INCOME TAX — COMBATING THE EFFECTS OF INFLATION IN LOAN TRANSACTIONS

It is somewhat ironical, that in these years when inflation is annually diminishing the value of money at a frightening rate, investors have done very little to protect capital involved in loan transactions. Admittedly some have made attempts to do so, but clearly, at a stage when the money market is not totally favourable to the lender, and finance is available at what is generally recognised as a fair commercial rate of interest, merely increasing interest charges to compensate for the decreasing value of the loan moneys will probably result only in a drop in the number of interested borrowers; furthermore, with the maximum tax rate of 45 cents in the dollar being reached at a relatively early level, there is not a great deal of incentive to increase the amount of income from the loan.

What is needed is a scheme whereby the lender receives a greater return from his investment, but which at the same time ensures that this increased return will not be classed as assessable income under s. 88(1)(f) of the Land and Income Tax Act 1954. Such an arrangement would necessarily involve two steps; firstly, the classification of such an increase in return as a capital receipt, and secondly the protection of the value of that capital from rapid changes in the rate of inflation. In short, the increase must be made a "variable capital allowance". Surprisingly, no-one appears to have attempted such an arrangement in New Zealand; at least, if one exists, it has not yet been before the courts. This article is accordingly an attempt to identify the problems and evaluate the chances of success of such transactions, which surely must be attempted within the near future.

(A) Is the distinction between Interest and Capital Allowance Accepted by the Courts?

It follows that, income tax being a tax only on income, payments of a capital nature do not in this country attract income tax. There is often great difficulty in deciding in any given factual situation, whether the payments have the character of capital or income, and to what degree. For a payment of a sum of money by instalments may have the character of any one of three concepts; it may be an annuity, purchased for a certain sum in which case it will be taxable in full as income;[1] it may, at the other extreme, be a series of purely capital instalments in which case of course, no part of the money received will be liable to tax; finally, there is the hybrid situation, probably the most common, where the instalments contain both capital and income elements, i.e. they are capital payments plus interest on that money.[2]

1. Section 88(1)(f), Land and Income Tax Act 1954.
2. Interest is of course assessable income under s. 88(1)(f), Land and Income Tax Act 1954.

It is not necessary for our purposes to spend a great deal of time on the first concept; it is relatively easy to distinguish an annuity payment from the other two alternatives. The position was well put by Romer L.J. in *I.R.C. v. Ramsay.*[3]

> "If a man has some property which he wishes to sell on terms which will result in his receiving for the next twenty years an annual sum of £500, he can do it in either of two methods. He can either sell his property in consideration of a payment by the purchaser to him of an annuity of £500 for the next twenty years, or he can sell his property to the purchaser for £10,000, the £10,000 to be paid by equal instalments over the next twenty years. If he adopts the former of the two methods then the sums of £500 received by him each year are liable to income tax. If he adopts the second method then the sums of £500 received by him in each year are not liable to income tax, and they do not become liable to income tax by it being said that in substance the transaction is the same as though he had sold for an annuity. The vendor has the power of choosing which of the two methods he will adopt, and he can adopt the second method if he thinks fit, for the purpose of avoiding having to pay income tax on the £500 per year. The question which method has been adopted must be a question of the proper construction to be placed on the documents by which the transaction is carried out."

Thus it is clear that it is the form of transaction which is important.[4] The wording of the agreement must be looked at and it is clear that for the court to find a pure annuity, the intention of the parties must be expressly directed to this end.

The main problem in this field arises when it becomes necessary to distinguish between payments which incorporate an interest element and those which are essentially of a capital character. Take for example the following factual situation:

> A sells a dental practice (plant, stock and goodwill) at Taihape to an impoverished young dentist for $9,500 payable in ten annual instalments each of $950 with security over plant and a guarantee from a solvent guarantor. The price initially discussed was $8,000, but A added on $1,500 when he found that the purchaser could only pay over a long term.

