TOPIC 6

DEDUCTIONS/ DEPRECIATION: GENERAL PRINCIPLES

LEARNING OBJECTIVES

After studying the material for this week you should be able to:

- Demonstrate an understanding of the plan of the Income Tax Act 2007 as it relates to deductions;
- Discuss the general principles underlying the allowance of deductions and losses by individual taxpayers;
- Analyse the deductions allowed when calculating net income for business related expenditure, particularly with respect to major items encountered in practice, for example:
  - The deductibility of motor vehicle expenses;
  - Use of the home for business purposes;
  - The deductibility of expenses for a new business;
  - Payments to a spouse;
- Identify the tax implications of losses, which may be brought forward from a previous year;
- Discuss general allowance for depreciation; and
- Apply special rules for depreciation in calculating the depreciation loss available to a business.

Supplementary Readings

1. Supplementary Readings in this Study Guide:

Additional Readings

2. Additional Reading References:

(i) Alley, C., Chan, C., et al. (2009). *New Zealand Taxation* (Chap. 8 & 9). Wellington: Thomson Brookers. [Referred to as **NZT**]

(ii) www.ird.govt.nz - for an online depreciation calculator and link to IR 260, IRD booklet on "Depreciation".

Topic Six Outline

Deductions: General Concepts

1. Plan of the deduction provisions of the Act.
2. General principles of deductibility of expenditures (including losses).
3. Deductions for business related expenses, with special reference to:
   - motor vehicle expenses;
   - use of the home for deriving income;
   - expenditure to begin a new business;
   - legal expenses;
   - payments to a spouse.
4. Losses brought forward from previous years.

Depreciation

5. Introduction
6. General allowance for depreciation.
7. Special rules on depreciation.

Personal Income Tax

BUSINESS: ANNUAL GROSS INCOME

Less: **Annual Total Deductions:**

- Motor vehicle expenses
- Home office
- Telephone and tolls - business
- Rental of business premises
- Legal fees
- Insurance premiums
- Wages to spouse
- Depreciation on business assets
- Repairs and maintenance
- Other business-related expenses
- Entertainment Expenditure

* **Net Business Income (Loss)** _____

Plus other income _____

Less: Other deductions & Net losses _____

→ **Taxable Income** _____

→ **TOTAL TAX LIABILITY**

→ *Less:* Allowable credits _____

→ Residual Income Tax (RIT) _____

→ Tax Payable (i.e. Terminal Tax) _____

Explanatory Notes

1. Deductions: General Principles:

1.1 Introduction

Refer to **NZT** 8.1

1.1.1 The first thing to know about what items of expenditure or loss may be deducted for tax purposes is that every item of deduction that may be claimed is governed by specific provisions in Part D of the Income Tax Act 2007 (ITA),which also includes references to other Parts of the Act. This cannot be stressed too strongly.

1.1.2 The 2007 Act simplifies the presentation of the law on deductions and reflects the latest case (judicial) law i.e.

"… if the general deductibility rule (general permission) does not apply then the specific provisions might:

- restrict the right to a deductions under the general rule or
- authorise a deduction that would otherwise not be available"

(TIB Vol. 16, No.5, June 2004, p 58 - 61)

1.1.3 Thus even though the ITA grants general permission and/or imposes rules for deduction/non-deduction of particular items of expenditure you will not find, for example, provisions which specifically mention advertising, wages, cleaning, purchases, vehicle running expenses, and a host of ordinary everyday items that occur in any type of business. Nonetheless, a number of items are singled out for specific mention or treatment.

1.2 Plan of the Act for Deductions (per the 2007 Core Provisions)

Refer to **NZT** 8.2.1 – 8.2.2

1.2.1 If a taxpayer wishes to claim a particular deduction they must be able to point to a provision in the Act allowing it.

- Sec.BC 3 – The core concept of **annual total deductions** is introduced. For any tax year this is the taxpayer's total deductions allocated to the corresponding income year. This sum has a pivotal role in the tax system for:

  - Sec.BC 4 allows a taxpayer to deduct **annual total deductions** against **annual gross income** to determine the net income or loss for the tax year; and

- Sec.BC 5 allows the deduction of any prior losses (determined under Part I) from net income to determine taxable income for the tax year;

- Sec BD 2 – says that an amount is a deduction if allowed under Part D;

- Part D - lays out the general rules that apply to deductions; and

- Part E – deals with timing of deductions, generally under the accrual rules (see **NZT** 8.3). Part E does not extend the deductibility rules.

1.2.2 Sec DA 1(1) is called the ***general permission*** section which allows deductions (including depreciation) for tax purposes. ***This is the most important authority for deductions and includes any expenditure or loss*:**

- incurred during the year in deriving (gaining or producing) assessable income; or

- incurred in the course of carrying on a business for the purpose of deriving (gaining or producing) assessable income.

Note: this section mentions assessable and/or excluded income, but for this course you may ignore excluded income which is income taxed another way e.g. life insurance.

Sec DA 2 is called the ***general limitation*** section as it lists 6 limitations to the general permission given above. Any expenditure of this sort is non-deductible e.g. capital and personal expenditure etc (see **NZT** 8.2.1). Nevertheless apportionment between business and personal expenditure is generally allowed given adequate proof e.g. home office expenses.

