Asymmetrical treatment of income and expense in New Zealand tax law.

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In this article, the writer shows how different items of income and expense are treated differently for tax purposes. This can mean benefits to some taxpayers at the expense of others and can lead to investment in uneconomic activities. Interest and inter-corporate dividends fall into this category, and this means in effect that companies which invest in shares receive a significant subsidy.

The economic neutrality of an income tax presupposes that income and expenses of a transaction be treated in a symmetrical fashion. If the income is taxable, the expenses should be deductible and vice versa. Asymmetrical treatment will have far reaching ramifications for individual taxpayers and the general economy. In that asymmetrically treated transactions yield a greater or lesser return than in the absence of taxation, the tax system provides a powerful but largely covert stimulus for some types of activity and imposes a correspondingly heavy burden upon others. The resulting growth and decline of the tax-favoured and tax-burdened sectors will be accompanied by redistribution of wealth and price changes. Tax-favoured transactions also provide the vehicle for tax avoidance, loss of revenue and reallocation of the national tax burden. At present, New Zealand income tax practice - the combined efforts of Parliament, the taxation authorities and the judiciary - allows several singularly spectacular instances of tax asymmetry.

I. NUMERICAL BACKGROUND

Consider a transaction which produces revenue of $100 per period from an expenditure of $80. In the absence of taxation and gearing, the transaction yields an accounting return of $20 or 25% per period. Suppose that income is taxed at a rate of 40%. Although taxation reduces the net income from $20 to $12, the deductibility of the expenditure reduces the net cost of the investment from $80 to $48 and the net return remains 25% per period. The neutrality of the tax is destroyed where the tax treatment of income is not matched by a symmetrical treatment of the expenditure. Table A illustrates the four possible cases:

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Table A

	No taxation	Revenue taxable exp. deductible	Revenue taxable - exp. not deductible	Revenue tax free- exp. deductibl
Revenue	100	100	100	100
less expense	80	80	80	80
Before tax profit	20	20	20	20
less tax	0	8	60	0
After tax profit	20	12	(40)	20
Net investment	80	48	80	48
Return	25%	25%	(50%)	42%

As illustrated by the Table, the asymmetrical treatment of revenue and expense will make the transaction either more or less profitable than in the absence of taxation. Of particular interest is the fourth column where the revenue is tax free but the expense is deductible. This asymmetry increases the rate of return above the economic rate and is the equivalent of a symmetrical treatment (column 2) combined with a subsidy equal to 100% of the tax.

Since gearing - the use of borrowed funds to finance all or part of the investment - not only amplifies the economic consequences of both tax asymmetry and any differentials between return and interest rates but also entails one of expenses subject to asymmetrical treatment under New Zealand law, it is appropriate to include the possibility of borrowed funds in the more general model. Suppose the taxpayer borrows at an interest rate **I** an amount **B** to purchase an investment at a cost of **X** which has an economic return rate of **R** in a jurisdiction which taxes income at a rate of **T**. The taxpayer's after-tax profit **(P)** can be expressed algebraically:

$$\text{after tax profit} = \text{before tax profit} - \text{tax}$$
$$\mathbf{P} = (\mathbf{RX} - \mathbf{IB}) - \mathbf{T}(\mathbf{RX} - \mathbf{IB})$$
$$= \mathbf{RX} - \mathbf{IB} - \mathbf{TRX} + \mathbf{TIB}$$

The four terms on the right side of the equation refer respectively to revenue, interest expense, tax burden on revenue and tax benefit from interest deduction. Where the taxpayer pays the purchase price entirely out of borrowed funds **(X = B)**, the profit expression reduces to :

$$\mathbf{P} = (\mathbf{R} - \mathbf{I} - \mathbf{TR} + \mathbf{IT})\,\mathbf{B}$$