Are the annual payments each year of a capital nature or do they contain an interest element which is taxable to A?

The immediate conclusion one would draw from the above facts is that A in order to give the purchaser a chance to buy, gives him longer to pay for it, adding interest to the original sum as com-

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3. [1935] All E.R. Rep. 847, 854.
4. See also *I.R.C. v. Wesleyan and General Assurance Society* (1948) 30 T.C. 11, 16, *per* Lord Greene M.R.

pensation. If this is the conclusion to be drawn from the above facts, then the case of *Vestey v. I.R.C.*,[5] is authority for the proposition that if there is an interest element, that element should be dissected from the capital and taxed accordingly.

This approach has not however, always been accepted by the courts. In *I.R.C. v. Ramsay*,[6] Romer L.J. stated that a man who wished to exchange a capital asset, over a period of years, could avoid paying any tax on the annual sums by selling the asset for a total price in excess of its current value to be paid over a period without any interest. However, Cross J. in *Vestey* considered that he could find sufficient support in *Sothern-Smith v .Clancy*[7] and *Lord Howard de Walden v. Beck*,[8] to differ from that conclusion. The question as to whether on a strict argument of precedent Cross J. made the correct decision is a difficult one to answer, but the grounds behind his reasoning, *viz* the ease with which it would be possible to avoid paying tax merely by calling the sum total of the instalments the "purchase price", are very strong, and his judgment has since been approved in the Court of Appeal.[9]

But the immediate impression does not provide the only alternative. It is possible that the extra $1,500 has been added on to cover "capital risk"; thus risk covers two possibilities. Firstly, capital risk in the true sense, i.e. the danger that the capital may be lost in a risky investment, and secondly, capital risk in the sense of capital depreciation through inflation.

The basic authority for the claim that an allowance can be claimed for capital risks, in both the above senses, is the Court of Appeal decision of *Lomax v. Peter Dixon & Son Ltd*[10] the facts of which were as follows; the respondent had advanced to a Finnish company sums amounting to £319,000. These advances were assumed by the Courts to be repayable on demand. The two companies entered into an agreement to rearrange the indebtedness, the essential conditions of which were:

(1) The Finnish company agreed to issue to the respondent 680 notes of £500, amounting to £340,000, £20,400 more than the amount originally owed. That is, they were issued at a discount of 6%.

(2) The notes were to bear interest at a rate linked to that of the Bank of Finland but were not to exceed 10%.

(3) One hundred of the notes were to be repaid in 1933, and thereafter 29 notes per annum.

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5. [1961] 3 All E.R. 978.
6. Supra. See also *Foley v. Fletcher* (1858) 28 L.J. Ex. 100 and *I.R.C. v. Wesleyan & General Assurance Society* supra at p. 16.
7. [1941] 1 All E.R. 111, 115 and 116, *per* Lord Greene M.R.
8. 23 T.C. 284, 398 *per* Wrottesley J.
9. See *West Hertfordshire Main Drainage Authority v. I.R.C.* (1963) 41 T.C. 244, 260 *per* Donovan L.J.
10. (1943) 25 T.C. 353 (emphasis added).

(4) If the Finnish company made a net profit in excess of a specified sum, the notes were to be redeemed at a premium of 20% above par value.

The Crown argued that the discount and premiums amounted to interest on the notes, but the Court unanimously held, in a judgment delivered by Lord Greene M.R., that they were a capital risk allowance and thus not assessable income. The ease with which the Court of Appeal came to such a radical decision is somewhat surprising; Lord Greene did not appear to doubt for a moment that he was coming to the correct decision. At page 364 (emphasis added) he gave the rationale of his decision:

> "Now let me take the opposite case where the credit of the company and the security which it offers are not such as to enable it to offer its debentures at par at a normal rate of interest applicable to sound securities. The object of the company is to make its issue attractive and various alternatives are open to it. It may make the issue at par but give a high rate of interest. Here the defect in the security is expressed in terms of interest. The whole of the interest is unquestionably income and is taxable as such, although the high rate of interest is attributable in part, to the capital risk. Another course which the company may take, and for commercial reasons probably will take, is to fix the rate of interest at a more normal level and make the issue at a discount; or it may make the issue at par and offer a premium on redemption . . .*Here the defect in the security is expressed in terms of capital.* I venture to think that no businessman would regard the discount or premium as anything but capital matters."

