The taxation of interest-free intra-family loans

*P. J. Carroll**

The recent decision of the Court of Appeal in Rossiter v. C.I.R. has caused tax practitioners to re-evaluate the use of loans in tax planning. In this paper Peter Carroll critically examines the judgments in Rossiter, and in the light of that examination expresses some thoughts on the use of loans within the family group.

The tight money market which has prevailed in the economy over the past few years and the high rates of interest currently charged by commercial lenders have undoubtedly prompted many borrowers to look to wealthier family members for loans which are non-interest bearing, or which bear interest at less than current market rates.

Although the discussion that follows is generally limited to the current treatment of interest free loans for gift duty purposes and in particular to the recent Court of Appeal decision in *Rossiter* v. *C.I.R.*,[1] it will also cover briefly a number of related taxation aspects of some significance which can arise in the context of intra-family loans, especially the problems of "on lending" and "on demand loans".

The issue whether interest free loans are subject, in part, to gift duty is one which, to an extent, involves questions of form and substance. In terms of economic reality there is no doubt that the use of funds without the obligation to pay any interest or to pay interest only at a preferential rate when compared with market rates, constitutes a valuable economic benefit to a borrower.[2] In fact, however, there are currently questions as to the valuation and taxability of this benefit.

In the absence of gift duty liability, interest free intra-family loans can be effective media for income and gift splitting, and for estate freezing and can thus be regarded as valuable tax planning tools. A simple example serves to illustrate their potential.

Assume that a wealthy taxpayer, with a sixty percent marginal tax rate, withdraws $100,000 of his invested capital which he then lends to his two children on demand who in turn re-invest that sum. Assuming a ten percent return

* Barrister and Solicitor of the Supreme Court of New Zealand.

1 [1977] 1 N.Z.L.R. 195. 2 See, for example, Finance Act 1975 (U.K.), s. 41.

on the capital invested both before and after the loan, a $10,000 income would be gained. In the father's hands, tax liability in respect of that amount would be $6,000. In the children's hands, however, the total tax liability would be about $2,100,[3] due to the income splitting effect of the transaction[4] and the progressive rate tax structure. Thus an immediate net saving of about $3,900 dollars for the family would result. In addition, as will be seen, the transfer of the income would be effected without incurring gift duty. The total immediate tax advantage thus gained is obvious and, of course, the interest derived by the children will not swell the father's estate and will itself produce further income for the children.

The same result could be achieved if, instead of reinvesting the money in the market place, the children used it to purchase income producing property owned by the father. That property would be replaced in the father's estate by the debt created by the loan and any subsequent increases to the value of the property transferred, or returns by way of income from it, would accrue to the benefit of the children and would not go to swell the estate of the father which would thus be pegged or frozen, in respect of the property transferred, at the level existing at the time of the transfer.

In addition, in both of the above examples the father, if he wished to make a gift to the children of all or part of the debt or the value of the property transferred, could begin to forgive the debt created over an extended period of time, splitting the gift into a number of smaller gifts, thereby minimising the total amount of gift duty payable in respect of the amount of the debt ultimately forgiven. This would be possible because of the progressive gift tax scale, the nil rate on the first $8000, and the annual gift duty exemptions.

The imposition of gift duty on interest free loans in such circumstances would obviously accord with the economic realities of the transactions and, moreover, would tend to diminish the value of the taxation and duty savings achieved by them to the extent of the amount of duty imposed. Such a tax would also tend to restore a degree of tax equity as between those persons presently making use of interest free loans for income tax and estate and gift duty avoidance purposes and those who are either without the ability to do so or who are unaware of their potential for avoidance.

I. INTEREST FREE LOANS: THE CASES IN CONTEXT

Section 2(2) of the Estate and Gift Duties Act 1968[5] provides that a gift is made on which duty is payable whenever there is an inter vivos

> Disposition of Property . . . without fully adequate consideration in money or moneys worth passing to the person making the disposition: Provided that where the consideration is inadequate, the disposition shall be deemed to be a gift to the extent of that inadequacy only.

3 At 1976-77 basic tax rates, assuming that the children have no other income, exemptions and rebates of the two children would further tend to diminish the total tax liability.

4 But note the possible effect of s. 96 of the Income Tax Act 1976, discussed in Part V, infra.

5 In this paper referred to as "the Act".

The question as to whether or not this definition extends to an interest free loan of money was recently examined in *Rossiter* v. *C.I.R.*[6] It was held by the Court of Appeal[7] that a loan of money, when it did not involve interest[8] or a promise to repay the sum lent on demand, constituted a gift of the difference in value between the amount lent and the chose in action represented by the promise to repay the sum lent, discounted to its level of value as at the time when the loan was made by the application of an appropriate rate over the term of the loan.

In an earlier Court of Appeal decision, *C.S.D.* v. *Card,*[9] it had been established on very similar facts to those existing in *Rossiter* and on legislation which cannot be distinguished from that currently in force, that such loans were not taxable as gifts.[10]

The facts of *Rossiter* were that the taxpayer, upon his retirement from farming in 1972, had entered into an agreement with his son to sell the latter his farm for its full value of $62,500, and the live and dead stock on the farm for a further $16,360. The purchase price payable in respect of the farm property was to be by way of $20,000 cash, with the balance of $41,500 being left outstanding as a loan for a period of ten years, secured by a second mortgage over the farm property. $10,000 of the loan was to carry interest at the rate of five percent per annum and the balance was to be interest free though repayable in part by half yearly instalments of $500 during the currency of the loan. The purchase price of the live and dead stock was left outstanding as an unsecured interest free loan repayable after five years.

The son at all times had a right to make earlier repayment of the loan than provided for in the agreement and it was not disputed that that transactions were bona fide and that a genuine indebtedness existed between the parties.

The Court of Appeal held that the loans made in this case, whether regarded as loans of money per se, or as sales of property for a specified money consideration which permitted payment of the purchase price over an extended period of time, constituted dispositions of property within the purview of the Act and that the consideration given for them was less than fully adequate in money or money's worth because, according to Cook J., "Manifestly a right to receive a specified sum at a future date is less valuable than a right to receive that same sum forthwith".[11] In other words it was felt that, at the time when the loan was made,[12] there was a difference in value existing between that which was given — the sum lent — and that which was received — the chose in action represented by the promise to repay in the future — and accordingly it was held that there was a gift to the extent of this difference.

The appropriate discount rate to be applied for the purpose of valuing the extent of this difference for gift duty purposes was not in issue in the case. The Commissioner when making his assessment had adopted the rate of five percent

6 [1977] 1 N.Z.L.R. 195.
7 Richmond P., Woodhouse and Cook JJ.
8 Defined as 'the return or compensation for the use or retention by one person of money belonging to another' per Rand J. in *Re Farm Security Act* (1947) S.C.R. 394, 411. Interest is usually expressed as a percentage of the amount lent.
9 [1940] N.Z.L.R. 637.
10 See the discussion infra in this Part and in Part II B.
11 Supra n. 6 at 203.
12 The time for valuation of gifts posited by s. 66 of the Act.

per annum used in the present value table appearing in the Second Schedule to the Act. The court had only to decide whether the Commissioner was justified in making the assessment. However, Cooke J. did comment[13] that the Commissioner was not, as a matter of law, bound to adopt that rate[14] but that from the taxpayer's point of view it could not be said to be unreasonable.

In support of its conclusion on the question whether a loan of money was a gift, the Court of Appeal cited and approved the decision of the High Court of Australia in *McGain* v. *F.T.C.*[15] and further stated that in so far as *Card*'s case was applicable, the reasoning of Smith and Fair JJ. was to be preferred.