If **B** is set equal to $500, **R** to 20%, **I** to 16% and **T** to 40%, this equation generates the columns in Table A when one or both of **TR** and **TI** are set equal to zero. Where the revenue is tax free but interest deductible, then :

$$\mathbf{P} = (\mathbf{R} - \mathbf{I} + \mathbf{IT})\,\mathbf{B}$$

The investment will yield positive profits so long as :

$$R - I + IT > 0$$

or

$$R > I(1 - t)$$

Due to the asymmetrical tax treatment, the transaction will be profitable although the economic rate of return (R) is considerably less than the rate of interest. At a tax rate of 40% and an interest rate of 20% , the transaction will profitable so long as its rate of return exceeds 12%. The shortfall between the rate of economic return and the cost of borrowed funds is compensated by the tax benefit (ITB) associated with the deduction of the expense. This situation will arise in any system of income taxation where, on the one hand, certain items of economic income are excluded from the tax base and, on the other hand, the regime allows deduction of expenses incurred to produce that income.

II. TWO CASES UNDER NEW ZEALAND LAW.

New Zealand law excludes from the income tax base numerous types of income in the economic or accounting sense, the commercially most significant of which are inter-company dividends, certain capital gains and life insurance proceeds. To the extent that the expenses incurred to produce these income streams are tax deductible, the after tax return will be higher than the return in the absence of the tax regime.

Consider the following two transactions:

Case 1. Taxpayer Limited purchases shares for $1000 out of its own resources and, at the same time, borrows $1000 to finance other aspects of its business such as the acquisition of trading stock.

Case 2. Taxpayer Limited provides $1000 to Borrower Limited by subscribing for $1,000 of shares in Taxpayer Limited's wholly owned Subsidiary Limited and Subsidiary Limited purchases $1000 of shares in Borrower Limited. Taxpayer Limited borrows the on-lended funds, e.g., from the public through the issue of debenture stock.

In both transactions, the taxpayer seeks to obtain tax free income (inter-company dividends) and also deduct the expenses incurred to acquire (case-2) or carry (case-1) the income earning asset (shares). The expenditure involved in producing the income streams will be the cost of the asset and interest incurred on the indebtedness. Whereas the $1,000 paid for the shares is rendered non deductible by section 106(1)(a),[1] the deductibility of interest turns upon the structure of the transaction and unresolved questions under sections 104 and 106(i)(h).

1 Unless otherwise specified, all statutory citations refer to the Income Tax Act 1976.

A. Case-1.

The deductibility of interest in this transaction depends upon whether there is sufficient nexus between the employment of capital and the production of assessable income.[2] Had the taxpayer borrowed funds for the explicit purpose of purchasing shares, it could not satisfy the nexus requirement. However, the taxpayer will structure the transaction so as to create the appearance of "a sufficient relationship between the expenditure and the income earning process." [3] It will explicitly identify the loan with the other transaction, e.g., by giving the lender a security interest in the acquired property. Deductibility of interest then depends upon whether the legal structure or economic substance of the transaction controls operation of the nexus requirement. Although the courts repeatedly state that the form, unless it is a sham,[4] controls the tax consequences, throughout the opinion in *Banks*, Richardson J. emphasises that the factual use of the asset at the time of the expenditure determines the nexus.[5] In the present situation, the factual use of the borrowed funds is certainly more ambiguous than may be implied by the legal form of the transaction. In the sense of "but for" causation, the borrowed funds are employed, in whole or in part, to carry the shares: the taxpayer would not have incurred the debt but for the decision to acquire the shares.

Prior to the judiciary's adoption of the present nexus test and its stated preference for form over substance, the judiciary had occasion to deal with the deductibility of interest in transactions similar to case-1. In *Bryant and May, Bell and Co. Ltd.* [6] the taxpayer used own funds to purchase tax exempt New Zealand government stocks rather than to pay a debt owing to its supplier in England; when the exchange rate improved, the taxpayer paid the supplier. The taxpayer sought to deduct interest on the purchase money debt owing the supplier.