Although these comments were limited to capital risk in its primary sense noted above, his Lordship did specifically state that protection of money against depreciation in value was based on the same principles and similarly acceptable.[11]

The question to be answered is how, in individual cases, is it determined whether the discount is of a capital or income nature, and Lord Greene, in the course of his very comprehensive judgment, laid down several factors which must be taken into account when coming to a conclusion.[12] The first point made was that where a loan is made on reasonably sound security at a commercial rate of interest, there will be no presumption that any premium paid is interest; secondly, the true nature of the discount or premium is a question of fact, not law, and in deciding its nature in any particular case, the following points were thought by Lord Greene to be important:

(1) The term of the loan.
(2) The rate of interest expressly stipulated.

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11. Ibid., at p. 364.
12. Ibid., at p. 367.

(3) The nature of the capital risk.
(4) The extent to which the parties may be supposed to have taken the capital risk into account when making the contract.

On the facts before the Court it was decided that, since there was danger of armed conflict between Finland and Russia, which might have resulted in loss of the money in toto, and the actual interest rate charged was approximately 5%, which represented a normal interest charge, the parties must have intended the discount, having regard to the long term of the loan, to represent a protection against capital risk,[13] and it thus was not taxable.

This decision is not the only authority in this field, but it does appear to be the only occasion where the taxpayer succeeded in such a claim. In *I.R.C. v. Thomas Nelson & Sons Ltd*,[14] cited by Lord Greene, interest at 3% was to be paid on a loan together with premiums which varied with the date of payment. The premiums in question were held to be interest, not capital payments, but a brief look at the reasoning provides a good illustration of how the courts will approach this problem. The Lord President considered the combined effect of the interest and premium payments, and noted that taking into account the variations, the interest rate would be around 5%—5.5%, in the circumstances a reasonable commercial rate. His assessment of the parties' motive for adopting this form of payment is, it is submitted, excellent:

> ". . . it is at least explainable on the reasonable supposition that the borrowers in this case might have been expected to pay interest at a small uncommercial rate, but not to pay a reasonable rate of interest until the loan which was employed in the purchase of new plant had had time to fructify."[15]

Again, in the cases of *Davies v. Premier Investment Co. Ltd* and *Hewetson v. Carlyle*,[16] which appear to be the only other cases where *Lomax v. Peter Dixon* has been discussed judicially, there was no interest rate as such, but at the conclusion of the ten years of the loan, a premium of 30% was to be paid. Moreover, if the loan was repaid before the expiry of the ten years, the premium was to be taken at 5% per annum. On these facts, it is not surprising that McNaghten J. concluded that the premiums were a part of the interest charge.

These, then are the authorities in this field and the approaches the courts have taken; it may be pertinent to turn now to a consideration of the particular facts in the example given above, although in problems as borderline as these, one must proceed with the words of Lord Greene himself, in *I.R.C. v. British Salmson Aero Engines Ltd*[17] constantly in mind. At page 289F of his judgment he said:

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13. Ibid., at p. 365.
14. (1938) 22 T.C. 175.
15. Ibid., at p. 180.
16. (1945) 27 T.C. 27.
17. [1938] 3 All E.R. 283.

> "There have been many cases which fall upon the borderline. Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as would an attempt to find reasons."