In McGain, an 87 year old man made four interest free loans to a family company repayable over fifty years. Two of these loans involved actual money, the other two involved sales of property with the amount owing remaining outstanding as a loan. There was no doubt that the latter two transactions involved dispositions of property within the purview of the legislation, but in respect of the actual loans of money, the argument was made by counsel for the objector that the money advanced by the lender pursuant to the loan agreements did not amount to dispositions of those sums. The High Court rejected this submission and said that the real question which the court must ask itself is[16] "whether the payment of money by the lender to the borrower constitutes a disposition of property, not whether a loan is a disposition of property" and suggested that the obligation of the borrower to repay went only to the question of the adequacy of the consideration given and not to the initial question whether there was a disposition of property. On this basis it is not difficult to see why the reasoning of Smith J. in *Card* that a loan was disposition of property because[17] "from the point of view of the lender, he has paid over or alienated his money in return for a promise to repay the whole or part of it" was approved by the High Court.[18]

On the matter of adequacy of consideration the High Court accepted that it was appropriate to discount the chose in action represented by the promise to repay to its present value and to treat the amount of the discount as a gift made by the lender to the borrower for, as was observed by Taylor J.:[19]

> . . . it is obvious that the value of a contractual right to repayment at some remote future time of a specified sum is not the specified sum itself; it is a lesser sum which can be and often is ascertained by the application of an appropriate discount rate.

The Full High Court agreed with this observation and it was asserted that:[20] "It is not open to doubt that a promise to repay £2,000 by instalments of £40 over fifty years without interest is not fully adequate consideration for a payment of £2,000".

As to the appropriate discount rate to be applied, Taylor J. at first instance equated the term with the rate of interest on the loan, and he accepted evidence that this rate could have been as high as nine percent per annum. As the Commissioner had used only seven percent per annum when applying the discount

13 Supra n. 6 at 203.
14 In the writer's view this is incorrect, see n. 34 infra.
15 (1965) 112 C.L.R. 523 (Taylor J.); (1966) 116 C.L.R. 172 (Full High Court).
16 (1966) 116 C.L.R. 172, 174.
17 [1940] N.Z.L.R. 637, 654.
18 Specifically approved by Taylor J. in the High Court of Australia, supra n. 15 at 529.
19 Ibid., 531.
20 (1966) 116 C.L.R. 172, 175.

to the loan, it was felt by the Full High Court that the objector could not complain about the rate which was used.

The effect of *Rossiter* and *McGain,* which is to subject interest free loans for a specified term to gift duty, is to some considerable degree directly in conflict with the tax treatment of such loans promoted by *Card,* which, until *Rossiter,* had been acted upon in many intra-family loan arrangements and had been apparently accepted by the Commissioner, as evidenced by the practice which he adopted of not challenging such loans.[21]

In *Card,*[22] the taxpayer, in 1925, had lent money to his son to enable the son to acquire a farm property. The initial loan made to the son was an amount of £2,000 which was repayable on demand, and which carried interest at a lower rate of five percent per annum. It was a term of the loan, which was secured by a mortgage over the farm purchased with the money, that any further advances made by the father to his son should be interest free and repayable on demand. There was a provision, however, that demand for repayment could not be made at any time within the first five years of the loan, or alternatively, until at least one year after the father's death, whichever was the earlier. A number of further advances were made under the loan and ultimately the Commissioner of Stamp Duties issued an assessment for gift duty in accordance with the Death Duties Act 1921, a forerunner of the Estate and Gift Duties Act 1968.

In the Court of Appeal Myers C.J. and Ostler J. were of the opinion that there had been no disposition of property within the meaning of paragraph (a) of section 39[23] of the Death Duties Act 1921. Myers C.J. commented that[24] " . . . I cannot think that any reasonable person would regard as an alienation by the lender a sum of money which was merely lent and was to be repaid by him in full". Ostler J. agreed with this approach, and said further that a loan of money was not a disposition of property since paragraph (d) made it clear that[25] " . . . the release of a debt is a disposition of property which is strong evidence to indicate . . . that the making of the loan was not also intended to come within the definition".

If there was a disposition, Ostler J. felt that the promise to repay was full consideration for it in the absence of some common law or statutory presumption of interest on loans for duty and tax purposes. Smith J. was of the opinion that there was a disposition as the same money used to make the advances was never intended to be repaid, but he felt that the promise to repay the sum lent was fully adequate consideration for the disposition. He reasoned that to escape liability[26] " . . . the lender need not, like the man in the parable, increase his pound: it is sufficient if his transaction is the equivalent of keeping it laid up in napkin".

21 See n. 30, infra.

22 [1940] N.Z.L.R. 637.

23 Paragraph (a) is identical to the general words now appearing in the definition of 'Disposition of Property' in s. 2(2) of the Act which were given primacy over the other paragraphs in the 1968 consolidation.

24 Supra n. 22 at 649.

25 Ibid., 652. Note that this approach was given some validity in *Card* because the Commissioner's assessment for duty went to the full amount of the disposition. Ostler J.'s approach is based on the existence of double taxation in the case where a loan is made and is then forgiven.

26 Ibid., 655.

Fair J. was of the opinion both that there was a disposition of property made and that there was a gift within the purview of the legislation as the consideration given by the borrowers, the promise to repay, was not a "fair equivalent"[27] of the disposition.

The issues involved in the three cases of *Card, McGain,* and *Rossiter* were in reality identical, being first whether the loans in question constituted dispositions of property and second whether they involved less than fully adequate consideration in money or moneys worth. A feature of *Card* however was that the result of a finding against the taxpayer on both issues would have resulted in the imposition of gift duty on the value of the whole amount loaned, not merely on the inadequacy existing, namely, the amount of the discount. This apparent absurdity was caused by the application of section 49 of the Death Duties Act 1921, the forerunner of section 70 of the present Act. The Commissioner did not rely on section 70 in *Rossiter.*[28] The Act considered in *McGain,* the Gift Duty Assessment Act 1941-1957 (C'th), did not contain a provision like section 70.

It had been suggested by academic writers sometime prior to *Rossiter,* that the Commissioner could possibly use the *McGain* decision to challenge the validity of *Card.*[29] It had also been suggested[30] that because of the length of time which had elapsed since the decision, the presumed reliance upon it by many taxpayers, the opportunities which had arisen for legislative abrogation of the effect of the *Card* decision in 1955 and in 1968 which were not taken advantage of, and the case of *Re Manson,*[31] the court, when asked to review the issues again would probably fail to change the effect of the *Card* decision. This most certainly was not the case in *Rossiter* however. There the Court of Appeal felt quite unconstrained to consider itself bound by, or to reach any particular result on the basis of *Card,* despite the arguments addressed to it.[32] Because of the apparent change introduced by *Rossiter* it is now proposed to analyse critically the judgments of the Court of Appeal.

II. THE ROSSITER CASE

A. The Practical Effect of the Decision

The effect of the decision in *Rossiter* is to tax a loan as a gift, at the time when it is made, "to the extent of the notional interest, or in other words the difference between future value and present value"[33] of the sum lent assuming a discount

27 This was the test for adequacy of consideration established in the cases of *A.-G.* v. *Boden* [1912] 1 K.B. 539, 561 and *A.-G.* v. *Earl of Sandwich* [1922] 2 K.B. 500, 517, a test adopted by the Court of Appeal in *N.Z. Insurance Co.* v. *C.I.R.* [1958] N.Z.L.R. 1077, 1078.

28 See per Cooke J., supra n. 6 at 206.

29 For example, Hill, *Stamp, Death, Estate and Gift Duties* (Sydney, 1970) pp. 202, 600; *Adams and Richardson's Law of Estate and Gift Duties* (4th ed., Wellington, 1970) 56; and Congreve, "Gifts for Duty Purposes", in Richardson (ed.) *Essays on the Estate and Gift Duties Act 1968* (Wellington, 1969) 35.

30 *Adams and Richardson,* ibid., 56.

31 [1964] N.Z.L.R. 257.