The **general limitations may be overridden** by the Subparts in Part D which allow various specific items to be deducted or not deducted for tax purposes. For example, depreciation being a capital item is specifically authorised by Sec DA 4 which overrides the capital limitation given in Sec DA 2(1) (being part of the 6 general limitations given above). Also refer to **NZT** 8.4.2 –8.4.6.

A loss in the context of deductions covers the situation where there is no actual expenditure by the taxpayer. The writing off of a bad debt, for example, involves no expenditure of the amount written off, but that amount could be described as a loss. Also this deduction is an example of a **specific limitation** as bad debts may be deducted only where they have actually been written off - Sec DB 31(1). (Also refer to **NZT** 8.2.7)

2. General Principles of Deductibility of Expenses

Refer to **NZT** 8.2.2 – 8.2.4

2.1 *Sec.DA 1(1)* the **general permission** provides for *annual deductions*:

(a) **Incurred in deriving assessable income**. Where taxpayers derive income from rents, for example, they will be allowed a deduction for the expenses incurred in gaining that income, such as rates on the premises, maintenance outgoings, etc. To be deductible, the expenses must directly relate (called nexus/link) to the production of assessable income. **This is known as the first limb.** See **NZT** 8.2.3-8.2.4

or

(b) **Incurred in carrying on a business** for the purpose of deriving income. Here the expenditure or loss must relate directly to the carrying on of the business but need not necessarily relate to any particular item of income. The taxpayer merely needs to show that the business, in which the expenditure or loss was incurred, was carried on for the purpose of deriving/producing income. **This is known as the second limb.** See **NZT** 8.2.3-8.2.6.

or

(c) That may be prohibited under the **general limitations** of Sec DA 2 or specifically limited (overridden) by other sections of **Part D.** See **NZT** 8.4.

2.2 Expenditure or loss *must have been incurred* and the taxpayer must be committed to the expenditure before it can be said to have been incurred.

2.3 Expenditure or loss is deductible in the year in which it is incurred regardless of when the income to which it relates is derived, except in the case of expenditure caught under the timing and quantifying rules (e.g. prepayments/accrual expenditure) (see NZT 8.3).

2.4 An expense or loss may have been incurred for more than one purpose but only that portion relating to assessable income is deductible. Therefore, apportionment may be necessary.

2.5 There does not have to be a direct relationship between the expenditure and the income - it is deductible if it is incurred in carrying on the business, e.g. investor borrowed money to purchase a commercial building for rental purposes and occupies part of the building to operate a separate business, say a travel agency. Interest payable on money borrowed is to earn rental income, but if investor is not in receipt of this

income interest expense is still deductible against income from travel agency business.

2.6 The expenditure does not have to be paid in cash before it is deductible, as long as it has been incurred.

2.7 The expenditure does not have to be incurred in New Zealand.

2.8 Whether or not an amount is assessable in the hands of the recipient is irrelevant in determining the deductibility by the payer.

2.9 Deductibility does not depend upon a net assessable income arising.

2.10 For an item to be deductible, in a particular period, the liability must be established before the end of that period.

2.11 Expenditure incurred as a pre-requisite to earning income is not deductible.

2.12 Generally, expenses incurred after termination of a business are not deductible unless it can be shown otherwise.

2.13 Allowable expenditure or losses are first deducted in calculating the assessable income of the related class: any remaining balance is deducted in calculating the assessable income of the other class of income derived in that income year.

2.14 Other general principles have emerged from the Courts and some of these are:

(a) The Courts are tending to adopt "commercial accountancy" principles in deciding whether or not particular items are deductible for tax purposes. However, the Courts have made it clear that this concept is overridden by a specific provision in the Act to the contrary, either allowing or disallowing expenditure of a particular nature.

(b) The tax legislation should not dictate to taxpayer how to carry on the business or what expenditure should or should not incur in so doing. If the taxpayer chooses to imprudently incur expenditure, it is still nevertheless deductible so long as there is a reasonable nexus between the expenditure and the income derived, and it is not otherwise prohibited from deduction by a specific provision of the ITA 2007.

(c) In the same context, there is no authority in the ITA for amounts expended by a taxpayer to be reduced to what another more prudent taxpayer would have incurred. However, this principle is

modified to the extent that, if a taxpayer incurs additional expenditure, partly for business purposes and partly to produce a benefit for himself, it is appropriate for the Revenue authority to limit the deduction excluding the additional amount.

3. Deductions for Business Related Expenditures

Refer to **NZT** 8.5

3.1 The *general permission or test of deductibility* under, S*ec DA 1(1),* sets out in *broad terms* the categories of expenditure or loss that are deductible to a taxpayer in calculating taxpayer's net income.

3.2 However as discussed, this general provision is restricted by *Sec DA 2* (and other Subparts of Part D) which prohibits certain deductions. The main items of expenditure **not allowed** as tax deductions unless satisfying certain conditions include:

(a) Capital (as distinct from revenue) expenditure - *Sec DA 2(1)*. The distinction between capital and revenue expenditure for tax purposes generally coincides with that adopted in accounting, i.e. whether it produces a benefit which extends beyond the current income year. (Refer also to Supplementary Reading, *The Capital/Revenue Distinction* and **NZT** 8.4.2)

(b) Bad Debts - except in so far as the Commissioner is satisfied that the amounts have actually been written off as bad debts in the income year. Sec DB 31(2)-(4). See **NZT** 8.5.4.