Adopting the criteria in Lord Greene's judgment, one is immediately struck by the lack of any really decisive factor in the example; the term of the loan is ten years and is best described as neutral in its effect; the nature of capital risk likewise, is hardly decisive; here there is no lack of security. Therefore, if the premium is to be a capital allowance, it must be against the risk of loss by inflation. The interest rate, as computed from the premium, provides however, an interesting issue; after allowing credit for principal reduction the rate works out at approximately 2%, an amount which one would consider far too small to represent a commercial rate of interest, but which could conceivably be a small safeguard against inflation. This latter conclusion, on the other hand, runs counter to certain dicta from Lord Greene in *Lomax v. Peter Dixon.* At page 367 of the report he stated:

> ". . . Where no interest is payable as such, different considerations will, of course, apply.
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> . . . Similarly, a 'premium' will normally, if not always, be interest".

These words are, it is submitted, a little difficult to understand, and form, with respect, the only possible flaw in an excellent judgment. If in an extremely risky investment, no set interest rate was set, but there was provision for a premium of perhaps 50% over two years, there seems no conclusion which could be drawn, other than that a large proportion of that premium was of a capital nature. It may be that Lord Greene was influenced by the simplicity of his own example,[18] where the premium equalled an interest rate of 10%, reasonable of course in the normal circumstances.

Bearing these comments in mind, it is submitted that the rate of 2% suggests that the excess amount is a capital allowance, to protect against inflation, rather than a small interest charge.

Before continuing with a more detailed discussion of the possibilities of the protection of capital against inflation, mention must be made of dicta in *Vestey v. I.R.C.*,[19] which may perhaps provide another explanation of the character of an excess sum paid by the borrower. At the end of his judgment Cross J. stated:

> "It is not a case like that envisaged by Wrottesley J., where the only possible purchasers are not in a position to pay a capital sum down, and the only way to obtain a good price is to accept payment of an agreed capital sum by instalments over a fairly short period. This [*Vestey*] is a case where

18. Supra, n. 10 at p. 362.
19. Supra, n. 5.

what is called the purchase price clearly contains an interest element."

It is difficult to understand the basis for this exception. The justification for not regarding it as an interest payment is that the period is too short to warrant compensating the lender for loss of the use of his money. On the other hand, if a payment is made which is ultimately greater in total than the original price which was agreed upon, there must be some explanation for the excess amount; to say that it is always a capital allowance is to ignore the realities of the situation, for there is even less reason to protect the capital against inflation than to charge interest over such a short period.

It is submitted that in this situation there should be no presumption that the excess payments are of a capital nature, and that all factors should be taken into account in determining the character of those payments.

Thus, it is plain that the courts will not automatically classify any excess payment as interest; they will determine its character by a consideration of all the relevant factors in any particular case, and, if it is interest, it will be taxed as assessable income. If on the other hand it is an allowance to guard against capital risk it will be free from income tax.

(B) The Courts and Inflation:

In the case of a taxpayer who wishes to protect his debt against the effects of inflation, it seems clear that it would be not a little dangerous to rely on an implied agreement to win over the courts. They will normally expect a reasonable commercial rate of interest to be charged and in the absence of an express provision for a premium or similar independent payment,[20] the courts may not be prepared to accept arguments to this end, and will treat the payment as being one of interest. It should be remembered that the taxpayer has succeeded in only one claim of this nature.

An extreme example may serve to illustrate that the reluctance of the courts to accept an allowance for capital risk without express stipulation by the parties, is not just a Commonwealth but worldwide approach.

In a German case decided before the German Federal Tax Court, the taxpayer alleged that interest at 3.5% on a savings account did not constitute income except in so far as it exceeded the average annual rate of monetary depreciation of 2.5%. By a unanimous decision his claim was refused.[21]

20. *Lomax v. Peter Dixon* 25 T.C. 353, 362.
21. Referred to in Mann, note 25, infra. The court's reluctance to accept claims which allow for capital depreciation is not limited only to claims to lessen one's tax liability in "interest" cases. cf. *Bales v. U.S.* 108 F. 2d 407; and *Secretan v. Hart* [1969] 3 All E.R. 1196 where an attempt to treat an apparent capital gain as mere compensation for the depreciation of the original asset failed.