32 See the discussion in Part II B, infra.

33 [1977] 1 N.Z.L.R. 195, 203 per Cooke J.

factor of five percent per annum.[34]

It would appear that no gift is made whenever the borrower has the immediately exercisable right to demand payment of the amount lent or, alternatively, where interest at a rate greater than or equal to the rate of five percent is stipulated for on the loan even though at the time when the loan was made it is not intended by the lender to either demand repayment, or to require the interest provided for to be paid. This was recognised in *Rossiter*[35] and it results from the fact that what must be valued at the time of the disposition are the rights given to the lender, not the actual money or moneys worth passing to the lender as a result of those rights. Section 26 of the Act[36] can clearly not apply in such circumstances since, in the case where a loan carries interest at five percent, or where it is repayable on demand, there is no gift made — a necessary prerequisite for the application of that section. It is suggested that this is undesirable as clearly a benefit can pass to a borrower in receipt of an on demand loan where no demand is made, just as it does to a term borrower, and it places a substantial premium upon form and hence upon proper tax planning.

In addition, it was recognised in *Rossiter* that a right given to a borrower to make an earlier repayment than provided for in the loan did not constitute a valuable consideration in money or moneys worth to the lender, as at the time when the loan was made it was not a right given to, or exercisable by him. Thus, even if repayment is made the day after the loan is made, there is still a gift of the full amount of the discount applicable the previous day, that is on the full potential value of the gift, even though this potential is never realised.

In the writer's opinion, the conclusion reached by the Court of Appeal in *Rossiter* is difficult to accept particularly, it is suggested, in the light of the *Card* decision and the somewhat anomalous tax treatment which, as a result of *Rossiter,* is now accorded interest free term loans.

B. The Treatment of Card's Case

In *Rossiter* the Court of Appeal gave a number of reasons why it did not consider itself bound by its earlier decision in *C.S.D.* v. *Card.*[37] First, it was suggested by Cooke J. that *Card* could be distinguished on its facts for:[38] "It was not a case of a sale from father to son with an incidental loan. It was a case of a loan from father to son to enable the son to acquire a farm, the loan being secured by a mortgage." It is suggested that whether the loan is in the form of a loan

34 Cooke J. suggested, idem., that "in some cases there may be room for argument about what is an appropriate discount rate" and also that the Commissioner was not bound by law to adopt the rate of five percent per annum used in the tables appearing in the Second Schedule of the Act when discounting the loan. He was apparently alluding to the practice of the High Court of Australia in *McGain* and in *Bray* v. *F.T.C.* (1971) 123 C.L.R. 348 where evidence was accepted as to a reasonable rate of interest, which rate was then applied for discounting purposes. However, in the writer's opinion, Cooke J. was incorrect in making his assertion as the plain wording of s. 25(2) of the Act, made applicable to the valuation of gifts by s. 68(1), must preclude the use of any other rate when assessing the present value of a future interest.

35 Supra n. 33 at 204.

36 Made applicable to gifts by reason of s. 68(2) of the Act.

37 [1940] N.Z.L.R. 637.

38 Supra n. 33 at 205.

of money per se, or alternatively is a "constructive loan" made in the wider context of a sale of property with the purchase price remaining outstanding as a loan, is relevant in a gift duty context[39] in only two respects. First, in relation to the question whether the loan is a disposition of property within the meaning of the Act, and secondly in relation to the question whether section 70 of the Act can be applied to the promise to repay. This latter question was not argued by the Commissioner in *Rossiter*. Any weight which the distinction suggested by Cooke J. might have carried is negatived by two factors. In the first place both Cooke and Woodhouse JJ. had found that whether regarded as loans per se or as loans made incidental to some wider transaction they would still be regarded as dispositions of property within the purview of the Act.[40] In the second place, the Court of Appeal approved and applied the reasoning of the High Court of Australia in *McGain*. *McGain* cannot be distinguished from *Card* in the manner in which Cooke J. suggested that *Rossiter* could be distinguished from *Card*. In addition to the arguments made against the validity of any distinction on the facts, it is nowhere indicated in any of the judgments in either *Card* or *Rossiter* that the reasoning adopted would apply only to the type of arrangement there considered. In fact, quite the reverse is true, and it is suggested that had *Card* come before the present Court of Appeal for determination, the dissenting reasoning of Fair J. would undoubtedly have been supported.

Secondly, in *Rossiter* it was suggested that *Card* could be distinguished on the ground that it had raised a different issue, or more particularly, that it "had promoted the heroic argument that the capital sum, although advanced merely as a loan, should itself be regarded as a straight out gift"[41] rather than a gift merely in terms of any inadequacy involved. As Woodhouse J. remarked[42] "It is not surprising that such an extreme position failed to attract a particularly enthusiastic response from the Court".

It is submitted that this basis for distinguishing *Card* is as unconvincing as that previously considered. In *Card* it was true that section 49 of the Death Duties Act 1921 would have had the effect of making the amount of the gift extend to the whole amount lent in the event of a finding that there was a disposition of property and an inadequacy of consideration within the meaning of the Act. However, this was not really in issue in the case, it having been correctly conceded by counsel that section 49 did apply[43] and, therefore, the court was faced with the same two issues facing the Court of Appeal in *Rossiter* namely, was there a disposition of property, and if so, was there less than fully adequate consideration in money or moneys worth for that disposition.

Thirdly, it was suggested by Cooke J. in *Rossiter* that *Card* was not binding on the Court of Appeal, for[44] "on no view is *Card*'s case a clear decision on the issue raised in this case" because of[45]

> . . . the reservation by Myers C.J. of his opinion on the interest point, the dissent of

39 Note its possible significance however to the question whether there has been a retention or a reservation of an interest in property in the context of s. 12 of the Act.

40 Supra n. 33 at 198 per Woodhouse J. and at 203 per Cooke J.

41 Ibid., 200 per Woodhouse J.

42 Ibid., 199.

43 Supra n. 37 at 645.

44 Ibid., 207.

45 Ibid., 206.

Fair J., the varying routes whereby Ostler and Smith JJ. reached their conclusion . . . *Card's* case is hardly a promising foundation for a stare decisis argument here.

This argument raised by Cooke J., while somewhat more soundly based and convincing than those previously considered, failed to take account of the simple fact that *Card* stood for some thirty-seven years before being challenged by the Commissioner, and during this time had undoubtedly been relied upon by lenders as settling the more general and possibly more significant issue of whether interest free loans were taxable as gifts. It is submitted, with respect, that Cooke J. can be criticised in his approach to the difficulties posed by the *Card* decision, in that he did not give greater recognition to the factors mentioned in *Re Manson*[46] as being pertinent to the question of whether the Court of Appeal should overturn an earlier decision of its own.

In *Manson* the Court of Appeal said that it ought not to overturn or overrule an earlier decision of its own merely on the grounds that a central issue arising in the case presently before it was not fully argued,[47] or that the earlier case is "in conflict with the decisions of overseas Courts of varying status decided on the language of Statutes whose meaning . . . is not easy to distinguish from that of our own."[48] Further to this it was stated that, in the absence of a compelling reason,[49] "If we were to overrule, we would merely be substituting (for the earlier decision) an opposite conclusion which we thought preferable. That can never be a sufficient ground, however wide the power to overrule a precedent decision of the same Court may be . . . ."

A number of factors were mentioned in the case which it was suggested would militate against the overruling of an earlier decision of the court. These can be briefly described as follows:

(1) That the earlier decision has been followed and applied in some other cases.

(2) That the earlier decision has stood for many years and has been relied on.

(3) That the earlier decision causes no injustice to individuals. In a purely revenue matter it was suggested that if Parliament thinks it acts unfairly against the State then an amendment can easily be effected.

(4) That the legislation under consideration has been consolidated and amended since the earlier decision but no amendment has been made to abrogate its effect.

All of the factors mentioned in *Manson,* save the first[50] were present as at the time when *Rossiter* was decided. It is suggested that the third factor mentioned provides a particularly strong argument against non-interference by the court with the *Card* decision. In *Rossiter,* the Court of Appeal, rather than rectifying an anomaly or injustice in the law against an individual, was in fact creating one by affording different tax treatment to loans of money compared with that afforded loans of other property, and moreover, to term loans compared with that afforded

46 [1964] N.Z.L.R. 257.