(c) Payments made by one spouse to another, except where the payment is a genuine one for services rendered in the production of the taxpayer's gross income, proper wage records are maintained, and the prior consent of the Commissioner has been obtained (*Sec GB23 and Sec DC5). S*ee **NZT** 8.6.5 & 15.2.8 to 15.2.11.

(d) Interest, unless paid on capital, used in the production of assessable income, or necessarily incurred for carrying on a business for the purpose of producing gross income *Sec DB 5 and Sec DB 6*. See **NZT** 8.5.3.

(e) Income tax and additional tax for late payment (*Sec DB 1)*.

(f) Any expenditure or loss to the extent that it is of a private or domestic nature (*Sec DA (2)(2*). Apportionment of expenditure incurred for both business and private purposes is allowed, on a pro-rata basis. See **NZT** 8.4.3

(g) Expenses incurred in deriving **exempt**, **employment income**, **schedular income** (withholding tax limitation) or **non-residents' foreign sourced income** (*Sec BD 1(3-5)*).

Refer to Reading 1(c) on deductibility of holiday bach expenses relating to (d) interest and (f) expenditure of a private or domestic nature.

3.3 In addition to prohibiting certain deductions, the Act specifically provides for a number of deductions which would otherwise not be permitted. For example, the following expenditures are specifically made tax-deductible:

(a) Expenditure incurred in borrowing money, or obtaining or renewing a lease, where the money or lease is used in the production of income or running a business (*Sec DB 5* and see **NZT** 8.5.3).

(b) Accident Compensation levies (*Sec EF3*) .

(c) The cost of patent rights, or expenses incurred in granting, maintaining or extending a patent, used in the production of gross income (*Secs DB 28-31*).

(d) Expenditure on Research and Development and Scientific Research (*Sec DB 33, DB 34* and see **NZT** 8.5.5).

(e) Contributions by an employer to:

(i) Employees' benefit funds (e.g. contribution to Southern Cross) – *Sec DC 6*;
(ii) Employees' superannuation fund (providing the fund is Government approved) – *Sec DC 7*;
(iii) Former employees (or their spouses) as pensions (*Sec DC 2)*; and
(iv) Retiring allowances paid to an employee (*Sec DC 1)*.

(f) A loss incurred through theft by an employee or other person engaged for the purposes of the taxpayer's business (*Sec DB 42)*.

(g) Expenditure incurred by taxpayer in calculating or determining the amount of income for the year. This includes accountancy fees – see reading from the IRD TIB on the Deductibility of Accounting Fees. Following the TRA decision 14/07 these must now be deducted in the year when the work is undertaken, not the income year to which the work relates.

(h) Entertainment expenses (see **NZT** 8.5.6).

3.4 Motor Vehicle Expenses

Refer to **Secs DE 2-6** and **NZT** 8.5.7.

3.4.1 Under Sec *DA 1*, motor vehicle expenses are tax-deductible providing the expenses are incurred in deriving (gaining or producing) income.

3.4.2 However, *Sec DE 2* permits motor vehicle expenses to be fully deductible by self-employed persons (to the extent to which they are incurred in producing gross income) only if complete and accurate details are kept of:

(a) The total distance covered by the vehicle in the income year; and
(b) The distance travelled in producing gross income.

3.4.3 If inadequate records are kept, i.e. no logbook details maintained, only 25% of the motor vehicle expenses (including depreciation) of each vehicle is deductible (*Sec DE 4).* This is the maximum deduction allowed. If no business records are kept there is no deduction.

3.4.4 This requirement for detailed records does not apply in cases where the commissioner is satisfied that a motor vehicle is used 100% for business purposes.

3.4.5 If a privately owned car, (i.e. one not shown in the business accounts) is used for business purposes, Public Service mileage rates may be used to calculate the tax deductible expense of using the vehicle in the production of gross income, provided:

(a) The total usage for business purposes does not exceed 5000 kms for the year; and
(b) Accurate details of distances travelled and trips involved are kept.

3.5 Use of the Home for Deriving Income

Refer to **NZT** 8.6.8.

A professional or business taxpayer who uses part of the dwelling for his income earning activities may claim a portion of the total outgoings (heat, light, rates, insurance, interest on mortgage, repairs and maintenance) of his home, as well as depreciation.

The portion is based on the ratio:

$$\frac{\text{Area used for income earning activities}}{\text{Total area of home}}$$

Actual toll calls incurred in income earning activities are deductible, as is a portion of the telephone rental. The portion for the rental is based on the ratio of:

$$50\% \quad \text{or} \quad \frac{\text{Business usage}}{\text{Total usage}} \quad \text{if} > 50\%$$

(Refer to TIB Vol. 5, No. 12, May 1994, p 2)

3.6 Expenditure to Begin a New Business

The broad principles are the same for each of these types of expenditures.

(1) Expenditure relating to capital items, (i.e. those which have a benefit extending beyond the current income year) is not tax deductible. Examples include:

- purchase of premises;
- legal costs associated with the purchase of premises; and
- costs of repairs and maintenance where such costs result in significant improvement of the particular asset(s).