The Commissioner disallowed the deduction under section 80(1)(h) of the Land and Income Tax 1923, which is substantially identical to section 106(1)(h)(i) of the present statute, on the grounds that the interest expense was not employed in the production of assessable income. The taxpayer argued that the reference to "capital" in section 80(1)(h) referred only to fixed capital and not to circulating capital. The court accepted this argument "for the purposes of this case" but held that an interest deduction was precluded by section 80(2),[7] the forerunner of section 101 and 104(a) of the present

2 *Commissioner of Inland Revenue* v. *Banks* [1978] 2 N.Z.L.R. 485 (C.A.).

3 Ibid. 478.

4 See most recently *Marac Life Assurance Ltd.* v. *Commissioner of Inland Revenue* (1986) 9 T.R.N.Z. 331, 342-343 (C.A.).

5 [1978] 2 N.Z.L.R. 472, 479-481.

6 *Bryant and May, Bell and Co., Ltd.* v. *The Commissioner of Taxes* [1933] N.Z.L.R. 831(S.C.), 1212(C.A.).

7 "In calculating the assessable income of any person such income from one source only, any expenditure or loss exclusively incurred in the production of the assessable income for any income year may be deducted from the total income derived for that year. In calculating the assessable income of any person deriving

Act, since the interest was not "exclusively" incurred in the production of assessable income. The court's decision is clearly guided by the economic substance of the taxpayer's affairs:[8]

> [The payment] was not made because the company required credit to enable it to pay for such goods or for the expansion of its business. It was made partly in hope of ultimately saving exchange and partly for the purpose of investing the money in four-and-a-half-per-cent tax free government debentures or stock. The interest which the appellant chose to pay is only deductible in the calculation of the assessable income if expenditure of the sum for interest was exclusively incurred in the production of the company's assessable income. It is plain, we think, that the expenditure was not so incurred. It was incurred in order to keep temporarily in the country a large sum of money for the purpose of earning non-assessable income.

Bryant was followed by *Public Trustee* v. *Commissioner of Taxes*.[9] In order to pay death duties, the executor of a large estate elected to borrow funds rather than to liquidate estate assets consisting principally of assets producing non-assessable income in a form of dividends from company shares. Deduction of interest was sought under either section 80(1)(h) or section 80(2) of the Land and Income Tax Act 1923. If interest was deductible, there was no disagreement as to the amount of the deduction. The parties had stipulated [10]:

> if the Court finds that as a matter of law interest payable on moneys borrowed to pay death duties constitutes interest payable upon capital employed in the production of assessable income, the sum deductible will be a sum bearing to the total interest payable upon the loan the same proportion as the total property producing assessable income bears to the total value of the estate, probate values and assets as at date of death being taken as the basis.

The issue before the court was whether the stipulated sum was deductible under section 80(1)(h) and section 80(2). Most of the discussion focusses upon the relationship between these two sections and whether borrowing to pay a debt can qualify as employment of capital in the production of income for purpose of section 80(1)(h). The court held that it does by reference to the economic substance of the transaction : [11]

> The question of whether money is expended in and for the production of assessable income cannot be determined by considering only the immediate reason for such income from two or more sources, any expenditure or loss exclusively incurred in the production of assessable income for any income year may be deducted from the total income derived by the taxpayer for that year from all such sources as aforesaid. Save as herein provided, no deduction shall be made in respect of any expenditure or loss of any kind for the purpose of calculating the assessable income of any taxpayer".

8 [1933] N.Z.L.R. 1212, 1219-1220.
9 [1938] N.Z.L.R. 436 (C.A.).
10 Ibid. 445.
11 Ibid. 452.

> making the payment and ignoring the purpose with which the liability was incurred. If the suggestion made on behalf of the commissioner is sound, then a merchant who borrows money to enable him to pay off debts incurred by him in his business, and to continue to employ his existing assets in the production of income, would not be permitted in the calculation of his assessable income, to deduct the interest on moneys so borrowed. The true inference, I think, in the present case is that the money borrowed enabled the trustee to pay out of the estate the amount of the death duties and left the moneys so borrowed or its equivalent in capital assets in the estate to be employed in the production of income.