47 Ibid., 271.

48 Ibid., 271 per McCarthy J.

49 Idem.

50 The case had not been followed in New Zealand since it was decided. Decisions to the same effect had been made, however, in the United States, see e.g. *Johnson* v. *U.S.* 254 F. Supp. 73 (1966) but cf. *Mason* v. *U.S.* 513 F. 2d 25 (1975), especially at 30 n. 15.

on demand loans, when no such differential treatment had previously existed.[51]

The last factor mentioned in *Manson* (the consideration without amendment of the legislation in question, and the non-abrogation of the effect of the decision) was suggested to be, of itself, a matter which would make the court reluctant to interfere in a decision which was purely a revenue one. Cooke J., however, showed no such reluctance in finding that the 1955 and 1968 consolidations of the estate and gift duties legislation did not give rise to any presumptions of legislative acceptance of the decision. He cited Lord Wilberforce in the recent case of *Farrell* v. *Alexander*[52] in support of his conclusion. There Lord Wilberforce had said that[53]

> . . . self-contained statutes, whether consolidating previous law or doing so with amendments, should be interpreted, if reasonably possible, without recourse to antecedents, and that recourse should only be had when there is a real and substantial difficulty or ambiguity which classical methods of construction cannot resolve.

The soundness of this approach, however, is brought into question by the conflicting statement, made in the specific context of a tax statute, of Lord Reid in *I.R.C.* v. *Hinchy*[54] where he said:

> The Act of 1952 is a consolidating Act and one must presume that such an Act makes no substantial change in the previous law, unless forced by the words of the Act to a contrary conclusion. Therefore, in interpreting a consolidating Act it is proper to look at the earlier cases and the provision which it consolidated.

Of the two conflicting lines of reasoning existing in relation to this point, it is suggested that the approach of Lord Reid, being supported by the Court of Appeal in *Manson,* is to be preferred.

It is suggested therefore that if, as has been submitted above, *Card* and *Rossiter* could not be distinguished on their facts, and if the issues in the two cases were the same, then following the reasoning in *Manson* a decision contrary to *Card* should not have been made in *Rossiter.* Cooke J., however, suggested that[55]

> The most that can be said from the objectors' point of view is that the reasoning of two of the four members of the Court of Appeal, and perhaps the reasoning of the Judge in the Supreme Court (Johnston J.) can logically lead to the inference that they would have rejected the different claim now made by the Commissioner.

and on this basis he decided that there was no determination by the Court of Appeal in *Card* of the issue raised in *Rossiter.*

With respect, the writer would argue that on the question whether a loan of money was or was not a gift, the reasoning of only one of the five judges called upon to determine the question in *Card,* Fair J., would support the finding reached in *Rossiter.*

In addition, it is suggested that the Court of Appeal in *Rossiter* could quite justifiably have reached the same decision, had it been prepared to limit its finding solely to the context of sales of property with incidental loans, rather than by attempting to include loans of money per se, and had it been prepared not to

51 See the discussion infra, Part II C.1.
52 [1977] A.C. 59.
53 Ibid., 150.
54 [1960] A.C. 748.
55 [1977] 1 N.Z.L.R. 195, 206.

approve and apply the High Court of Australia's decision in McGain insofar as it applied exclusively to loans of money simpliciter (i.e. the finding that such a loan was a disposition of property within the purview of the legislation). The distinction between *Rossiter* and *Card* on the facts, drawn by Cooke J. would thus have been valid. Having failed to do this, however, it is submitted that the Court of Appeal in *Rossiter* was incorrect in its conclusion insofar as it is in conflict with the finding in *Card* that an actual interest free loan of money[56] is not taxable as a gift because *Card*'s case, to the extent that it applied to the facts in *Rossiter,* should have been followed.

C. The Issues that Arose in Rossiter

1. *Is an interest free loan a disposition of property?*

The initial question which needs to be asked when determining whether an interest free loan is in fact a dutiable gift, is whether or not it constitutes a disposition of property within the purview of the Act.

'Disposition of property' is defined in section 2(2) of the Act as any "conveyance, transfer, assignment, settlement, delivery, payment, or other alienation of property, whether at law or in equity" and the section then proceeds in paragraphs (a) to (f) to include as dispositions of property certain specific transactions.

Because of the collocation of the general words in the definition denoting transfer of property, and the words "or other alienation of property" it would seem that the definition does not extend to a transfer of property per se, but rather only embraces transfers of property which also amount to alienations by the transferor.[57] Thus, it would appear not to extend, for example, to a loan of a chattel or an item of property such as a car or a house, the lender of such chattels or items still retains an interest in them and has certain rights of ownership over them, in particular the right to have them transferred to him at the end of the agreed period of the loan. The lender in such a case only foregoes his rights of present use and possession of the property for the agreed period of the loan, he does not alienate his beneficial ownership of it. Thus it would seem that such a loan, not amounting to a disposition of property within the purview of the Act, would not amount to a gift either, even if no consideration, other than the promise to re-transfer the property lent at some later date or alternatively when demanded, is given for it.

In *Rossiter* and in *McGain* it was held that the loans of money which were made, did amount to dispositions of property. Viewed in the "wider context", mentioned in *Rossiter,* of a sale of property for a specified money consideration which permitted payment to be made over an extended period of time, or, in other words a sale with an incidental loan, this finding is without doubt correct. There is both a transfer, and an alienation of that property which is sold. In the

56 As compared with a "constructive" loan which arises when property is sold with the purchase price remaining outstanding as a loan, as was the situation in *Rossiter.*

57 As to the interpretation of s. 2(2) see the comments of Cooke J. in *Carmody* v. *C.I.R.* [1975] 1 N.Z.L.R. 118, 122, but note certain observations in *Ord Forrest Pty Ltd* v. *F.C.T.* (1974) 4 A.T.R. 230.

"narrower context" however, where the loans are treated as loans of money per se, the question is substantially more difficult.

It would appear that there is a degree of ambiguity in section 2(2) which makes it uncertain, in the case where money is lent, to what property passing to the borrower the definition should be applied. On one hand it can be argued that the property passing to the borrower when a loan of money is made is the cheque given, or the notes and coins transferred to him. This, the argument goes, becomes the subject of absolute ownership by the borrower, for it is never intended that when the loan is repaid the same cheque or the same notes and coins given by the lender to the borrower should be returned to him. Rather, it is intended that he receive only an amount of money equal to that which was lent. On this view it can be suggested that a loan of money differs from a loan of goods or chattels[58] and does amount to a disposition of property within the meaning of the section.

Alternatively it may be argued that when a loan of money is made, that which is transferred is a "fund" or a "corpus", the transfer of which is merely effected by the payment of the cheque or money passing from the lender to the borrower. The transferor of the "fund", it is argued, at all times during the period of the loan retains his beneficial ownership of it and his right of reversion in it, or the right to have it re-transferred to him at the end of the period of the loan. Again this is via the medium of a cheque or alternatively a bundle of notes and coins, certainly not the same as those which he gave initially but rather an amount equivalent to them. On this view it is suggested that a loan of money cannot be distinguished from a loan of goods or chattels; that it does not amount to an alienation of the property transferred; and thus that it does not amount to a disposition of property within the purview of the Act.

Support for the "money" argument may be found in the judgments of Smith and Fair JJ. in *Card*,[59] in the reasoning of the High Court of Australia in *McGain*, and by implication also in *Rossiter* where Woodhouse J. was of the opinion that[60] " . . . it is impossible to fault the reasoning in the *McGain* case and I think the decision should be regarded as good law in New Zealand" and Cooke J. remarked[61]

> In the simple case of an interest-free term loan, not being part of a more extensive transaction, there seems to me to be no convincing answer to the opinion of Smith and Fair JJ. in this court in *Commissioner of Stamp Duties* v. *Card* . . . and of the High Court of Australia in *McGain* v.*Federal Commissioner of Taxation* . . . that the payment of the money by the lender to the borrower is a disposition of property within the meaning of the Act.