(2) Expenditure relating to revenue items, (i.e. those which are incurred in the production of gross income in a given year) is tax deductible. Examples include:

- rates on new premises acquired to establish a business;
- legal expenses involved in collecting debts; and
- repairs which merely maintain, but do not significantly improve an asset.

In relation to legal expenses there are three expenses which are (at first sight somewhat unexpectedly) deductible for tax purposes are (see **NZT** 8.6.9):

(a) Legal expenses incurred in relation to preparing, stamping, registering or renewing a lease, or incurred in borrowing money - where the lease or money is used for the production of gross income (*Sec DA 1(1)(b)*).

(b) Changes to company constitutions.

(c) Breach of traffic or other regulations or other infringements of the law by employees unless the:

(i) employer is implicated in the illegal acts of his employees; or
(ii) employee is not engaged in carrying on the lawful business of the employer.

Thus, parking and speeding fines of employees obtained whilst "on the job" can be paid for and claimed as a deduction in calculating net income by the employer. However, in applying public policy considerations fines and penalties are not deductible (see **NZT** 8.6.6).
See also Reading 1(d) from the Tax Information Bulletin on Fines incurred by a trucking firm.

From the 2009/10 income year businesses with $10,000 or less of legal expenses are able to deduct them in the year they were incurred, irrespective of them being of a capital nature as per the Taxation (Business Tax Measures) Act 2009. This was done by inserting a new section DB62 into the ITA2007 which overrides the capital limitation.

3.7 Deductions for Payments to a Spouse

Refer to ***Sec DC 5, Sec GB 23,*** **NZT** 15.2.8-15.2.11, 16.3.8 and 8.6.5.

No deductions for payments to a spouse may be made, **unless** the Department's **prior** consent is obtained. Before approval will be granted, the Department must be convinced that the payment is a genuine one and made at arm's length. The skills and duties involved in the performance of the services for which payment is made will be carefully assessed.

Application for approval must be supported by a statement or simple declaration signed by the taxpayer (or agent) setting out:

(1) The nature of the business in which the spouse is employed;

(2) Precise and full details of duties performed;

(3) Number of hours worked by the employed spouse during the average week and the number of weeks worked (or to be worked) during the year;

(4) Particulars of other labour employed and wages paid, other than

to the spouse;

(5) The mode of payments to the spouse, for example, in cash at regular intervals periodically, by crediting to the spouse's account, etc;

(6) Wages (to be) paid to the spouse.

It should be noted that:

(a) The ITA requires payment to be made. However, in certain circumstances crediting an account is equivalent to payment (for example, as one of the employees paid by means of a direct credit schedule);

(b) The payment must be reasonable, with due regard for the services rendered. There must be no element of a gift in the payment;

(c) Full and proper employee wage and PAYE records must be kept in respect of the spouse.

4. Losses Carried Forward From Previous Years (Personal Taxpayers)

Refer to **NZT** 8.6.10 and 11.2

Under *Section BC 4(3)* losses incurred by a taxpayer can be carried forward without time restriction and are available to be offset against future assessable income.

A loss carried forward is regarded as a deduction and is deducted from net income in the determination of **taxable income** (*Sec BC 4(4)*).

Where more than one year's losses are carried forward, the losses are offset in the same order as that in which they are incurred.

Special rules relate to carrying forward the losses of companies and these will be covered in **Topic 10** and **NZT** 11.3.

With reference to losses, it should be noted that losses incurred in a hobby are not deductible from other assessable income. In Harley v CIR (1971) NZLR 482 (See Tax Practitioner - Case Notes - for a summary of facts of case), the point was emphasized that if a taxpayer conducts what would normally be a business without the intention of making a profit, he is not in business at all, and the losses he makes are therefore not deductible. A hobby is a leisure activity which is not conducted for the purpose of making a profit.

5. Taxation Aspects of Depreciation

Refer to **NZT Chapter 9**

5.1 Introduction

Depreciation is tax deductible under the general permission for deductibility Sec DA 1 and Sec DA 2(1) overrides the general capital

limitation. **NZT** 9.1.2 – 9.1.3 summarise the general features of the regime.

6. General Allowance for Depreciation – Depreciable Property

The general principles of depreciation are explained in Chapter 9 of **NZT**. However, it should be noted that:

(1) There are three methods of calculating depreciation; *diminishing value, straight line,* and *pool method* - **NZT** 9.2.1.

(2) When calculating the depreciation deduction it is important to remember that the date the asset is *acquired* determines the rate of the depreciation available to taxpayer.

(3) To claim a depreciation deduction on an asset, the taxpayer must own it (or lease it under a specified lease), and it must decline in value while it is <u>being or available to be used</u> in the business. This new requirement of "being used or available to be used" is not defined within the Income Tax Legislation. It raises a boundary issue. Nonetheless, this requirement determines the amount of the deduction. See **NZT** 9.1.5.

(4) Prior to this regime intangible assets could not be depreciated. Intangible assets purchased ***after*** 1st April, 1993, now qualify for an annual depreciation deduction.

(5) Section EE 8 permits taxpayers to elect prospectively, or retrospectively, that an asset will not be depreciable property. The election under this section is effective from the time of the acquisition of the asset, or its entry into the tax base, until the asset is disposed of or exits the tax base. See **NZT** 9.1.8.