The facts of both *Bryant* and *Public Trustee* are similar to those in case-1: The taxpayer acquires or continues to carry assets which generate non-assessable income by borrowing funds for another ostensibly unrelated transaction. The result in both cases was that the presence of the exempt income limits - wholly in *Bryant* and partly in *Public Trustee* - the deduction allowed for interest. However, the two cases do not control the deductibility of interest in case 1 for neither case enunciates a rule for determining when capital is employed in the production of assessable income for purposes of section 80(1)(h) of the Land and Income Tax Act 1923, the predecessor to section 106(1)(h) of the present statute. In *Public Trustee* the nexus problem was circumvented by stipulation; the arguments in *Bryant* assume that if the interest constituted interest within the meaning of section 80(1)(h) the interest was non-deductible. Viewed more generally, the two decisions favour an apportionment of interest in case-1. This comports with the result in *Public Trustee* as well as the finding in *Bryant* that the carrying expense was not incurred "exclusively" in the production of assessable income.

B. Case-2.

The transaction in case-2 is structured around the language of section 106(1)(h)(ii). This provision was enacted in 1985, probably to deal with the situation where a company borrows funds to finance a capital project undertaken by a subsidiary. The parent will be better placed to borrow funds and will generally prefer to transfer the borrowed funds to the subsidiary in exchange for shares rather than debt securities. Further, conduct of a business through a subsidiary affords the parent the protection of the corporate veil. The parent's return will be in the form of dividends from the subsidiary. Since this income is tax free, the interest would not be deductible in the absence of section 106(h)(ii). This section provides in effect that the parent shall suffer no tax detriment solely by reason of the organisational form of its business. However, unlike sections 104 and 106(1)(h)(i), this section does not condition deductibility upon the use to which the subsidiary puts the capital. It is this omission that the second transaction seeks to exploit.

It is unlikely that Parliament when enacting section 106(1)(h)(ii) meant to give companies a tax deduction for borrowed capital used to generate tax free income. However, given the absence of any express limitation in that subsection, the deductibility of interest in case-2 depends upon whether the interest expense must also meet the requirements of section 104. If so, the interest would be non-deductible, subject only to the tracing problem raised by case-1. Although the courts have for some time queried the relationship of the two sections,[12] the Commissioner has yet to state a case which would force its resolution. In the meantime, taxpayers can continue to obtain the benefit of the interest deduction in transactions such as case-2. It is interesting to note that the court in *Bryant* assumed that under the Land and Income Tax Act 1923 deductibility interest had to satisfy section 80(1)(h) as well as section 80(2), the predecessors to sections 104 and 106(1(h)(i).

III. REGULATORY ALTERNATIVES

Other income tax regimes seek to ensure the symmetrical treatment of income and expense in a variety of ways. Clearly the most effective (as well as politically most unacceptable) approach is to broaden the tax base to include all types of economic income. By far the most common approach is that adopted in sections 104 and 106(1)(h): the statute permits deduction of expenditure only if incurred in the production of assessable income and leaves to the judiciary the task of determining the requisite nexus. This approach is followed by the Income Tax Assessment Act (Australia) in section 51(1) which includes the rules in sections 104, and 106(1)(a) and 106(1)(j) of the New Zealand statute as well as by section 265 of the Internal Revenue Code (USA) which prohibits deduction of interest incurred to purchase, produce or carry tax exempt securities. In these jurisdictions, as in New Zealand, the taxpayer must overcome the presumption of validity of the Commissioner's determination of deficiency and the judiciary's nexus test focusses primarily upon the purpose of the expenditure. However, up to now, the New Zealand and Australian courts have confined their attention to instances involving expenditures with more than a single purpose and have not yet been confronted with the vexatious tracing problem raised by case-1.

