

Financial planning fees - income tax deductibility

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Summary

All references are to the Income Tax Act 1994 unless otherwise stated.

This interpretation statement considers the deductibility under section BD 2, of a range of financial planning fees charged to investors. In this regard the status of the investor will be important, ie whether the taxpayer is a passive investor, a speculative investor, or in the business of trading in investments.

This statement replaces public ruling BR Pub 95/10 that appeared in Tax Information Bulletin Vol 7, No 7 (January 1996), and the Taxation (Core Provisions) Act 1996 re-issue BR Pub 95/10A published in Tax Information Bulletin Vol 8, No 10 (December 1996). The public ruling ceased to apply at the end of the 1998-1999 income year.

Some of the conclusions in this statement differ from those in public ruling BR 95/10, reflecting experience and case law arising from decisions from the Taxation Review Authority (TRA) and the High Court since that ruling was issued. These changes will impact most on those investors coming within the definition of "passive investor" described in the statement. This category of investor will now, in certain circumstances, be entitled to deduct a greater range of fees than detailed in the earlier binding ruling.

In general, financial planning fees will be deductible if they are incurred in deriving the taxpayer's gross income, under section BD 2(1)(b)(i), or incurred in the course of carrying on a business for the purposes of deriving gross income under section BD 2(1)(b)(ii). Deductibility is prohibited if the fees are of a capital nature under section BD 2(2)(e).

The deductibility of financial planning fees depends on whether the investment to which the fees are paid relates to:

- an "excepted financial arrangement" (eg shares and options to purchase shares), or
- a "financial arrangement" (eg bonds, bank loans, mortgages, and government stock).

If the investment is an excepted financial arrangement, deductibility of fees will depend on whether the fee is part of the cost of the investment, and whether that investment is

"trading stock" or "revenue account property" of a business or speculative investor respectively. The primary focus of this interpretation statement is on this type of investment.

If the investment is a financial arrangement, the accruals rules apply and the treatment of planning fees will depend on whether the financial arrangement was entered into before or after the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 received its royal assent on 20 May 1999. Full details of how the "old" and "new" accrual rules apply to financial planning fees are discussed later.

Planning fees will be non-deductible if the income derived from the investments is exempt income or non-assessable income.

Fee categories

The fees charged by financial advisers vary from one adviser to another, but generally can be separated into a number of categories. Financial planners give the fees they charge various names, but the crucial point is the nature of the fees charged and when they are incurred. The nature and the timing of when the fees are incurred will determine whether they are of a revenue nature and therefore deductible for income tax purposes, or whether they are of a capital nature and not deductible.

The fees can be summarised as:

- a. Initial planning fees: Fees charged in relation to services provided by the adviser for the initial interview where the investor and the adviser discuss the investor's investment goals, savings objectives, cash requirements, and life and general insurance requirements. The adviser then prepares a draft portfolio plan for the investor. Further interviews, discussions, and adjustments to the draft plan may follow until it is acceptable to the investor.
- b. Implementation fees: All fees for services associated with implementing the draft plan devised in (a). They will include any one-off up front fees paid to or made in respect of services or charges to advisers, administrators, executors, fund managers, etc., to purchase or acquire the investments. They include brokerage, and any payments to custodians on implementation of the plan or charges by fund managers for entry into the investments.
- c. Administration fees: Generally described by advisers as "annual on-going" fees. They are charged by the adviser to cover the costs of maintaining records of the investor's transaction with the adviser. This category also includes charges relating to the handling of cash for the investor, such as the withdrawal and deposit in the investor's account with the administrator, bank charges, and other administration fees. Also included are any fees or commissions charged by the adviser for collecting income from the investments and arranging this to be paid to or credited to the investor's account with the adviser, or to the investor's own bank account.
- d. Monitoring fees: Annual charges for monitoring and reporting to the investor on the performance of the portfolio (including the performance of the fund managers and the adviser) in terms of the investor's goals and relaying this information to the investor. The adviser will, from time to time, report on the portfolio's performance and relay this information to the investor.
- e. Evaluation fees: Any fees for services relating to an evaluation of an existing portfolio. Typically, where an investor has an existing portfolio of investments and either seeks a financial adviser's advice for the first time, or seeks confirmation that the portfolio's performance is matching the goals originally set either by the investor or with the assistance of a financial planner at the initial planning stage. This is a

more detailed examination of performance of the portfolio than simply monitoring performance and reporting to the client. It may or may not result in a recommendation from the adviser to make changes to investments within the portfolio to maintain the investor's aims.