In *Card*, Fair J. considered that[62] "the payment of moneys was an absolute disposition of them and the obligation to repay does not prevent that being so". Smith J. took a similar view to this, as did the High Court of Australia in *McGain* where it was suggested that the promise to repay went only to the matter of

58 *Adams and Richardson*, op. cit., 30.
59 [1940] N.Z.L.R. 637, at 654 and 658 respectively.
60 [1977] 1 N.Z.L.R. 195, 200.
61 Ibid., 203.
62 Supra n. 59 at 658.

adequacy of consideration and that[63] "the real question for the Court was whether the payment of money by the lender to the borrower constitutes a disposition of property, not whether a loan was a disposition of property".

Support for the "fund" or "corpus" argument is found in the judgments of Ostler J. and Myers C. J. in *Card*. The latter suggested that no "reasonable person would regard as an alienation by the lender a sum of money which was merely lent and was to be repaid in full".[64] Support may also be found in the judgment of Cooke J. in *James* v. *C.I.R.*[65]. In that case, the "money" argument was raised in support of a proposition that a loan of money was not a "settlement of property" within the meaning of section 105(2) of the Land and Income Tax Act 1954[66] but rather was an absolute disposition of the amount lent. If that were so then for the purposes of section 105(2) there could be no corpus of which it could be said that the lender remained the beneficial owner. In rejecting this argument Cooke J. said that he thought it[67]

> . . . altogether too technical and refined an approach to the section to suggest that as the same cheque (or the same notes and coins) would not be used if the objector demanded repayment of his loan, the settled sum cannot revert to him or be under his control.

and he added, that when a loan is made[68] "What is settled is a fund. The income from the fund is identifiable".

While it is not suggested that the income tax legislation and the gift duty legislation in this country are in pari materia in all respects, the similarity of the argument as to "corpus" or "fund" which arises in the context of both Acts, and the explicit finding of Cooke J. in relation to that argument in *James* case, do weigh in favour of a similar finding in the context of the Estate and Gift Duties Act 1968.[69]

Perhaps a hint that the issue was not fully understood in *Rossiter* is provided by the fact that Woodhouse J. in his judgment spoke of "property in the fund" passing when the loan was made.[70] Again, this would appear to be somewhat inconsistent with the ultimate finding that the loans were dispositions of property. Furthermore, the *James* "corpus" argument was not raised in *Rossiter*. Had it been raised it is suggested that the court would have decided *Rossiter* purely on the basis of the "wider context" — the sale and incidental loan — and the "fund"

63 (1966) 116 C.L.R. 172, 174. The validity of this test is open to question and it goes somewhat further than the arguments put by Smith and Fair JJ. in *Card* and by Taylor J. at first instance in the High Court in *McGain*. The test fails to recognise that it is the obligation to repay that possibly makes a loan of property not a disposition of that property. Nevertheless, it still must be seen as support for the "money" argument. The authors of *Adams and Richardson*, op. cit., 30, also suggest that the "money" argument represents the better approach to the question as does Congreve, op. cit., 35.

64 [1940] N.Z.L.R. 637, 649. Ostler J. took a similar view. Ibid., 652.

65 [1973] 2 N.Z.L.R. 119.

66 Now s. 96(3) of the Income Tax Act 1976.

67 Supra n. 65 at 124.

68 Idem.

69 A difficulty is experienced with reliance on *James* in that Cooke J., obiter, accepted *McGain* as authority for a loan of money being a disposition of property, and there is an obvious inconsistency between the two views as *McGain* is posited on the "money" approach. Thus, one of the views expressed by Cooke J. must be incorrect.

70 Supra n. 60 at 198.

argument would have remained open in the case of an actual loan of money. It is suggested, however, that the "fund" argument in respect of an actual loan of money is probably now precluded on the basis of what was explicitly stated in *Rossiter* and the failure of Woodhouse J. to consider the "wider" and the "narrower" constructions separately.

2. *If an interest free loan is a disposition of property is the consideration adequate?*

The next question that arises in the determination of whether an interest free loan is taxable in part as a gift, assuming that a disposition of property has been made, is whether less than fully adequate conideration in money or moneys worth has been given for the disposition. On this matter, it is suggested that there is very little doubt but that the *Rossiter* decision was correct. It is patently clear that a right to repayment exercisable at some future time is not as valuable, at the time when the loan is made, as the sum lent, in the absence of interest. The right to repayment is a chose in action and when it does not bear interest it is clearly not the "fair equivalent" of the sum lent. Rather it is some lesser sum, the amount of which is easily capable of valuation by applying a discount rate to the sum lent over the term of the loan. The amount of the discount is the value of the inadequacy, and hence the amount of the gift involved.

It was argued in *Card* by Ostler J. that in the absence of some express or implied right of the lender to be paid interest arising either by contract, by statute, or by common law, none ought to be imputed to the parties for gift duty purposes. This argument does find some support in the American case of *Johnson* v. *United States*,[71] a decision of the Texas Federal District Court. In that case it was said that[72]

> The time has not yet come when a parent must suddenly deal at arm's length with his children when they finish their education and start out in life. There is no legal requirement, express or implied, to charge them interest on money advanced to them at that stage.

Smith J. in *Card* also put forward a suggestion that the promise to repay a loan was fully adequate consideration for the making of it since the father had a right, if he wished, to keep the money in cash and it was sufficient for gift duty purposes if the transaction maintained his money without increase, or in other words, "was the equivalent of keeping it laid up in a napkin". This argument also gains support from *Johnson*. It is submitted that both the arguments are invalid in the New Zealand context in the face of the specific statutory mandate in section 25(2).[73]

The *Johnson* case has come in for a large amount of criticism from academic writers in the United States[74] mainly on policy grounds. Many of the criticisms raised by these writers would seem to apply in New Zealand and militate against the arguments raised by Smith and Ostler JJ. Therefore, even if there is no

71 254 F. Supp. 73 (1966).

72 Ibid., 77.

73 See discussion infra., Part II C.3.

74 E.g. O'Hare, "The Taxation of Interest-Free Loans", 27 Vand. L.R. 1085; Westover, "Gift Taxation of Interest-Free Loans", (1967) 19 Stan. L.R. 870; and Comment, (1967) 65 Mich. L. Rev. 1014.

specific rate which is made binding by the statute, the result reached by the Court of Appeal is a proper and desirable one.

3. *If the consideration is inadequate how is that inadequacy determined?*

The third question arising in the context of the gift duty issue in relation to interest free loans is that involving the measure of the inadequacy or, in other words, the appropriate discount rate to apply.

Cooke J. commented in *Rossiter's* case that there could, in a suitable case, be some argument as to the appropriate discount or interest rate to apply.[75] He also suggested that the Commissioner was not bound to use the rate of five percent per annum specified in section 25(2) of the Act and the present value tables appearing in the Second Schedule. It is suggested, with respect, that he was wrong and that the rate of five percent per annum made appropriate for the valuation of gifts by reason of section 68(1) of the Act, is the only one that can be validly used by the Commisioner for assessment purposes.[76]

That a more appropriate rate than the five percent rate could be found for the purpose of discounting interest free loans and the promiss to repay therein contained is almost beyond doubt. This matter, however, will be considered later in this paper, and it is not proposed to consider it at this point. It is sufficient merely to remark that this ground does not afford, from the point of view of the taxpayer involved, a valid ground for criticism of the case, for, as Cooke J. remarked:[77] "the discount rate applied could not be said to be unreasonable".

III. CERTAIN POLICY CONSIDERATIONS

It is suggested that as well as the technical matters already considered, the effect of *Rossiter* is undesirable on a number of general policy grounds. It is proposed to consider some of these.