In the U.S.A., the Commissioner has frequently challenged interest deductions in such situations under section 265. The American courts profess to the same general test as their New Zealand and Australian counterparts: Disallowance of the deduction does not follow [13]

> merely because the taxpayer incurred or continued indebtedness at the time that he held tax exempt securities.... The touchstone for decision is the purpose of the tax payer in incurring or continuing the indebtedness.

However, the courts consistently reject any avowed purpose which lacks economic substance. For instance, where the taxpayer uses the exempt securities as collateral, a deduction is disallowed even though the loan proceeds were employed for a purpose other than purchasing or carrying tax exempt securities.[14] The high credit rating associated with continued ownership of tax exempt securities or and the maintenance of a balanced investment portfolio are not accepted as justification for the taxpayer's decision to borrow funds rather than to liquidate tax exempt securities. This case law demonstrates

12 See, most recently, *Pacific Rendezvous Ltd.* v. *Commissioner of Inland Revenue* (1986) 8 NZTC 5146, 5150, (C.A.).

13 *Levitt* v. *U.S.* 517 F.2d 1339, 1443 (8th Cir.1975).

14 *Wisconsin Cheeseman, Inc.* v. *U.S.* 388 F. 2d 420 (7th Cir. 1968).

borrow funds rather than to liquidate tax exempt securities. This case law demonstrates the inherent shortcomings of the purpose-oriented tracing rules. The most obvious indicium of purpose - the legal form of the arrangement - is inherently unreliable since it is open to manipulation in the case where the taxpayer holds both income earning and income exempt assets. The court can disregard the implication of the transaction's form only by attaching priority to the economic substance of the transaction, a criterion which operates without regard to or often contrary to the stated purpose of the borrowing.

The obvious alternative to a purpose-based test is a rule which associates income with deductible expenses irrespective of the taxpayer's purpose or intent. One common rule makes expenses deductible, first or only, against the income which they generate. Section 50 of the Income Tax Assessment Act (Australia) requires that expense incurred in producing income from dividends be deducted first from income from dividends and then from income from property and finally income from personal exertion. This requirement seeks to ensure tax symmetry in view of the rebate allowed for dividend income. Under section 163 of the Internal Revenue Code (U.S.A.), taxpayers other than limited companies are entitled to deduct investment interest - that incurred to produce or carry property held for investment - not in excess of investment income. Similarly in New Zealand,[15] section 188A requires that losses from specified activities be offset first against assessable income from the activity and any excess loss may be deducted from other assessable income only to the extent of $10,000.[16] These schedular reporting requirements represent a particularly ineffective solution to the symmetry problem since they presuppose a correct matching of income and expenses. The taxpayer can rearrange her expenses in the manner of case-1 so as to prevent them from being considered investment expenses for purposes of section 163 of the Internal

15 Until its repeal in 1985, section 102(2) provided: "Any expenditure or loss which is deductible under this Act and is incurred in gaining or producing non-assessable income shall be deducted in calculating the non-assessable income and shall not be deducted in calculating assessable income".

16 On their face, these activities do not involve tax asymmetry. In most cases, operation of the venture generates only assessable income. Indeed, section 188A appears to create a tax asymmetry or at least contravene the general rule in section 104 in that it prescribes deduction for expenses incurred in carrying on a business for the purpose of gaining or producing assessable income. However, the picture changes when one considers that most participants in such ventures finance their investment by means of borrowed funds and tax savings. This borrowing results in interest expense in addition to that conduited through the partnership. In view of this additional fact, many schemes involving specified activities do indeed pose a severe threat of tax asymmetry. Until turn-around, the excessive expenses completely shelter the otherwise assessable income generated by the business. To the extent that the expenses are of a non-cash nature, the venture can generate a tax free cash flow to the investor. This will be the case whenever the non-cash expenses exceed repayment of any principal associated with debt carried by the venture and/or the investor. Under these circumstances, the investment becomes directly analogous to that in case-1. See Cooper *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance* (1985) 85 Colum. L. R. 657, 673 .