The court's attitude to claims for the recognition of the effects of inflation has been governed by the international principle of "nominalism".

> "Monetary obligations, according to the general rules of modern legal systems, must be discharged by the payment of the number of monetary units fixed in the obligation regardless of changes in the valuation of money. This principle is usually referred to as 'monetary nominalism'."[22]

The concept finds justification in the fact that the majority of contracts are entered into by parties who do not consider for a moment the effects of inflation upon their return. The basic assumption is that unless they express a contrary intention, in which case the courts may have resort to the contrary principle of "valorism", the parties are understood to have contracted with reference to the nominal value of debt expressed in the contract. A statement by Lord Denning, may be read as an amusing, if typical example of the court's adherence to the nominalist principle:

> "A man who stipulates for a pound must take a pound when payment is made, whatever the pound is worth at the time. Sterling is the constant unit of value by which in the eye of the law everything else is measured. Prices of commodities may go up or down, other currencies may go up or down, but sterling remains the same."[23]

It would seem therefore, to be essential for any taxpayer who wishes to preserve the purchasing power of his investment, and at the same time to avoid the return being assessed as taxable income, to make his intentions explicit.

(C) The Taxpayer and Inflation — Ways of Protection:

The remainder of this article will be devoted to a discussion of the means available to the taxpayer to protect his capital; a short time will first be spent on the form of allowances which are most likely to be accepted by the courts, and then an effort will be made to find in particular how the taxpayer can protect himself against variations in the rate of depreciation which may affect the real value of the basic sum he has sought as compensation.

Clearly it is not sufficient merely to claim an interest rate of 20% and state that half of this sum is true interest and the other half an allowance for capital depreciation. The decision in *Lomax v. Peter Dixon* makes it quite clear that in such circumstances the full 20% will be taxed as interest. The taxpayer should strive to find a form removed as far as possible from the usual mode of paying interest; a quarterly amount would be totally unsuitable since it is probably the closest form to normal interest payments which could

22. Dach, *"Tax Aspects of Inflation"*. (1960) American J. of Comparative Law 657.
23. *Tresseder-Griffin v. Co-Operative Insurance Society* [1956] 2 Q.B. 127, 144.

be used. An additional 10%, independent of the interest charge would not be particularly appropriate, but as a hybrid form, might well be accepted by the courts if the intention of the parties is clear. It is submitted that the best method of providing for an allowance for capital depreciation would be to agree upon a lump sum to be repaid annually, along with the basic interest payments, which should of course be at the normal commercial rate.

The necessity of including a basic interest charge at a reasonable commercial rate does however, involve certain problems; the whole concept of an independent capital protection charge rests on the assumption that the court will draw a distinction between this type of allowance and that of interest. However, it is a financial fact, that interest rates today incorporate in the percentage a small allowance for the depreciating value of the capital lent, and the danger of losing the investment. It is suggested that before the courts will readily accept such an allowance as contemplated, expert evidence will need to be tendered to the effect that interest payments include such allowances, to what extent, and what the normal interest charge would be if no capital allowances were included, and the payment represented purely compensation for the loss of use of the money lent. This sum would represent the "reasonable commercial rate" which should be charged along with the capital allowance.

However, such a provision as mooted above would not, if the capital allowance consisted of a single invariable amount, provide full or even adequate protection for the taxpayer, especially if the loan is over a long period of years.[24] Thus it is not surprising that throughout the world, but especially in the United States and Europe, contracting parties have for some time, often agreed upon specific provisions for protecting themselves against the effects of inflation. There are various means of doing this,[25] but for our purposes only one is *important;* viz. "the agreement to pay a sum of money of domestic currency, linking it to something which may be expected to maintain its face value in terms of money".[26] The main "yard-sticks" to which the taxpayer's debt can be linked are, the price of gold, the consumer price index, stock market index or the annual rates of inflation as included in the "New Zealand Official Vital Statistics" or "Monthly Abstract of Statistics".[27] It is intended to deal briefly with these in two categories; first, the "gold price" and