- f. Replanning fees: Fees for services relating to the replanning of a portfolio arising from category (e) services due to changes to the investor's objectives. This could entail minor changes, or the complete restructuring of investments and a change in investment strategy. Re-planning fees do not necessarily refer to advice supplied by the same adviser. The fees could be for advice by an adviser to a new client who had previously managed his or her own portfolio or had previously engaged a different adviser. Included in this category are any other fees as described in Initial planning fees at (a) above, when there has been a complete restructuring of investments.
- g. Switching fees: Fees related to the costs involved in selling existing investments and/or purchasing new investments arising from a recommendation by the adviser as a result of category (e) or category (f) services. The fees will be charged by the adviser for changing investments within the portfolio. Also included are any fees relating to the withdrawal in whole or in part from an existing portfolio.

Financial planners may charge a global fee that will include fees for more than one of the above categories. It will then be necessary for the fees to be apportioned between the categories, based on the actual work done, to ensure the fees are correctly treated for deductibility purposes.

A similar apportionment exercise needs to be undertaken in the case of "performance fees", where an investor may have the option of being able to elect to pay a performance fee instead of fees for some or each of the categories noted above. Performance fees are a form of global fee paid to advisers based on how well the portfolio of investments selected by the adviser and agreed to by the investor, is performing against some predetermined measure.

The calculation of the seven categories of fees noted above might be based on a standard fee structure, hours of work put in by the adviser, the amount of the investments made by the investor, or a combination thereof. Performance fees on the other hand, are calculated under some predetermined formula based on how well the investor's portfolio, as recommended by the adviser, performs over a period of time. These fees could include a standard amount, plus a percentage based on the extent to which the level of growth or return from the portfolio exceeds previously agreed targets, or the fee could be based solely on a percentage of the returns/agreed targets.

Irrespective of the name given to the fee, or the basis of its calculation, the income tax treatment of the fees will be determined having regard to the services performed in establishing, administering and altering the investor's portfolio, based on the seven categories of services mentioned above. It may be that in certain cases the performance fee is paid in respect of all the seven categories of services, while in other instances the fee may be only for the services coming within some of the categories, eg the administration and monitoring fee categories. In view of this, it is not the description (label) that the adviser attaches to the fee charged that is relevant, rather it is what service(s) the fee is actually paid for that determines whether or not the fee is deductible. Performance fees are in reality no different to any other global or multi-service fee charged by an adviser. How the amount is apportioned among the categories of services is a question of fact to be determined in the circumstances of the particular case.

Investor categories

Investors fall within one of three categories:

Passive investors: Persons whose primary aim is to derive dividend and interest income from a secure investment portfolio. There may also be a secondary hope or possibility that the investments will provide long-term capital appreciation. They will make changes to their investment portfolio from time to time to achieve this aim. Some investors may also be "actively" involved in monitoring their investment portfolios (or engage a financial adviser to do this for them) to ensure that the primary aim of maximising dividend and interest yield is maintained.

The passive investor will not be in business as an investor, nor will the investor buy or sell investments for short-term gains (speculator).

Speculative investors: Investors who acquire an investment with the intention of selling it for the purpose of making a profit from the transaction.

These acquisitions and sales are generally of a one-off nature.

Business investors: Persons are in the business of investing when the nature of their activity, and their intention in respect of that activity, is sufficient to amount to a business (as discussed later in this statement).

The following table is a summary of the income tax treatment of financial planning fees as they apply to excepted financial arrangements (eg shares and share options and interests in unit trusts) discussed in this statement. The table also indicates when the fees will be deductible. The deductibility of fees relating to financial arrangements is discussed later.