(6) Some assets cannot be depreciated for tax purposes (non-depreciable property - **NZT** 9.1.6), and the reducing value of some other assets is calculated in a special way. These assets include:

- trading stock;
- land;
- financial arrangements under the accrual rules;
- goodwill.

Note:

(a) Students are <u>not required</u> to know about the valuation of land, financial arrangements and goodwill.

(b) The depreciation rates applicable to each asset is listed on the IRD website, www.ird.govt.nz

In addition to the various rates of depreciation, which are permitted as deductions for assets there is a deduction for the cost of assets acquired, $500 if acquired after 19 May 2005; the proviso is listed at **NZT** 9.1.9.

7. Special rules on depreciation

7.1 Purchase of a Depreciable Asset

Points to note are:

(1) Depreciation of land and buildings - no depreciation is allowed on land. Depreciation on buildings is allowed until the month of disposal(see **NZT** 9.6.4). Note that other depreciable assets generally are not depreciated in the year of sale. Generally, no deduction is allowed if the disposal value < adjusted tax value, as this is regarded as a capital loss. However, there are exceptions which were introduced in 2004. (*See TIB Vol 17 # 7, September 2005*, pp 38)

(2) The rates of depreciation available to an asset owner are set by the Commissioner of Inland Revenue, and these rates may be changed at any time by him. However, where the rate being used is that set under a general determination, the legislation prevents the Commissioner from reducing the rate for assets which are already owned.

(3) In two circumstances the Commissioner will issue economic rates at a taxpayer's request. This special rate may be revoked when the circumstances surrounding the application changes.

(4) Where a depreciable asset is no longer useable taxpayer may apply to the Commissioner for a determination stating that a deduction can be claimed for the remaining tax adjusted value of the property (*other than buildings*). This deduction effectively becomes the depreciation deduction for the year.

(5) Under the regime the rate of depreciation is obtained by applying certain general rules (see **NZT** 9.3):

7.2 Depreciation on Motor Vehicles

The rate of depreciation to be applied to these assets will vary according to their usage. To determine the rate the general rule as outlined in **NZT** 9.3.4 is to be adopted.

Where business motor vehicles are being for private purposes Sec DA 1 requires an adjustment to be made of the vehicle depreciation (see **NZT** 9.5.1).

7.3 Disposal of an Asset

See **NZT** 9.6.

The following points should be noted:

(1) The allowance for depreciation is restricted to amounts caused by fair, wear and tear or obsolescence, and therefore any loss due to extra-ordinary circumstances, such as a fire or accident is not allowed.

(2) For the purposes of this paper (110.289), you may accept that depreciation recovered on the sale of any asset is assessable income.

7.4 Insurance recovered on a depreciable asset which is damaged or destroyed

See **NZT** 9.6.5.

The following points should be noted:

(1) Where an asset (other than a permanent building) is lost or destroyed, the tax effects are the same as if the asset had been sold for a price equal to the insurance etc. proceeds received.

(2) When an asset is damaged, and the insurance proceeds or other payments exceed the cost of the repair, the excess must be deducted from the asset's adjusted tax value.

(3) When a building has been sold (<u>or</u> an amount received as insurance recovery) and a depreciation allowance made - if the consideration received is below the written down book value, no further deduction for depreciation is allowed *i.e.* **losses** made on the sale or disposal of buildings are **not deductible**.

Work Preparation

Read and study the material required for this week.

Review the following questions.

1. Jeff Seaver is a plumber. He pays his wife a salary of $10,000 for keeping the accounts and acting as a receptionist. Approval from the IRD has been gained for a payment of $5,000. How much is deductible? Give reasons with reference to the appropriate legislation.

2. Zed Co Partnership disposes of the following assets on 31 January 2009.

Asset	Cost Price ($)	Adjusted Tax Value ($) (30/06/2008)	Sale Price ($) 31/1/2009
Machinery	44,000	32,000	36,000
Building	104,000	100,000	96,000
Truck	12,000	8,000	6,000
Motor car	36,000	20,000	14,000

(i) What are the income tax implications of the sale of these assets? Please note that the selling prices are GST exclusive and the motor car is used 60% for private use.

(ii) How will the results from these sales affect the income tax calculation of this Partnership and which income year should the transactions be shown?

3. Additional information relating to John Kurarangi's plumbing business (see **Topic 4**, Review Question 3):

Cash receipts:

Sale of fixed asset – Trailer, sold 22 April 2008		650

Cash payments:

ACC levies	2,000	
Accounting fees	1,750	
Advertising	2,720	
Bank fees	140	
Drawings	36,400	
GST payments to IRD	14,000	
Hire of equipment	460	
Interest - bank overdraft	490	
Insurance - business	2,200	
Legal costs	1,500	
Licences	630	
Life insurance premiums	500	
Loan principal repayments – Uncle Bruce	1,000	
Mobile phone – rental & calls	1,620	
Motor vehicle expense – Mazda Ute	5,500	
Motor car expenses – 70% private	700	
– 30% business	300	
Purchases	60,580	
Provisional tax payments – 2009 tax year	9,000	
Protective clothing	350	
Purchase of capital item – Ryobi mitre saw	1,200	
Rent – shed	2,400	
Repairs & maintenance	1,560	
Stationary	1,150	
Subscription – trade magazine	250	
Term loan (business) – interest	1,200	
– principal	3,560	
Telephone – home business	1,540	
– home private	750	
Terminal tax payment – 2008 tax year, paid 7 April 2009	4,250	
Wages (net)	20,450	
Wages – PAYE	4,000	
GST on payments	10,500	
Total		193,650
Cash movement		(2,000)
Bank balance at 31 March 2009		7,700 O/D
Reconciled to computer cash book		7,700 Cr

Extra information provided by John Kurarangi:

(a) Ryobi mitre saw purchased on 16 October 2008.

