreement by the payee to the grant, renewal, extension, or transfer of the land right:

116 *Vector Ltd v Commissioner of Inland Revenue* [2014] NZHC 2069, (2014) 26 NZTC 21-096.

117 At [21]–[51]. See also the High Court decision: *Vector Ltd v Commissioner of Inland Revenue* (2014) NZHC 2069, (2014) 26 NZTC 21-096 at [47]–[58].

118 By the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 (2014 No 39), s 10).

(ii) the transfer of the land right from the holder of the land right to another person.

Income

(2) The amount is income of the payee.

Exception for payment as consideration for transfer of land right

(3) The amount is not income of the payee if—

(a) the payee is the holder of the land right; and

(b) the amount is consideration for the transfer of the land right to the person paying the amount; and

(c) the amount is not sourced from funds provided, by the owner of the estate in land from which the land right is granted, for purposes that include obtaining the surrender or termination of the land right; and

(d) each of the payee and the person paying the amount is not associated with the owner of the estate in land from which the land right is granted.

Exception for tenant or licensee of residential premises

(4) The amount is not income of the payee if the payee—

(a) is a natural person and derives the amount as a tenant or licensee of residential premises whose expenditure on the residential premises does not meet the requirements of the general permission; and

(b) is not associated with the owner of the estate in land from which the land right is granted.

Exception for payment of capital contribution

(5) The amount is not income of the payee if the amount is derived as a capital contribution.

Commissioner of Inland Revenue v Fullers Bay of Islands Ltd (2006) 22 NZTC 19,716[119]

The issue in this case concerned the treatment of legal fees paid to solicitors for an unsuccessful litigation aimed at securing a contract to perform services via a tender process. It was alleged that the taxpayer had lost the contract due to an unfair process. The High Court held that the expenditure was on capital account. The Court of Appeal dismissed the appeal. The contract was a capital asset. The fact that income generated from the contract, had it gone ahead, would

119 For a discussion on the decision of the High Court see Eugen Trombitas "The New Zealand Judiciary and the Capital/Revenue Distinction at the Beginning of the Twenty-First Century – Upholding the Integrity of the Tax System" in Adrian Sawyer (ed) *Taxation Issues in the Twenty-First Century* (The Centre for Commercial & Corporate Law, University of Canterbury, Christchurch, 2006) 79 at 80–82.

have been on revenue account, was irrelevant. As the expenditure had been spent trying to secure a capital asset it was capital expenditure.

Birkdale Service Station Limited v Commissioner of Inland Revenue (2000) 19 NZTC 15,981[120]

The taxpayers were five petrol stations that had entered into agreements with Mobil Oil Ltd for the supply of petrol. Under the agreements the taxpayers received payments to be exclusively supplied by Mobil. It was held that this was on revenue rather than capital account.[121] The terms of the agreement were not considered to be sufficiently long term to mean the payments had a capital character, especially when considered in the context of how those businesses were run and that it was in the taxpayer's interest to sign such agreements. Nor did the payments have to be used on capital expenditure. The primary issue in the Court of Appeal was whether the High Court had been correct not to award costs on the basis that the action was a test case. The majority of the Court of Appeal allowed the appeal and awarded costs.

Milburn New Zealand Ltd v Commissioner of Inland Revenue (2001) 20 NZTC 17-017 (HC).

Milburn Ltd ran a concrete business which involved making and selling cement. Its business model involved securing supplies, such as acquiring subsidiaries, to maintain their primary concrete business. At issue was whether Milburn could deduct the expenditure for the costs of resource consents and licenses to assess whether it could develop quarries to supply its main business. Some of the resource consents in question had been refused.

The Court held that it was capital expenditure as it was a cost towards establishing a permanent structure with which to earn income. This conclusion was supported by the fact that the resource consents were in themselves long-term assets that would exist independently of the quarries.[122] The Court affirmed that the nature of the expenditure was not dependent on the outcome on the investment.

120 For a discussion on the case see Trombitas, above n 119, 79 at 87–93.
121 For all the taxpayers with one exception.
122 The Supreme Court discussed *Milburn*, and other relevant case law, in *Trustpower* (SC), above n 42, at [51]-[63]. The Court considered that *Milburn* was not distinguishable from *Trustpower* (SC): at [53]-[56].

Auckland Gas Co Ltd v Commissioner of Inland Revenue (2000) 19 NZTC 15,702[123]

Auckland Gas concerned whether expenditure on upgrading pipes within an existing distribution system was on revenue or capital account. Auckland Gas has been gradually replacing its cast iron pipes with a more effective polyethylene piping. The Privy Council held that this meant the pipes were being replaced and not repaired. This in turn, meant that the expenditure was on capital account and was not deductible. That the pipes were being replaced was decided on the basis that the polyethylene piping improved the original product and changed the character of the object as a whole, making the expenditure capital rather than revenue.