A. Treatment of On Demand Loans

In *Rossiter's* case it was stated that there was a gift involved in the making of a loan only "When the loan is not repayable on demand and there is no interest".[78] Thus, it is apparent that a taxpayer wishing to transfer a benefit to someone through the medium of an interest free loan may still do so, and avoid the imposition of gift duty on the loan, merely by making the loan technically repayable on demand even though never intending to exercise the right to make demand. In the writer's opinion this distinction between "term" loans and "on demand" loans, while possibly valid in the market, is completely inappropriate where the lender and the borrower are not dealing at arm's length.[78a]

75 [1977] 1 N.Z.L.R. 195, 203.

76 See n. 34 supra.

77 Supra n. 75 at 203.

78 Ibid., 204 per Cooke J.

78a The general view expressed here is embodied in s. 4(16) of the Gift Duty Act 1971 (Vic.) which provides that where a non-arm's length loan is on demand a gift is deemed to have been made, at the end of each year that demand is not made, of the value of the interest forgone. The interest is at a prescribed rate.

By way of example, it is suggested that in all probability a father who wishes to benefit his son by giving him the interest free use of a sum of money for a period of five years will be wholly unconcerned with whether the money is technically repayable at a definite time or, alternatively, on demand. At the end of the five year period, when repayment is made, the benefit to the son from the use of the money is clearly identical whether the loan was for a term or on demand. Moreover, if the use of the term loan will result in liability for gift duty, and the use of "on demand" loans will not, surely the parties will adopt the latter. The taxability or non-taxability of an interest free loan it is submitted ought not to depend on a distinction as slender as that suggested here and, therefore, it is suggested that this affords a valid policy argument against the desirability of the result of the *Rossiter* decision.

B. Lending of Property other than Money

For the reasons already suggested[79] loans of property other than money are not currently taxable as gifts under the Act even though the loan is made for no consideration other than the bare promise to re-transfer the property lent at the end of the agreed period of the loan.

This, it is suggested, is another example of the undesirable situation pertaining after the *Rossiter* decision. Ideally, the interest free lending of all potentially income earning property should be subject to gift duty. In the absence of this ideal howover, it is inappropriate to subject only loans of money to this treatment.

An intending interest free lender could, under the existing legislation, use the money he would have lent, to purchase a home and lend this to the borrower rent free. The borrower could then rent the house to someone else, the rental payments received being the equivalent of income from the interest free use of money. Alternatively he could live in the house himself, thereby freeing for investment or other use, money which he would otherwise have expended on rental or mortgage payments. In such a case there would clearly be no liability for gift duty even though a substantial benefit, equal in every way to the benefit passing under an interest free loan, is transferred to the borrower. It is submitted that a different tax treatment of the two transactions is very difficult to justify.

C. Tax Planning Premium

Allied to, and arising out of the inconsistencies suggested above, a further criticism of the post-*Rossiter* situation is afforded by the emphasis, for tax purposes, which it places on form, and hence on tax planning.

As a general rule, the tax system should be as neutral as possible as between different modes of achieving substantially identical results. Where two different modes of achieving an identical result elicit different tax treatment it can represent, to the extent of the difference, a failure of the tax legislation.[80] It is difficult to accept that the current gift duty legislation should endeavour to encourage loans of one particular type and discourage the use of others by taxing the latter, and

79 Supra., Part II C.1.
80 Unless the provision in question is a deliberate encouragement of a particular action.

not taxing the former, but this it seems, is exactly the situation after *Rossiter* in the case of term loans, as against demand loans and loans of other property. Accordingly a substantial premium has been placed upon the use of demand loans and loans of property.

It is not suggested that an ideal tax, which would mete out different tax treatment only if there was a relevant economic difference between taxpayers, could ever be achieved. It is submitted however, that we should not be satisfied with the situation existing after *Rossiter* as it falls so far short of the ideal, particularly as the tax treatment afforded interest free loans following *Card* represented a more neutral solution to the difficulty. *Rossiter* marks a retrograde step in this respect — away from neutrality.

The apologist for the present treatment afforded interest free loans, following *Rossiter*'s case, could find some support in the statement made by Lord Greene in the case of *Henriksen* v. *Grafton Hotel Limited*[81] where he said:

> It frequently happens in income tax cases that the same result in a business sense can be secured by two different legal transactions, one of which may attract tax and the other not. There is no justification for saying that a taxpayer who has adopted the method which attracts tax is to be treated as though he had chosen the method which does not, or vice versa.

This statement has, however, been criticised, quite correctly in the opinion of the writer, as being[82] "a proper and necessary attitude for a judge who is charged with construing the existing tax legislation. It is not a justification which anyone else can invoke".

D. Gift Duty Policy

In Adams and Richardson[83] it is suggested that the gift duty legislation in New Zealand has two main purposes. The first is to "protect the estate duty base" which it does by taxing inter vivos dispositions of property which, but for the disposition, would be included in the disponor's dutiable estate upon his death. The second purpose is that of "raising revenue" (although this purpose can now be largely disregarded as the result of recent increases in the annual value of gifts which is nil-rated under the Act and the minimal amount collected over the past few years).[84]

On this basis, it is possible to argue quite strongly that the tax imposed in *Rossiter's* case on the interest free loan made there, is not warranted in terms of gift duty policy. The amount lent was at all times included, at its full value, in the lender's estate for estate duty purposes and thus there was no avoidance of that duty for which protection is required. Furthermore, if the amount of the loan were ever forgiven by the lender this forgiveness would be taxed in accordance with the method and at the rates of duty provided for in the Act. To take advantage of the exemptions expressly provided for in the Act and of the progressive rate

81 [1942] 2 K.B. 184, 193.
82 Bale, "The Interest Deduction Dilemma" (1973) Can. Tax J. 317, 323.
83 Op. cit., 2.
84 In 1975 only $2,751,000 was collected. It is likely to be significantly less than this in 1976 as a result of the increased level of exemption introduced in that year.

scale of duty, the argument goes, is not really avoidance of a type which, in the absence of specific legislation, it is appropriate to prevent or discourage by the imposition of gift duty.

An argument along lines very similar to this met with some success in the decision of the Texas District Court in the case of *Johnson* v. *United States*[85] where the purposes of gift duty suggested in Adams and Richardson were recognised, and suggested not to have been violated by the making of the loans there in issue. The court in *Johnson's* case refused to impute interest at a reasonable rate to the transaction[86]. The finding made there, however, has promoted a degree of academic criticism insofar as it failed to recognise the estate freezing effect of interest free loans for[87]

> The principal, had it not been transferred to the taxpayers' children, would most likely have generated income to the taxpayers, some portion of which would have been saved and reinvested giving rise to additional income. This continually accumulated income would have been includable in the taxpayers' estates . . . . By effecting a present transfer of this income to their children, the taxpayers avoided estate taxation.

This counter-argument is further supported by the statement of the Ways and Means Committee in the United States, that gift duty has the further purpose of tending:[88]

> to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons rather than one, with the result that the taxes imposed by the highest tax brackets of the income tax law are avoided

or in other words the purpose of protecting the income tax base, and preventing income splitting. Thus, the policy considerations are more complex than would first appear and again would tend to indicate that the distinction which now exists between different interest free loans is undesirable.

IV. WHAT RATE OF INTEREST SHOULD BE ADOPTED FOR THE PURPOSE OF THE DISCOUNT FACTOR IN RESPECT OF INTEREST FREE TERM LOANS?