(b) List of fixed assets as at 1 April 2008 are:

- Mazda Ute with an adjusted tax value of $8,000; this was purchased 2nd hand.
- Motor car – adjusted tax value: $25,000
- A *new* computer with an adjusted tax value of $1,800.
- Trailer- adjusted tax value of $950.
- Tools (power) with adjusted tax value of $4,500. All purchased brand new.

Depreciation on all fixed assets is calculated on <u>diminishing value</u> basis.

(c) John has a small room in his house, which he uses as his office. He estimates this to be about 10% of his floor size. He lists the following expenses from home:

- Electricity: $1,500
- Rates: $1,000
- Insurance (house): $400
- Depreciation: $7,500

(d) Legal costs of $1,500 were to set up a family trust for John's children.

(e) Included in the toll calls from John's mobile phone were some personal calls, totaling $200, made to his daughter in Australia

(f) Accounts payable on hand at 31 March 2009 are:

- IRD PAYE $450
- Purchases $1,125 (**GST inclusive**)

Accounts payable as at 1 April 2008 were:

- Purchases $1,350 (**GST inclusive**)
- Ute repairs $450 (**GST inclusive**)

(g) Stock on hand at 31 March 2009 was $5,000. Opening stock on hand totalled $7,000. These figures are **GST exclusive**.

(h) "Loss of earnings" insurance of $540 was paid from John's personal bank account.

Required:

1. Identify and justify the items which John is entitled to claim as deductible expenses in calculating his taxable income.

2. Would any of the proceeds from the sale of the trailer be assessable income to John?

Source: Butterworths, *"Deductions – continuing business losses – intention an activity ..."*, New Zealand Current Taxation 5, Vol. 29, 1985.

DEDUCTIONS — CONTINUING BUSINESS LOSSES — INTENTION AND ACTIVITY; INCOME TAX ACT 1976, s 104

TRA Case 48 (1985) 8 TRNZ (in the course of publication), Judge Bathgate.

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Over a period from December 1976 until 31 March 1980 the objectors A (an employed solicitor) and B (an employed accountant) were in partnership in a joint venture involving farming (beef cattle fattening) and the intention to operate dog kennels. Partnership losses were apportioned equally and claimed as deductions by the partners in their individual tax returns for the years in question. Upon reviewing the partnership activities in 1981 the Commissioner decided they did not constitute a business within the meaning of the Act and issued amended assessments to the partners disallowing the partnership losses. After also having their objections to the amended assessments disallowed the partners stated a case by way of appeal to the Taxation Review Authority.

The only item at issue being whether or not during the relevant times the partnership activities amounted to a "business". This being the case the intention and modus operandi of the partners must be carefully scrutinised.

A and B were well known in dog breeding circles and formed their partnership with the intention of constructing and running their own kennels in conjunction with a farming business. The aim was for B (who was dissatisfied with his promotion prospects in the IRD) to retire early (when the enterprise was established) and run the kennels and farming operation while A would remain in full-time employment and work part-time for the partnership.

A and B established a range of criteria which a suitable property had to meet including, location (near Auckland), size (more than 50 acres), quality (for dry stock farming), site for house and kennels, approriately priced and capable of sustaining a profitable enterpirse to provide B with a full-time job and A part-time involvement.

After making inquiries of a number of established kennel operators regarding costs and returns, a 50 dog complex was planned which would provide a gross income of over $13,500 (in 1976).

A property of about 51 acres meeting their criteria was found which had previously been operated profitably as a dry stock run. Overall the partners anticipated making a profit by 1980 with the kennels being the major contributor.

To enable the purchase of the property the partners sold their home in Auckland and arranged finance to cover the balance as well as the purchase of cattle. In order to facilitate building of the kennels B took time off from work for this purpose although construction was later delayed by bad weather. Cattle were purchased and wintered on the property during 1977.

The first partnership return for the four months to 31 March 1977 showed no income but substantial outgoings for interest, depreciation and haymaking in particular. It was also accompanied by a note specifying the partners intention with regard to their activities as outlined above.

The first sales of cattle realised substantial profits and this plus B's promotions

lead to increased emphasis on cattle farming and deferral of kennel construction although attendance at dog shows continued. Both partners worked on the farm for a few hours each day and full-time at weekends.

Despite gross profits on cattle sales being earned in the years to 31 March 1978 and 1979 net losses still resulted due to travel, interest and depreciation charges being taken into account.

When B fell ill and was hospitalised in winter of 1979 attempts were made to obtain other persons to manage the kennels but to no avail and so the partners sold the property vacating the premises in June 1980.