24. The rate of inflation during the 20th century has had a tremendous effect on the real value of money. In England between 1914-1969 the purchasing power of the pound has dropped by 80%, and even between 1963 and 1969, by 25%. In New Zealand, over the last five years the purchasing power of the dollar has dropped by approximately 36.5% for consumer goods. Thus it must be apparent that many of those who made loans for substantial periods at a fairly low rate of interest would have in most cases managed to protect the purchasing power of their money, but would have made no profit worth mentioning.
25. See generally Mann, *Legal Aspects of Money* (2nd ed.) 1971 p. 125.
26. Ibid.
27. Both available from the Government Printer.

secondly, with price indices in general, leading to a conclusion as to the most suitable formula for present purposes.

There can be no doubt that, in the Commonwealth at any rate, if it is reasonably expressed, a clause relating the debt to the price of gold is quite valid.[28] For example, in *Feist v. Societe Intercommunale Belge*[29] there was included in the contract a clause which related the amount to be repaid to the gold standard. The House of Lords decided that the clause should be construed not as meaning that the amount (£100) should be paid in a particular way, but that it imposed an obligation *to pay a sum which would represent the equivalent of £100 if paid in a certain form i.e. by gold.* Lord Denning's "nationalistic sentiments" apart, the only occasions on which English courts have refused to give recognition to a "gold clause", have been either when the reference by the parties has not been sufficiently expressed, or when they have expressly stipulated payment in gold or gold coin; this of course is illegal.[30] Similarly, on an international scale, "gold clauses" appear to be accepted. The International Court of Justice in the *Serbian Loans* case[31] had this to say of such provisions:

> "The 'gold franc' thus constituted a well known standard of value to which reference could appropriately be made in loan contracts when it was required to establish a sound and stable base for repayment."

The "gold clause", although it would probably be accepted by courts if worded clearly, has however inherent problems which, it is submitted, make it unsuitable for use as a measuring stick in internal New Zealand transactions.

Prior to the Second World War, the price of gold in London, due to London's position as commercial and financial capital of the world, was regarded as decisive. Today the price of gold however, fluctuates from place to place throughout the world and there is no real standard price. Since we in New Zealand do not have a "gold price", we should have to link it to the price of gold in some other part of the world, or, what is more likely, to some other currency which is related in turn to the price of gold; this would in New Zealand's case be probably the "Euro-dollar", which has to a certain extent replaced the old "gold standard". Thus, if such a clause were to be used, it would perhaps read as follows:

> "Pay annually in New Zealand dollars a sum equal to 6% of the original loan, plus an amount representing the equivalent

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28. *Ottoman Bank v. Chakarian* [1938] A.C. 260; *New Brunswick Rly Co. v. British & French Trust Corp. Ltd* [1939] A.C. 1.
29. [1934] A.C. 161.
30. For example *Tresseder Griffin* case. Supra, n. 23.
31. Permanent Court of International Justice Series A: No. 13-24; Collection of Judgments; Judgment No. 4. pp. 32, 33.

> of $100 if paid in gold of or equal to standard of weight and fineness in New York (or substitute for 'gold' 'Euro-dollars') on the 10th day of September 1973."

While this may be a suitable arrangement for overseas investors wishing to invest over a long term in New Zealand, such a clause would be quite unsuitable for the majority of taxpayers. The relationship to the "gold price" measures not so much the depreciation of the purchasing power of domestic currency, but the external fluctuations in international exchange rates. By no means are the external and internal rates of depreciation identical and gold clauses would possibly not give a sufficient accurate picture of internal currency movements to enable "exact" calculations to be made.