Revenue Code or dividend expenses for purposes of section 50 of the Income Tax Assessment Act.

A more effective tracing rule is one which keys deductibility to asset ratios or income ratios. One possible standard is that stipulated by the parties in *Public Trustee*: where a taxpayer holds both assets which generate assessable income and assets which generate non-assessable income, interest is deductible only in the proportion of income assessable assets to total assets. This standard was recently applied by the Australian High Court in *Reliance Finance Corp.* v *F.C.T.*[17] In the U.S.A., Congress recently adopted this rule to deal with the deductibility of interest incurred by financial institutions which hold tax exempt securities in their portfolios.[18] Alternatively, tracing could be keyed to income streams rather than asset ratios. For instance, a deduction for interest would be allowed only in the same proportion that taxable income bears to total income. The author was unable to find any implementation of this approach in the case law or legislation. While the asset-ratio rule avoids the evidentiary problems inherent in the purpose-based standard, it requires additional financial information from the taxpayer, entails all the difficulties associated with asset valuations divorced from arms-length dispositions and may render non-deductible a greater or lesser proportion of interest than actually incurred to carry or purchase tax exempt securities.[19]

The transactions in case-1 and case-2 may also run afoul of other more general institutions of New Zealand tax law. Since the two arrangements, although not "shams", have as one of their purposes tax avoidance, they are subject to challenge under section 99. In addition, the transaction in case-2 invites characterisation as a "financial arrangement" under the recently enacted accruals legislation, particularly where, as is generally the case, the agreement protects dividend and redemption obligations with priorities both inside and outside of insolvency as well as personal guarantees and property securities which make them virtually indistinguishable from the obligations associated with a secured loan.[20]

IV. RAMIFICATIONS

The asymmetrical treatment of income and expense in case-1 encourages firms to purchase tax exempt securities even though the economic rate of return on these assets is less than the cost of funds borrowed to finance the purchase and even though other assets yield a higher economic rate of return. Where the firm pays tax at a rate of 40%

17 (1986) 18 A.T.R. 224 (S.Ct.N.S.W.).
18 26 U.S.C.A. sec 265(b).
19 For instance, where the taxpayer can borrow single rate of interest, its portfolio contains taxable and tax exempt securities but taxpayer has geared the purchase of the tax exempt securities higher than the taxable securities, the asset ratio rule will overstate the amount of deductible interest.
20 Income Tax Act 1976 s.64B(i), 64C(2); these transactions are predicted on the dubious assumption that, since structured as share issues, they qualify as "excepted financial arrangements".

and can borrow at 20%, it will profit by borrowing to increase its holding of shares so long as those shares return at least 12% in dividends and capital gain. In contrast, the firm could not fund by means of indebtedness the acquisition of an assessable income asset, unless that asset produced an economic return in excess of 20%. Firms not wishing to alter their debt equity ratio will find it profitable to divest themselves of assessable income assets and acquire non assessable income assets, even though the former have a higher economic return than the latter. The additional demand for borrowed funds and non-assessable income assets will place upward pressure upon interest rates and the prices of these assets.