Types of Investors	Passive	Speculative	Business
Initial planning fees	Non-deductible	Deductible (2)	Deductible (2)
Implementation fees	Non-deductible	Deductible (1)	Deductible (3)
Administration fees	Deductible (1)	Deductible (1)	Deductible (1)
Monitoring fees	Deductible (1)	Deductible (1)	Deductible (1)
Evaluation fees	Deductible (4)	Deductible (1)	Deductible (1)
Re-planning fees	Deductible (4)	Deductible (1)	Deductible (1)
Switching fees	Deductible (4)	Deductible (1)	Deductible (1)
Fees incurred in earning exempt income or non-assessable income	Non-deductible	Non-deductible	Non-deductible

Key

(1) Deductible in income year incurred, unless

- the fee is "accrual expenditure" (i.e. paid in respect of a future period also).

(2) Deductible in the year incurred, unless

- the fee is "accrual expenditure", or
- the fee is in respect of "preliminary expenses" (ie paid before any such activity has commenced).

(3) Deductible in the year incurred, unless

- the fee is "accrual expenditure", or
- paid in respect of a "financial arrangement"

(4) Deductible in the year incurred, unless

- there is a significant change to the investment structure (eg a change from a rental producing structure to a share investment portfolio resulting in a changed income flow)

Issues

The question considered in this statement is: in what circumstances will the Commissioner allow financial planning fees as a deduction under either section BD 2 or the accruals rules of the Income Tax Act 1994? This will be determined by the following:

- Whether the taxpayer is a passive, speculative, or a business investor.
- The nature of the service fees charged to the investor by the financial adviser, and whether these fees are on revenue or capital account.
- If the fees are paid before the commencement of a speculative or business undertaking, whether the fees are "preliminary expenditure" and not deductible.
- How the trading stock and revenue account property rules affect the deductibility of planning fees.
- If the planning fees are "accrual expenditure", how deductibility is affected.
- If the investment is a "financial arrangement" as defined, whether the arrangement was entered into before or after 20 May 1999 - the date of royal assent of the Taxation (Accruals Rules and Other Remedial Matters) Act 1999.

If the arrangement was entered into before 20 May 1999, whether:

- the investor is a cash basis holder or a non-cash basis holder,
- the fees are contingent or non-contingent on the implementation of the financial plan.
- if the fees are non-contingent, whether they are more or less than 2% of the "core acquisition price".

If the arrangement was entered into on or after 20 May 1999, whether:

- the investor is a cash basis person.
- the fees are non-contingent. If they are non-contingent, they are excluded from the accrual rules and treated under normal income tax deductibility rules.

Distinction between "excepted financial arrangements" and "financial arrangements"

Given that the focus of this statement is on excepted financial arrangements, it is

important to know the distinction between excepted financial arrangements and financial arrangements. Both terms are defined in the Act. In the context of this statement excepted financial arrangements are basically equity investments that rely on the profitability of the entity invested in to determine the return to the investor. Shares and share options are a more common form of excepted financial arrangements as far as investors are concerned.

On the other hand, financial arrangements are debt instruments that will generally have a fixed rate of return in the form of interest. The definition in the Act describes a financial arrangement as any debt or debt instrument, or any arrangement whereby a person obtains money in consideration for a promise by any person to provide money at some future time or upon the occurrence or non-occurrence of some future event or events. It also includes any arrangement that is substantially similar in nature. Bonds, bank loans, mortgages and government stock are examples of financial arrangements.

Background

An investor who seeks advice from a financial adviser will be charged for the services provided. Whether any of these fees are deductible for income tax purposes will depend on the type of fee expense incurred and the type of investor who incurs the fee.

When an initial financial plan has been devised, agreed to by the investor, and implemented by the adviser, that is not necessarily the end of the matter. Usually systems are in place that require the adviser's continual involvement. Most financial advisers offer a continuing monitoring service that is generally part of an overall advisory package. The investments are often (but not always) placed in the care of a custodian (presumably for security reasons), the income derived from the investments passes to the adviser or custodian where it is placed in a trust account before being able to be drawn upon by the investor. The maintenance of these trust accounts by the adviser usually incurs costs that are charged to the investor. As part of the service, the adviser may monitor the portfolio to ensure that the aims of the investor are continually met. For this service the investor will often pay further fees. From time to time as part of this monitoring service the adviser can recommend changes to the investment mix. If the investor accepts these recommendations to change investments, further fees are incurred which may include brokerage and switching fees.