A further loss was incurred for the year ended 31 March 1980 with the majority of income being derived from grazing fees. The Commissioner in disallowing the losses alluded to the following factors.

- the partners were fully employed outside the partnership;
- the partnership was undercapitalised;
- losses were made in all years;
- the farm was sold; and
- the area was only 52 acres.

In addition the Commissioner argued that not only must there be an intention to make a profit but also at least a reasonable prospect of doing so, which was not the case with this partnership given the history of losses incurred.

Judge Bathgate accepted the testimony of A and B with regard to their intentions, change of plans in favour of cattle farming following the high initial returns, and time spent on the farm.

In ascertaining the objectors' intentions and whether or not they were in business he also stated that consideration and due weight must be given to the relevant surrounding circumstances and activities of the objectors. The twofold inquiry criteria (covering nature of activities and intention) outlined by Richardson J in *Calkin v CIR* (1984) 7 TRNZ 100 was quoted with approval. Thus Judge Bathgate was able to conclude that:

> . . . the objectors had the necessary intention to carry on their activities for profit. They planned and calculated their returns before engaging in their enterprise. They made enquiries and obtained relevant information for their activities. They carried out their plans; they purchased the property and cattle, and they commenced construction of the dog kennels. They paid relatively substantial sums and incurred substantial liabilities. They were persons engaged in different types of business activities, but they approached the partnership venture in a businesslike manner. They carried on the activities of a business in trading in cattle. They were committed to their enterprise for some years. Their initial prospects and fortunes, as they planned, were not met because of B's advancement in the Department, the returns from the cattle dealing, the drought and B's illness. I consider that the activities of A and B consequent upon the sale of the farm confirm a pattern of business the objectors commenced in 1976.

However, Judge Bathgate was also able to find on the facts that, following B's illness, the intention (and the nature of the partnership activities) changed sufficiently to enable him to conclude that from October 1979 a business within the meaning of s 2 of the Income Tax Act 1976 was *no* longer being carried out.

Thus for the year ending 31 march 1980 he was able to conclude on the facts that:

> . . . in isolation, not withstanding the continued intention of the objectors to make a profit in their venture, the practicalities, and consideration of their activities would result in a finding that the objectors were not carrying on a business during that year.

However, given that the partnership had been operating for a number of years one must accept that the business did continue into the 1979/1980 year so an additional factor (lack of intention) also needs to be present before the business test can be failed.

Judge Bathgate sums up this situation in the following way:

> . . . the decline or lack of activities is understandable and explained by B's incapacity. It is not unusual to have a temporary stop by an unexpected disruption caused by an illness to a principal. However, the partners realised in time that was more than a temporary holt. It was a permanent situation. They decided to sell the property. I consider then, *with the change of their intention*, together with the lack of trading and business work by them, the partnership business, as the word "business" is defined in the Act, ceased.

Thus, Judge Bathgate concluded that the business operated up until 30 October 1979 at which time the intention of the objectors to sell rather than wait to see if their position could be resolved, together with the lack of activity indicated the business had ceased.

Refer Statutes and Regulations [1204] — s 104 (Expenditure or loss incurred in production of assessable income).

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other Parts of the Act are progressively rewritten, with the intention that eventually all *income* or *deduction* provisions will be contained in Parts C and D respectively.

Subpart Z has been retained for terminating provisions.

PART D

Introduction

The purpose of Part D is to provide a legislative code of when an amount is a *deduction*. The legislation has a general deductibility rule, *the general permission*, which is set out in section DA 1. The rules in section BD 2(2) (1994 Act) have also been rewritten in section DA 2 as *general limitations* to *the general permission*. Section DA 3 sets out the legislative relationship between the specific rules and the general rules.

Specific *deduction* provisions are contained within subparts DB to DF and DN to DX. These subparts cover a range of supplementary *deductions*, specific entity rules, and limitations to *the general permission*.

The rules are not grouped according to whether they supplement or limit *the general permission*. Instead, the approach adopted favours a subject-based approach that gives taxpayers an assurance that, once they have dealt with the provisions in a discrete block, there are unlikely to be other provisions elsewhere that also need to be taken into account.

Nevertheless, the drafting still needs to identify which rules have priority, to reduce the need to revert to finding established common law principles. Hence, each section that allows a *deduction* concludes with a provision identifying its relationship with *the general permission* and the *general limitations*.

The general permission

Part D establishes a general overarching rule that allows a *deduction* for expenditure or loss that satisfies the nexus requirements of the general deductibility rule in section DA 1.

This general deductibility rule, termed *the general permission*, is an amalgam of section BD 2(1)(b)(i) and (ii) of the 1994 Act. It also explicitly reaffirms the implied position under the 1994 Act that a person has a *deduction* for an expenditure or loss incurred in deriving *excluded income*. This relationship is also clarified in the business test.

These provisions allow a *deduction* for an expenditure or loss incurred by a person (including a *depreciation loss*):

- in deriving *assessable income*, *excluded income* or a combination of the two
- in the course of carrying on a business for the purpose of deriving *assessable income*, *excluded income* or a combination of the two.