Whereas a firm obtains the benefit of tax asymmetry in case-1 by carrying tax exempt securities with funds borrowed for ostensibly other purposes, case-2 enables the firm to receive the same benefit without this subterfuge. The firm simply invests in tax exempt securities through a subsidiary which is equity-financed with funds borrowed by the parent. This undoubtedly contributes to the proliferation of subsidies and the Byzantine structure of New Zealand businesses. Case-2 also provides a vehicle for other tax minimisation arrangements. In particular, lenders and borrowers can restructure loan transactions in the form of equity issues. Suppose, for instance, that a borrower seeks $20 million in funds at a time when interest rates are 25%. Suppose also, that a lender pays 20% for funds borrowed from the public through debenture stock and that both the borrower and the lender are subject to taxation at a 40% rate. If the transaction is structured as an interest only loan at 25% ($5 million in interest per annum), the lender will realise $600,000 per annum after tax from the transaction[21] and the net after tax cost to the borrower will be $3 million where the borrower has sufficient assessable income to derive the full benefit of the tax savings associated with the interest deduction[22] and rises to $5 million where the borrower has no assessable income. Case-2 invites the parties to restructure the loan as an issue of equity shares by the borrower to a subsidiary of the lender. From the lender's point of view any dividend rate in excess of 15% will yield a higher after tax return than the loan alternative. From the borrower's point of view, the effect depends critically upon its tax position. If the borrower has other assessable income in excess of $5 million, it will be indifferent between a loan at the rate 25% or the issue of redeemable preference shares at 15%. In both transactions, $5 million of business income will be needed to service the dividend or interest payments. However, in many situations today, the borrower will be in the position of having net profit available for dividend payment but not subject to taxation. This profit will be in the form of tax exempt dividends, capital gains, and/or unrealised appreciation from real property. In these circumstances, there is no tax burden upon dividend payment and a $3 million dividend can be financed by means of a like amount of business income. Under these circumstances, any dividend rate on redeemable preference shares less than 25% will be preferable to paying 25% interest on a loan. In short, the borrower and lender can include a mutually beneficial financing arrangement at some rate between 15% and 25%. Suppose they settle upon a rate of 18%. The

21 Interest revenue ($5 million) less interest expense ($4 million) less tax on the assessable income (40% of $1 million).

22 Interest expense ($5 million) less tax benefit from the interest deduction (40% of $5 million).

transaction will yield the lender a profit of $1.2 million [23] which is double that of the return on a loan at the rate of 25%. The borrower can service the dividend obligation with $3.6 million of business income which is $1.4 million less than required to service a $25 million loan at 25% interest. The obvious loser in the transaction is the tax collector. A loan of 25% would have generated $2 million in tax revenue. By restructuring the transaction, the parties reduce the tax yield to zero and split the tax saving. The possibility of these arrangements encourages borrowers (and indirectly lenders) to invest in projects which are uneconomical in the sense that they return less than the going rate of interest. In order to maintain the tax basis for such arrangements (viz, the borrower has profits but no assessable income), these projects will be ones which generate tax free profits: e.g., investments in shares (generating tax free dividends and capital gains) and in real property (unrealised appreciation).

The effect of these transactions is uneven across assets and taxpayers. Since only limited companies can receive dividend income free of tax, they will be beneficiaries of the tax asymmetry in cases-1 and 2. Whereas individuals will pay for borrowed funds at market rates of interest, companies can obtain funds through loans disguised as share issuances at much lower rates. Tax asymmetry increases the demand for assets such as company shares and real property but not for income producing assets used in the agricultural, manufacturing or service sectors. To the extent that the supply of these resources is fixed in the short run (securities) and also in the long run (real property), the increased price results in abnormally high returns to the owners of these assets. The price increases also benefit those intermediaries who derive income from commissions charged on the turnover of these assets. Moreover, the tax asymmetry presented by cases-1 and 2 benefits taxpayers in higher tax brackets. Whereas a party who pays tax at the 40% rate and can borrow funds for 20% per annum can profitably invest in tax exempt securities so long as the economic return exceeds 12%, a taxpayer in the 30% bracket will demand at least a 15% rate of return. Accordingly, ownership of securities will concentrate itself in the hands of a group of taxpayers defined by the higher marginal rate.