It is the Commissioner's view that public ruling BR Pub 95/10 has been useful in respect of the deductibility of expenditure incurred in deriving gross income by investors. However, despite the issue of the ruling there has been occasional uncertainty on how it should be applied. This is especially so for passive investors, and how the continuing on-going costs should be dealt with. Although some of these were discussed within the commentary definitions of the three categories identified, investors, especially passive investors, may have difficulty in applying the Ruling. It seemed logical to extend and further define the present three categories to make it easier for investors to decide whether or not the fees they pay are deductible.

An issue that was not fully considered in BR Pub 95/10 was the deductibility of fees incurred by business and speculative investors before their activity commenced. Another issue not fully considered was the deductibility of fees once a speculative activity had commenced. These issues are now reconsidered, as are legislative changes to the trading stock rules and the accrual rules.

Financial advisers charge for a number of services provided to their clients, sometimes using different names for these component services. The tax treatment of the fees

depends not on the name given to the service, but on the nature of the service. To determine the correct tax treatment of a service, it is important to identify the exact service a financial adviser provides.

The adoption of the expanded categorisation of fees in this statement is intended to make it easier for passive investors to determine whether the fees they pay will be deductible for income tax purposes. The categories correspond to the process usually followed when an investor seeks the assistance of a financial adviser.

In some instances financial advisers will charge a global fee that may include fees for more than one of the categories of fees described in this statement. Then it will be necessary to apportion the fees into the appropriate fee categories in order to determine deductibility.

In addition, since the issue of public ruling BR Pub 95/10, the question of the deductibility of financial planning fees has been considered in three cases before the Taxation Review Authority (TRA). One of these cases was appealed by the Commissioner and heard before the High Court. These cases have established a framework of case law that requires some amendments to the Commissioner's position set out in BR Pub 95/10.

Legislation

Deductibility

Expenditure can be deducted from gross income if it is provided for in the Income Tax Act 1994. Section BD 2 states:

An amount is an allowable deduction of a taxpayer -

- (a) if it is an allowance for depreciation that the taxpayer is entitled to under Part E (Timing of Income and Deductions), or
- (b) to the extent that it is an expenditure or loss
 - (i) incurred by the taxpayer in deriving the taxpayer's gross income, or
 - (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or
 - (iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

Prohibition on deductibility

Section BD 2(2) qualifies the general deductibility test in section BD 2. Section BD 2(2)(e) prohibits the deduction of capital. It denies a deduction for expenditure:

- (e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined), E (Timing of Income and Deductions).

Section BD 2(b) prohibits a deduction where the expense relates to exempt income, denying a deduction for expenditure:

- (b) incurred in deriving exempt income under Part C (Income Further Defined), D (Deductions Further Defined), or F (Apportionment and Recharacterised Transactions).

Assessability

Under section BD 1, certain types of income are assessable. Sections CD 3, CD 4, and CE 1 further define income. The following income types are relevant to this statement:

- Business profits - section CD 3.
- Personal property sales - section CD 4.
- Interest, dividends, and annuities - section CE 1(1)(a).
- Benefits from money advanced - section CE 1(1)(b).
- Accruals income - section CE 1(1)(c).

Definition

"Business" - Includes any profession, trade, manufacture, or undertaking carried on for pecuniary profit:

Qualified accruals rules

The qualified accruals rules in Part EH provide rules for the timing and recognition of income derived and expenditure incurred in respect of financial arrangements. A financial arrangement is widely defined and means: a debt or debt instrument, an arrangement whereby a person receives money in consideration for a promise for repayment of that money at some future time or at the occurrence of any event, and any arrangements that are substantially similar. Bonds, bank loans, mortgages and government stock are examples of financial arrangements.

The deductibility of financial advisers' fees paid in respect of these financial arrangements is dealt with under the accruals rules and could result in a different tax treatment to investments such as company shares, which are not financial arrangements (ie they are "excepted financial arrangements"). The legislation provides a method for calculating the income (or loss) from financial arrangements. Basically, this methodology compares the total amounts paid out, with the total amounts received, from each financial arrangement. The difference is either gross income or expenditure incurred from the arrangement. Implementation fees paid to a financial adviser for the acquisition of a financial arrangement are included in the calculation of the income (or loss). This matter is further considered in this statement under the heading Qualified accruals rules and implementation fees.