The use of price indices seems much more appropriate for our purposes, for they achieve what the "gold prices" do not; *viz* a high degree of relationship with internal changes in the purchasing power of money. It is only intended to refer to one case in this discussion; it appears to be the only authority in the Commonwealth decided on the basis of an "index clause", and the judgment of the Australian High Court in the case, *Stanwell Park Hotel Coy Ltd v. Leslie*[32] is so clearly expressed that it will be difficult for New Zealand courts to avoid following it.

The question related to the calculation of the balance of purchase monies owed under a contract for the sale of land by S. to L. The total price of the land was £2,600 but it was to be paid in an unusual manner; the purchaser was to pay a deposit of £100 and complete the purchase by monthly instalments of £8.13.4. It was clause 22 which caused the trouble between the parties and having regard to its novelty, it is worth reproducing in full:

> "Provided always and notwithstanding anything contained in this Contract, it is hereby agreed by and between the parties hereto in order to provide for the equitable performance of this Contract in the event of inflation and/or deflation of price levels that if the Retail Price Index Number 'C' Series . . . shall have increased by twenty-five per centum or more above or decreased by twenty-five per centum or more below the Index Number for the years 1923-1927 for any period during the currency of this Contract, then the amount of each payment hereinbefore agreed to be made, shall be varied . . . in the manner following, that is to say: By being multiplied by a fraction . . . of which the Numerator shall be the Index Number last published before the date on which such payment is payable or paid, whichever shall be the greater, and the Denominator shall be the Index Number last published before the 10th day of February, 1942".

32. (1952) 85 C.L.R. 189 — It was incidentally a very strong court (Dixon, Williams, Webb, Fullagar and Kitto JJ).

Thus, the clause in any one year would work as follows: if the relevant index figures were 1200 and 1600 the calculation would be

$$\frac{£8.13.4}{1} \times \frac{1600}{1200} =$$ approximately £11.11.0., £2.18.0. higher than the set payment.

The High Court of Australia accepted this scheme as being completely valid; at page 201 the judgment commented on the rationale of the novel provisions:

> "There is no principle of law preventing parties adopting a fixed figure as the primary monetary expression of a liability and then proceeding to effect a substantive variation of that liability by providing that more or less money must be actually paid according as index numbers evidence a variation of price levels. That is only a method of measuring the actual liability contracted for."

This judgment shows that Australian courts will be likely to accept the tying of debts to a constant external factor to maintain the purchasing power of capital and there is no good reason why the New Zealand Courts would not take a similar approach. Such contracts are not unknown in this country; engineering contracts often have a clause linking the agreed price to an index of plant, machinery and labour, these to be taken into account either separately or in combined form, in the ultimate price paid for the work done. While it is true that these contracts, and that in the *Stanwell case,* were not to be found in the context of taxation, it is submitted that the principles would be the same. The High Court of Australia, in the above decision, permitted a variation of what was for the greater part a capital sum (there was a small interest allowance), and it is inconceivable that such a gain, to the extent that it represented capital would be taxable. It is submitted that should the courts accept the basic conclusion reached in that case; i.e. that the amount repayable under a contract may be variable to take account of internal changes in the value of money, then having regard to the decision in *Lomax v. Peter Dixon*[33] which accepts the legality of an independent capital risk allowance, there is no reason why a clause of the following nature should not be incorporated in any contract:

> ". . . interest at the rate of 6% per annum plus $100 representing an allowance for capital depreciation of 4% in 1972, to be increased or decreased in accordance with the percentage difference between the ( ) Index figures of the month of payment and those of the month of previous payment."

This formula (a very simple example) would enable the lender to get a sufficient return to cover the effects of inflation on his investment, but at the same time ensure that this increased return is regarded solely as a capital sum and not as assessable income.

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33. Supra, n. 10.