Tax asymmetry also entails a shift in the burden of taxation. This is most obvious in transactions where loans are structured as share purchases. If structured as a loan, the transaction in case-2 would generate $2 million in taxes whereas it generates no tax revenue when structured as a share purchase. More generally, companies can take advantage of tax asymmetry to reduce their tax bill either by substituting tax exempt securities for taxable securities at the same debt/equity ratio or by acquiring additional tax exempt securities with borrowed funds. Assume that the economic return on tax exempt securities is 15%, the return on taxable securities is 25%, the interest rate is 20% and the company tax rate is 50%. Under these conditions, a firm will reduce its tax liability by $1 through substituting $8 of tax exempt securities for $8 of taxable

23 Tax free dividend income ($3.6 million) minus interest expense on borrowed funds ($4 million) plus tax savings from interest deduction ($1.6 million).

securities with an increase in its net profit of $0.20.[24] A tax cut of $100 million would require that $800 million of taxable securities be exchanged for a like amount of tax exempt securities. If the firm wishes to reduce its tax liability in the amount of $1 through leveraged purchases of tax exempt securities, it would under the same assumptions have to borrow $10. This would be accompanied by a $0.50 increase of its net profit.[25] Reduction of tax liability in the amount of $100 million would require an additional $1 billion in borrowing.

In the twelve months from 1 January 1985 to 31 December 1986 the share market capitalization in New Zealand publicly listed firms rose from $17.6 billion to $42.4 billion. If only 1/25th ($1 billion) of this increase was financed by borrowing, the result would be a $100 million reduction in company tax. The $100 million lost to the tax collector is accompanied by a corresponding increase in disposable funds to the tax paying firms and it is this tax benefit which makes profitable the investment in securities having an economic return less than the cost expended to carry those securities. This $100 million in lost revenue must be balanced by one or more of the following: a decrease in government spending, an increase in government borrowing or a tax increase. If made up through a cut in government spending, the arrangement entails a $100 million transfer of wealth from the victims of the cuts to the tax avoiding firms. If made good by an increase in borrowing, there will be an upward pressure upon interest rates and the tax benefit will be partially funded by the community through increased interest rates.

V. CONCLUSION

The tax benefit resulting from the asymetrical treatment of interest and inter-corporate dividends comprises a significant subsidy to one group of taxpayers, those companies which invest in shares. The subsidy takes the form of making the rate of return on such investments higher than would obtain in the absence of the tax system. The subsidy is largely financed by other taxpayers who, in order to meet a fixed requirement for government revenue, must make good the tax revenue lost by virtue of the asymetry. Although other more direct forms of tax subvention have been rejected on efficiency grounds, no efficiency grounds have been advanced for the retention of the asymetrical treatment of interest and inter-corporate dividends. Yet, in so far as that treatment encourages investment in uneconomic activities, it is subject to the same economic arguments made for the elimination of the tax subsidies to, e.g., the farming and manufacturing sectors. Perhaps the continuation of the preferential treatment can be explained at least in part by reference to its covert nature. Unlike other forms of subvention, the subsidy is deeply anchored in the structure of the Income Tax Act. It rests on the intuitively appealing notions that company profits should not be taxed yet a third time and that, unless incurred in the production of assessable income, expenditures

24 Loss in revenue associated with disposal of $8 of taxable securities ($2) plus tax savings resulting from disposition ($1) plus increase in revenue from tax exempt securities ($1.20).

25 Gain in revenue from $10 of tax exempt securities ($1.50) less interest expense ($2.00) plus tax savings from the interest deduction ($1.00).

should not be deductible. However, as a mediating instrument, the nexus requirement has proven itself wholly inadequate under the present circumstances. The fault lies only in small measure in the almost inoperative vagueness of the statutory referent (the preposition "in") of the requirement; a similarly anchored concept has served as an effective enforcement constraint upon tax avoidance schemes in the U.S.A. In New Zealand, however, the agency charged with enforcement of the requirement finds itself caught between the rock of an aggressive private tax practice and the hard place occupied by a judiciary unsympathetic towards purposive arguments based on economic substance. It is not surprising, therefore, that the enforcement agency has only invited judicial scrutiny of the requirement where the amount at stake is relatively small and the downside risk is minimal. Under these circumstances, the nexus requirement functions not so much as a constraint upon tax avoidance but rather as a de facto shield for such practices.