If a planning fee is paid in advance to cover future income years, the fees may be "accrual expenditure", and deductibility may be spread over the number of years to which the fees relate. This too is discussed in more detail later in the statement under the heading Where the fee is "accrual expenditure".

Definitions

"Accrual expenditure", in section EF 1 and EF 4, in relation to any person, means any

amount of expenditure incurred on or after 1 August 1986 by the person that is allowed as a deduction under this Act,, other than expenditure incurred -

- (a) In the purchase of trading stock; or
- (b) In respect of any financial arrangement; or
- (c) In respect of a specified lease, or a lease to which section EO 2 applies, or

"Core acquisition price"

- (i) In relation to the holder of the financial arrangement, the value of all consideration provided by the holder in relation to the financial arrangement; or
- (ii) In relation to the issuer of the financial arrangement, the value of all consideration provided to the issuer in relation to the financial arrangement.

"Excepted financial arrangement" means any of the following arrangements:

(includes)

- (f) In relation to a holder or an issuer, shares, other than withdrawable shares, or an option to buy shares, other than withdrawable shares, where those shares were or that option was acquired or issued by the person before 8.00 p.m. New Zealand Standard Time on 18 June 1987;
- (g) In relation to a holder or an issuer, shares, other than withdrawable shares, or an option to acquire or to sell or otherwise dispose of shares, other than withdrawable shares, where those shares were or that option was acquired or issued by the person after 8.00 p.m. New Zealand Standard Time on 18 June 1987:

"Financial arrangement" -

(a) Subject to paragraph (b), means -

- (i) Any debt or debt instrument; and
- (ii) Any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice); and
- (iii) Any arrangement which is of a substantially similar nature (including, without restricting the generality of the preceding provisions of this subparagraph, sell-back and buy-back arrangements, debt defeasances, and assignments of income); -

but does not include any excepted financial arrangement that is not part of a financial arrangement:

(b) ...

Trading stock

Changes have been made to the tax rules regarding the valuation of trading stock. The Taxation (Tax Credits, Trading Stock, and Other Remedial Matters) Act 1998 made changes that will affect business and speculative investors. The amending legislation inserted a new subpart EE into the Income Tax Act 1994.

The definition of "trading stock" has been clarified so that it is limited to anything that is manufactured, produced, or acquired and held for sale or exchange in the ordinary course of a business.

Generally, commencing from the 1998-1999 income year, business investors will now be required to value their trading stock at cost or, in the case of an excepted financial arrangement where the stock is worthless, at a nil value under section EE 3. The previous valuation options of market value and replacement price are no longer available. For business investors, trading stock will not include any investment that is a financial arrangement to which the qualified accruals rules apply. However, excepted financial arrangements (shares, options and other equity type investments) must be valued at cost under section EE 13.

For speculative investors, "revenue account property" (property that is either trading stock or would give rise to gross income of the investor when sold or disposed of) that is an excepted financial arrangement, must also be valued at cost. Under section EF 2(1A) these "costs" of acquiring revenue account property (the investments) are not allowed as a deduction until such time as the investments to which they relate are sold.

Definition

"Revenue account property" means, in respect of any person, property which is trading stock of the person or otherwise property in respect of which any amount derived on disposition would be gross income of the person other than under section EG 19 (disposal of depreciable property):

Legislation

Section EE 5(1)

A taxpayer, other than a small taxpayer, that is valuing closing stock at cost, must include all costs required to be included by generally accepted accounting principles and must allocate those costs to closing stock using methods acceptable under generally accepted accounting principles.

Section EE 13

- (1) An excepted financial arrangement that is trading stock must be valued at cost.
- (2) In calculating the value of an excepted financial arrangement that is trading stock or revenue account property, a taxpayer must use one of the cost-flow methods authorised in section EE 6.
- (3) An excepted financial arrangement that is trading stock may be valued at nil if it -
 - (a) Has no current or likely future market value; and
 - (b) Has been written off as worthless by the taxpayer.

Section EF 2(1)

Subject to subsection (2), a taxpayer must allocate an allowable deduction in respect of the cost of any revenue account property to the later of -

- (a) The income year in which the property is disposed of by the taxpayer; and
 - (b) The income year (or years) in which the gross income is derived by the taxpayer in respect of the disposition of the property.
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