It was suggested above[89] that the discount rate is determined by the Act — section 25 and the Second Schedule. Obviously, given the current economic situation, that rate (about five percent) is unrealistic. What is an appropriate rate? One possibility would be to adopt a rate of interest determined by reference to that rate which would be demanded in similar circumstances between parties dealing at arm's length. This would certainly accord with the present practice of the Commissioner of not issuing assessments for gift duty in normal commercial transactions[90] and it would clearly extend to the maximum possible benefit which it could be suggested was derived by a borrower in receipt of an interest free loan. The rule would, however, involve some degree of harshness in many intra-family

85 254 F. Supp. 73 (1966). For a discusion of the case see Westover op. cit.
86 This decision is not accepted by the Commissioner in the U.S. however — see Revenue Ruling 73-61, 1973 1 C.B. 408.
87 Westover, op. cit., 874.
88 S. R. Hooton "Gift Tax Analysis on Non-Interest Bearing Loans" (1976) Taxes 640.
89 Supra Part II C.3.
90 *Adams and Richardson,* op. cit., 53.

loan transactions in that, judged by arm's length standards, many such loans might require the application of a very high rate of interest. This is caused by the risk factor which plays a very significant role in the determination of commercial interest rates. However, it is suggested that it is not appropriate in family transactions to apply the risk test and determine whether adequate security is taken for the loan in order to ascertain the proper interest rate to be applied because the family relationship, of itself, would tend to diminish, to some degree, the risk of ultimate loss of the amount lent.[91] In addition, many loans made between family members are made in circumstances in which no arms-length lender would make a loan to the borrower. It could be very difficult to calculate an arms-length rate in such circumstances.

It is suggested that these difficulties would be sufficient to warrant the rejection of the arms-length test. This conclusion is also reinforced by the fact that its adoption would involve certain administrative difficulties as the proper rate to be applied to each loan would have to be assessed taking all of the circumstances of the arrangement into consideration and, unless the Commissioner chose to deliberately adopt a low rate when making his assessment, could possibly lead to a great deal of litigation. In addition, the test would also involve a degree of uncertainty as a taxpayer could not know in advance whether or not the rate of interest which he provides for on a loan would be sufficient to prevent the Commissioner issuing an assessment for gift duty. It would clearly not be open for him to argue that the loan would not have been made had it been known that the rate would be as high as that adopted by the Commissioner.[92] Therefore, it is submitted that the arms-length test should be rejected.

In *Card's*[93] case, Fair J. suggested that there may be an exclusion from the scope of gift duty legislation for transactions normally and commonly carried out in the ordinary course of business and he remarked that:[94] "they might perhaps upon close scrutiny, fall within the letter of the Act, but if they are clearly outside its spirit, they are not taxable".

A similar suggestion, though arising in the context of an income tax statute, is contained in the case of *Bulmer* v. *I.R.C.*[95] Adams and Richardson, however, reject the suggestion that the words of the gift duty legislation can be limited to transactions involving some element of a bounty[96] and the writer would agree with this view. Therefore, it is suggested that this test also should be rejected.

A better test to be applied in the case of an interest free family loan than those already suggested (and rejected) would be one which determined the discount factor by reference to the amount of interest foregone by the lender, or in other words, by reference to the potential return from the money measured by determining an average or sufficient rate of return from investment on the market. To counter the difficulty of possible application to commercial loan transactions, the rate should accord with the prime bank lending rate in force from time to time for

91 Cf. *Bray* v. *F.C.T.* (1971) 123 C.L.R. 348-360 for an analysis of the relevant and irrelevant factors.

92 See, though in a different context, *Bell* v. *F.T.C.* (1953) 87 C.L.R. 548 and *Marx* v. *C.I.R.; Carlson* v. *C.I.R.* [1969] N.Z.L.R. 464.

93 [1940] N.Z.L.R. 637.

94 Ibid., 665.

95 [1967] Ch. 145.

96 *Adams and Richardson,* op. cit., 53.

very few commercial loan transactions would be made at less than this rate and, therefore, very few loans which are not intended to confer a bounty upon the borrower would be caught.

The adoption of this test would have the further administrative advantages of ease of application; certainty from the point of view of a lender wishing to avoid liability to gift duty, and the minimization of disputes as to the proper discount factor to be used by the Commissioner when making his assessment. A degree of tax avoidance by income splitting could still be achieved through the use of interest free loans, if this test was to be applied, whenever the return from the proceeds of the loan exceeded the prime bank lending rate. It is submitted that although the test proposed does to some extent represent a compromise, it would nevertheless fulfil the purpose of discouraging the use of interest free loans for purely tax avoidance purposes, and of being as neutral as possible between varying modes of achieving the same result, because it is not dependent upon external factors such as risk or the nature of any security taken for the loan.

V. SOME FURTHER DIFFICULTIES OF INTRA-FAMILY LENDING

It is clear that, apart from the specific gift duty difficulties of intra-family loans already discussed, there are also a number of further difficulties facing intra-family lenders where the terms on which or the circumstances in which the loans are made would not normally be present in most commercial transactions. In the discussion that follows it is proposed to consider a number of these difficulties, to comment on the context in which they may be of particular significance, and to suggest a number of possible solutions to the problems posed.

A. On Demand Loans

As has been stated above, in *Rossiter*[97] it was determined that loans which were interest free, but which were repayable on demand, did not constitute dutiable gifts for at the time when the loans were made the right to repayment, being immediately exercisable, constituted fully adequate consideration for the making of the loan. This finding would appear to be soundly based in the context of the present gift duty legislation as long as the promise is genuine and not merely a sham. Authority can also be found for it in the decisions of the High Court of Australia in *Fadden* v. *F.C.T.*[98] and *Bray* v. *F.T.C.*[99]

Accordingly, the use of demand loans in place of a normal term loan would seem to avoid the difficulty of the *Rossiter* decision. In addition, loans which are repayable on demand would appear to be slightly more flexible than a term loan, and would also allow the lender a degree of control over the use to which the proceeds of the loan are put. They are not, however, the panacea for tax and estate planners and intra-family lenders that an initial consideration might suggest them to be. This is due mainly to possible difficulties associated with section 96(3) of the Income Tax Act 1976, as a result of the decision of Cooke J. in *James* v. *C.I.R.*[1]

97 [1977] 1 N.Z.L.R. 195.
98 (1945) 70 C.L.R. 555.
99 (1971) 123 C.L.R. 348.
1 [1973] 2 N.Z.L.R. 119.

In *James* the question was raised whether the section operated to deem the income derived by a family trust from the investment of the proceeds of an on demand loan to be income of the lender.

The facts were that James, the objector, sold his farm for $40,318 to a company which he had incorporated. The company drew a cheque for this amount in his favour which he endorsed and passed on to the trustees of a family trust (the beneficiaries of which were his wife, his children and his grand-children) as an interest free loan, repayable on demand. The trustees then drew a cheque for the full amount received by them from James, and loaned this amount to the company for a term of five years, with interest payable in the meantime at the rate of six percent per annum. James then leased the farm from the company at a yearly rental more than adequate to cover the amount of interest payable by the company to the trustees of the family trust.

As has been said[2] "The result of all these moves was that the objector became a mere lessee of the farm which he had once owned and he was paying rent to the company. The trust was deriving an income by way of interest on the loan which had been made to the company and James was owed, free of interest, the money which had ultimately been used by him to purchase the farm".

The Commissioner, relying on section 96(3), had issued an assessment to James for income tax on the money received by the trustees from the loan to the company. The Commissioner was of the opinion:

(1) that James had made a settlement of property;

(2) that the income from that settled property was to be applied for the benefit of some other person (the beneficiaries under the trust) for a period possibly less than the prescribed period of seven years (because the loan was repayable on demand);

(3) that James remained the beneficial owner of the "corpus" of the settled property, and accordingly that the income received by the trustees from the company (the interest) was properly taxable to James himself.

Cooke J. held that the whole scheme was an "arrangement", and thus a settlement of property within section 96(1) and he accordingly upheld the Commissioner's assessment.

The case has been criticised on a number of grounds[3] and particularly for the very liberal interpretation which Cooke J. gave to the word "arrangement". Since *James* case no other case has come before the courts involving section 96(3) and the Commissioner has, to date, apparently not attempted to exercise the wide powers which the case would seem to have afforded him.