Poverty Bay Electric Power Board v Commissioner of Inland Revenue [1999] 2 NZLR 438

Poverty Bay concerned a similar issue to *Auckland Gas:* whether the taxpayer, the Board, could deduct the cost of putting part of the electrical system underground. Underground lines were more durable and long term than above ground powerlines. The Court of Appeal agreed with the High Court that the expenditure was capital in nature and not deductible. The underground powerlines were a superior product and were intended to create an enduring benefit.

Commissioner of Inland Revenue v Wattie (1998) 18 NZTC 13,991; [1999] 1 NZLR 529[124]

This case concerned whether incentives, primarily a lump sum of $5 million, offered to a commercial tenant to enter into a long-term lease of a commercial property was on capital or revenue account. The Privy Council held that it was capital. It said:[125]

> The crucial question is whether in all the circumstances the payment or receipt can properly be attributed to a particular year. The question is crucial because income tax is charged annually upon the income or profits of each year. If the payment or receipt cannot properly be brought into the income tax reckoning for a particular year then (apart from special statutory provision) it cannot be brought into that reckoning at all.

123 For a discussion on this case see Andrew J Maples "Beware Technological Developments: A New Zealand Perspective on Repairs and Replacement" (2001) 30 AT Rev 173; see also Andrew J Maples "Just when you thought *Auckland Gas* was the final word on Replacement with Polyethylene Pipe" (2002) 8 NZJTLP 351.

124 For a discussion on this case see Andrew Maples "Lease Inducements" (1999) March NZLJ 53; see also Eugen Trombitas "The New Zealand Judiciary and the Capital/Revenue Distinction – laying the essential foundations" in Adrian Sawyer, above n 119,51 at 57–59. *Wattie* was one of the decisions effected by the legislative changes discussed above at n 32.

125 *Commissioner of Inland Revenue v Wattie* (1998) 18 NZTC 13,991; [1999] 1 NZLR 529 at 15.

The Privy Council noted that incentives given to a party to enter an agreement, such as the payment of the lump sum in the present case, would only be income if it was sufficiently independent from the other terms of the agreement. That is, the inducement would only be considered a profit if it was far enough removed from the obligations in the agreement to constitute a benefit or bonus for the receiving party.

Commissioner of Inland Revenue v Rangatira [1997] 1 NZLR 129

This case concerned an appeal to the Privy Council against a decision of the Court of Appeal on whether the taxpayer, an investment company, had to pay tax on the sale of shares. The company had been involved in a number of large share sales over a seven year period. The High Court had considered that only a certain number of the sales were on revenue account. The Court of Appeal reversed the decision of the High Court and found that the applicable transactions (as some remained excluded) were revenue account. The Privy Council found for the company. Although it was accepted that certain transactions were on revenue account, the Privy Council considered that the Court of Appeal had been incorrect to depart from the findings in the High Court to find that the frequency of transactions over the seven year period meant that the company was in the business of buying and selling shares. However, it has been argued that the case was decided narrowly and that, by focusing on the Court of Appeal's decision to reverse the High Court's finding on an issue of fact, the Privy Council's decision turned on a technicality.[126]

Commissioner of Inland Revenue v Fraser (1996) 17 NZTC 12,607 (CA)

Fraser concerned payments made for an agreement to advertise the services of a bank. This, however, meant that Fraser may have to forfeit his journalism career. His existing employer barred its presenters from appearing in advertisements. Upon entering the agreement Fraser received a sum of $25,000 to induce him into the contract and, in consideration of a restraint of trade, further payments over a three year period that totalled $140,000. The inducement

126 Brett Wilkinson and Stuart Tooley "Gains From Share Realisations: Is It Time For A Legislated Capital Gains Tax?" (1998) 6 Waikato Law Review 57 at 69–71. *Rangatira* was cited in *Poverty Bay Electric Power Board v Commissioner of Inland Revenue* [1999] 2 NZLR 438 as authority for the proposition that an appellate court should not depart from a finding on a question of fact unless the decision is shown to be wrong: at 17. But note *Austin Nichols & Co Including v Stichting Lodestar* [2008] 2 NZLR 141 (Elias CJ, Blanchard, Tipping, McGrath and Anderson JJ) where the Supreme Court held that, in the case of an appeal by way of rehearing, an appellate court must come to its own view.

payment was held by the Court of Appeal to be capital in nature. The Court also considered that the restraint of trade was more onerous than that advanced in *Henwood* (discussed below), as the bank had the ability to prevent Fraser from appearing on TV for any appearance. These were also held to be capital as, like the inducement payment, the amount was non-refundable if the contract was prematurely terminated.

Henwood v Commissioner of Inland Revenue (1995) 17 NZTC 12,271 (CA)

This case concerned two payments made for acting services in advertisements for biscuits. The taxpayer maintained that 22 per cent of the payments were income, with the remaining 88 per cent given as consideration for his agreement to a restraint of trade clause. The restraint clause was narrow in scope, prohibiting the taxpayer from endorsing particular products from competing brands in New Zealand while either party was receiving payment from the agreement. The Court of Appeal held that the restraint of trade clause amounted to an intrusion onto the taxpayer's profession to such an extent that the payment was capital.