Thus, the concept of protecting your invested capital by linking it to a stable external yardstick would seem to be a viable proposition; a few moments should be spent however, in a discussion of what would be the most suitable "measure" for the majority of New Zealand taxpayers. All alternatives suggested excepting one, have serious defects, the "price of gold" as stated, does not reflect accurately enough internal currency movements and the Stock Exchange Index, which in theory should be the ideal measure since it reflects the views of those chiefly interested in investment, is in practice far too sensitive and volatile. Similarly, although Mr Muldoon in the 1971 Budget promised to extend the Consumer Price Index, the more comprehensive Index will not come into operation until 1974; until then it suffers from the problem that it reflects the changing value of money in relation to a relatively small group of goods (about 500), which may not represent inflationary trends throughout society as a whole. It is suggested that until the proposed changes take place in this Index, the most satisfactory yardstick would be the figures in the Monthly Abstract of Statistics, which give detailed information as to changes in the purchasing power of money; these would give at present the most accurate picture overall of the effect of inflation on debt capital.

There is one final problem remaining to be discussed in relation to capital payments and inflation. Since any premium paid in the form suggested above, would be of a capital character, and not interest, the payment could not be deducted under s. 112(1)(g), nor for that matter under s. 111.[34] Although in many cases, particularly those of loans for housing finance, the interest would not be deductible in any case, being for domestic purposes, there are a great many commercial investments in which, unless the money market had placed the lender in an extremely strong position, the borrower would refuse to give up his right to deduct compensatory payments.

In these circumstances, there would not be a great deal of opportunity to use the above clauses, but it may be possible by careful drafting to make such excess amounts deductible although prima facie they would be disallowed as capital expenditure. Under s. 121 of the Land and Income Tax Act 1954, the Commissioner, at his discretion, may allow a deduction of expenditure incurred in the borrowing of money employed by the taxpayer as capital in the production of his assessable income. There do not appear to have been any cases on this point in New Zealand but Gunn[35] has the following comment to make on the equivalent Australian section:

"A bonus payable on repayment of the loan is also not

34. cf. *Felt & Textiles of New Zealand Ltd v. C.I.R.* [1969] N.Z.L.R. 493, 495 per McGregor J. See also *Arizona Copper Co v. Smiles* (1891) 3 T.C. 149 where under the United Kingdom Act, it was held that where a company borrowed money, and covenanted to pay annual interest, and repay the capital with a bonus of 10%, the bonus was not deductible. Also *E.T. & W.H. Bridgewater v. King* (1943) 25 T.C. 385.

35. Gunn's *Commonwealth Income Tax Law & Practice* (6th ed.) para. 195.

deductible under the Commonwealth Act. It is not deductible under s. 51 as it is an outgoing of a capital nature. The sinking fund allowance under s. 67 is calculated on the assumption that the expenditure was incurred at the commencement of the loan. A bonus payable on maturity is not incurred in the year in which the money was borrowed but in the year in which the loan matures."

The practice of the Commissioner under s. 121 of the New Zealand Act appears to be the same; he will allow a premium paid at the time the monies are borrowed, but not any capital expenses later incurred. It is possible then, that the section could be used in the following manner; using the figures given earlier, instead of repaying $100 plus a variable amount annually, if the loan was for a period of ten years, a premium of $1,000 could be paid at the time of borrowing, and only the variable amounts be paid each year. It is submitted that the result here would be that the bulk of the allowance for capital risk could be deducted, but under s. 121, rather than s. 112(1)(g), and only a relatively small amount should remain as assessable income. The overall result would be very much as though a total interest rate of perhaps 10% had been charged, except that the lender would have made a substantial tax saving.

In conclusion, it is submitted that there is no reason why clauses such as this should not be incorporated into contracts for the lending of money. There is clear authority which the New Zealand courts would probably follow, and so long as the taxpayer was prepared to support his claim with actuarial evidence, there is a strong possibility that such protective clauses would be allowed. Any objections the borrower might have could be avoided by careful drafting and a judicious use of s. 121; for the lender, the only alternative is to demand interest, which is of course assessable income; he cannot lose!

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36. cf. *Neville & Co. Ltd v. F.C.T.* (1937) 56 C.L.R. 290.

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