Nevertheless, an intending interest free lender should be wary, where making the loan repayable on demand, if the circumstances in which the loan is made are prima facie ones to which the decision in *James* case, and section 96(3) could extend. That is, when a loan is made which is repayable on demand, or possibly repayable within seven years and the proceeds of the loan are either invested in income producing property, or re-lent at interest and it is part of an "arrangement"

2 Molloy, "Income Tax Provisions and Decisions of Special Importance in Legal Practice", [1977] N.Z.L.J. 194, 198.

3 See Molloy, op. cit.

that this should be done. If that is the case the lender should take steps to counter the possible application of section 96(3). Molloy[4] suggests that this may be done by providing that demand for repayment of the loan may not be made within the first seven years after it is made. Such an arrangement would certainly counter the application of section 96(3), but it would give rise to a gift of the discounted value of the loan over that seven year period. This would follow from *Rossiter* and *Bray* v. *F.T.C.*,[5] as it would amount to a loan for a term of seven years, thereafter repayable on demand.

It is possible for this difficulty to be overcome by providing that the loan carry interest at the rate of five percent per annum during this seven year period or, alternatively, by providing that the loan should bear interest only if demand is made for it before a certain date in the year in which it falls due. This latter arrangement was effected in the case of *Re Marshall*[6] and it was held there, by the Court of Appeal, that the failure by the lender to make demand did not constitute a disposition of property within the meaning of the Act, and accordingly was not a gift of the amount of interest which would have been payable had timely demand been made.[7]

B. Intra-Family On-Lending: The Interest Deduction Difficulty

It is not uncommon in many intra-family loan arrangements for the money which is lent to itself be borrowed from elsewhere at interest. In such a case a question arises as to whether or not the on-lender is entitled to a deduction for income tax purposes in respect of the interest which he pays. An example would be a person who borrows money from his bank at ten percent interest and on-lends that money to his son as a term loan at five percent interest in order to avoid the gift duty problems occasioned by *Rossiter*.

Interest deductions are regulated by sections 104 and 106 of the Income Tax Act 1976.[8] These sections, insofar as they are relevant provide that

> *Section 104.* In calculating the assessable income of any taxpayer, any expenditure or loss, to the extent to which it —

4 "Nasty Surprise for some 'On Demand' Lenders", [1973] N.Z.L.J. 336, 341.

5 (1971) 123 C.L.R. 348.

6 [1965] N.Z.L.R. 851.

7 An interest free lender making an on demand loan of this kind should be aware of the possible problem posed by s. 99 of the Income Tax Act 1976. It would seem that s. 99 can apply to arrangements outside s. 96 — see *McKay* v. *C.I.R.* [1973] 1 N.Z.L.R. 592 and the article by Bassett in this volume. Section 99 could possibly apply to the postponement of the right to demand interest for seven years for arguably its presence in the loan enables one to predicate that " . . . it was implemented in that particular way so as to avoid income tax" — *Newton* v. *F.C.T.* [1958] A.C. 450, 466. Quaere, however, whether the "predication test" still applies to s. 99. Nevertheless, if s. 99 did apply, the prohibition on the right to make demand would be void for tax purposes and s. 96(3) would thus apply with its full rigour.
A further potential difficulty exists if the loan of the kind under discussion is secured over some property of the borrower, for it is arguable that the postponement of demand is void either as a clog on the equity of redemption or by reason of s. 81(2) of the Property Law Act 1952 — see Molloy [1977] N.Z.L.J. 194, 202.

8 The relationship of these sections insofar as the deduction for interest is concerned was the subject of comment in the judgment of the Court of Appeal in *C.I.R.* v. *Banks* (1978) 2 T.R.N.Z. 323.

(a) Is incurred in gaining or producing the assessable income for any income year; . . . may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.'
Section 106 . . . no deduction shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters:
(h) Interest . . . except so far as the Commissioner is satisfied that —
(i) It is payable on capital employed in the production of the assessable income; . . .

On a literal interpretation of the meaning of the two sections it is apparent that an on-lender could clearly claim a deduction in respect of the interest which he pays when he on-lends at a rate of interest greater than which he pays, since the net result of the transaction is that he receives assessable income.

Similarly, when the money is on-lent interest free, it would appear that the on-lender would not be entitled to an interest deduction in respect of any interest which he pays, for in no way can it be said that the interest paid by him is paid on capital employed in the production of assessable income.[9]

Where, however, the money is on-lent with interest payable by the borrower, but the rate at which the interest is paid is the same as or less than the rate of interest paid by the on-lender, certain difficulties arise. There is a technical argument which can be made that, where, as in the above example, a taxpayer borrows money at ten percent per annum, and re-lends it at five percent, no right of deduction of the ten percent paid is possible because the net result of the allowance of such a deduction is that no assessable income is produced.

This argument found favour in the case of *Topper* v. *M.N.R.*[10] a decision of the Canadian Exchequer Court and it is certainly open for a court in this country on the basis of the deduction provisions in the Income Tax Act, to make the same finding. In *Topper*'s case, the taxpayer and his son had borrowed money on which interest was payable at the rate of six percent per annum. The money was on-lent to a company at the rate of six percent per annum, the same as was paid by the taxpayer. The taxpayer tried to deduct the amount of interest paid by him from the amount of interest received on the loan from the company. The Commissioner refused to allow this. The court upheld this disallowance of the deduction on the ground that the rate of interest provided for on the loan to the company merely corresponded to the rate of interest paid by the taxpayer and it could not be said that the loans were made for the purpose of earning income.

The total disallowance of the interest payment in the *Topper* case however, resulted in the taxpayer having an assessable income of six percent on the money lent, in respect of which he should have been entitled to deduct any costs incurred in the process of earning. The position is absurd, and the case has been criticised by a number of academic writers.[11]

Despite the *Topper* case, however, the present practice of the Commissioner in Canada is to allow a right of set-off of the interest received against the interest paid, and thus in the case where the money is borrowed at eight percent and re-lent

9 This is in accordance with the decision of the New Zealand Taxation Board of Review 2 N.Z.T.B.R. Case 7.
10 [1965] C.T.C. 22.
11 E.g. (1966) Can. Tax J. 405.

at seven percent, the seven percent could be deducted and the one percent would be disallowed.[12]

In New Zealand the treatment which would be afforded such an arrangement as that existing in *Topper*'s case is to some extent unclear. It is plain that there is no general right of set-off of interest received against income payable on borrowed money. It is clear, for example, that where a taxpayer sells a house owned by him, but has to leave money in the property as a loan to the purchaser, and then, as a result, has to borrow money elsewhere to purchase another home, he may not set-off the interest received against that which he must pay, even though the reality of the situation would seem to demand this.[13] Whether this may extend also to the case of an on-loan, where admittedly the transactions are more closely related, is a matter of some doubt.

It is suggested that a family member contemplating on-lending of money, should recognise the potential problem posed by the decision in the *Topper* case and where possible take steps to avoid its possible application. This is most easily done, it is submitted, by providing for a slightly higher rate of interest on the second loan than is payable on the first, or by utilizing guarantees rather than on-lending.

VI. CONCLUSION

It is submitted by the writer that, for the reasons given in this paper, the decision of the Court of Appeal in the case of *Rossiter* v. *C.I.R.*[14] is open to question in a number of respects.

The distinction which now exists for gift duty purposes between interest free term loans on the one hand and "on demand" loans and *Re Marshall*[15] type loans on the other will undoubtedly result in an increased use of the latter type of loan as a vehicle for tax planning. If on-demand loans are used, several pitfalls have been noted.

It has been further suggested that there are several policy reasons why the situation pertaining after *Rossiter* is undesirable. In any event, where the parties to an interest free loan are closely related, the integrity of the gift duty legislation would seem to require that a gift equal to the fair market rate of interest should be deemed to have been made, and that in this regard it should be irrelevant (except, perhaps, for determining the time when the gift is made and the time at which tax or duty should be paid on it) that the loan is repayable on demand, or at some specified future date.

12 See Edwards, Canadian Tax Foundation, *Report of the Corporate Management Tax Conference* 1974, 155.
13 E.g. T.R.A. Case 13 2 T.R.N.Z. 244.
14 [1977] 1 N.Z.L.R. 195.
15 [1965] N.Z.L.R. 851.