The priority of this rule in the overall scheme of income tax legislation has been established by the courts. Therefore it is appropriate for the rewritten Act to make the law more accessible to readers by identifying the approach adopted by the courts in determining how the general and specific *deduction* provisions interact with each other. For example, Richardson J in *CIR v Banks*,[9] held that:

> The statute provides a code in relation to deductibility. Section 110 prohibits the deduction of any expenditure or loss except as expressly provided in the Act. The general authority for deductions in calculating assessable income is contained in s 111 [*the general permission of the 2004 Act*]. . . . The next step is to consider the application of the specific provisions of s 112 [*the general limitations of the 2004 Act*] and subsequent deduction provisions, either modifying in particular classes of cases the right to a deduction which would otherwise exist under s 111, or authorising deductions not allowable under that section.

Rationalisation of rules having the same effect as the general permission

A key objective in the rewrite is to rationalise rules that have similar effect. Particular attention has been given to rules having a similar effect to *the general permission*.

Prime examples of this in the 1994 Act are the interest deductibility rule (section DD 1(b)(i) and (ii)) and the deductibility for an amount of depreciation (combined effect of sections EG 1 and EG 2). The effect of both of these rules is similar to the general deductibility rule in section BD 2 of the 1994 Act. In the rewritten Act, *the general permission* is intended to achieve the same outcome as these specific rules.

General limitations

There are six *general limitations*. Each generally overrides *the general permission*.

The policy underlying a specific *deduction* provision, however, may be to override a *general limitation*. If this is the case, this relationship between the specific *deduction* provision and the relevant *general limitation* is explicitly stated in the rewritten legislation in the final subsection of the relevant provision, headed "Link with subpart DA". The effect of these "relationship subsections" is confirmed by section DA 3, which codifies the effect of judicial interpretation on the relationship between the *general limitations* and specific *deductions* over a long period of time.

[9] [1978] 2 NZLR 472; (1978) 3 NZTC 61,236; (1978) 2 TRNZ 323

For example, in *Waste Management NZ Ltd v CIR*, [10] Richardson J stated:

> The expenditures in the present case are capital but that is not a bar to their deductibility if they satisfy the express criteria of section 124 [*of the Income Tax Act 1976*].

To provide greater clarity in the law, section DB 37(5) of the 2004 Act codifies that particular finding by the courts. Therefore there is no need for the reader to go to the common law to establish the relationship between this specific provision and the *capital limitation*.

As a result, the 2004 Act reflects the judicial approach to interpreting the 1994 Act. This simplifies access to the law, rather than leaving the reader having to revert to searching the common law to find the judicially determined relationships.

Capital limitation (DA 2(1))

Section DA 2(1) is a re-enactment of section BD 2(2)(e) of the 1994 Act. Any implicit override of this limitation is now addressed within each relevant specific deduction provision. This approach clearly identifies the policy rationale for that specific provision as allowing a *deduction* for capital expenditure.

Private limitation (DA 2(2))

Section DA 2(2) rewrites section BD 2(2)(a) of the 1994 Act. The latter rule has almost unlimited application throughout the 1994 Act, and the courts have consistently held that expenditure of a private or domestic nature is not allowed as a *deduction* unless Parliament expressly allows a deduction for private expenditure.

This principle has been carried through into the rewritten legislation, although there are some exceptions.

For example, in section DB 3 of the 2004 Act, the private limitation is overridden for expenditure a person incurs in determining specific tax liabilities.

Exempt income limitation (DA 2(3))

If any *income* is treated as *exempt income*, it follows that any expenditure incurred in deriving that *income* is not deductible.

Section DA 2(3), however, does not apply to deny a *deduction* for expenditure incurred in deriving amounts that are either not *income*, or are *excluded income*. For any expenditure within this category to be a deduction, it must satisfy either *the general permission* or a specific *deduction* and not be subject to any of the other *general limitations*.

[10] (1995) 17 NZTC 12,147

For example, in CIR v Brierley,[11] the Court of Appeal considered whether a deduction was allowed for interest incurred on funds borrowed to buy shares. These shares produced both taxable and non-taxable (but not exempt) income. The Court of Appeal held that no apportionment was necessary and therefore the exempt limitation could not apply:

> … the distributions were not 'income' within the meaning of section 106(1)(k). Not being income, they could not have been exempted from a liability which never existed.

Employment limitation (DA 2(4))

Section DA 2(4) rewrites section BD 2(2)(c).

Withholding tax limitation (DA 2(5))

Section DA 2(5) rewrites section BD 2(2)(d).

Non-residents' foreign-sourced income limitation (DA 2(6))

Section DA 2(6) is a new and explicit presentation of existing law and policy.

The provision states explicitly what was embedded in the interaction of sections BD 1(2)(c) and BD 2(1)(b)(i) and (ii) of the 1994 Act.

Under the 1994 Act, a foreign-sourced amount derived by a non-resident was not "gross income" under section BD 1(2)(c). Therefore expenditure or a loss incurred by a non-resident in deriving a foreign-sourced amount could not be an "allowable deduction" because it did not meet the nexus tests of deductibility. This non-deductibility of an expenditure or loss is clearer under the new drafting.

Relationship between the general permission, specific deductions and the general limitations

Position under the 1994 Act

The Income Tax Act 1994 does not explicitly state how specific provisions and the general rules are intended to interact. This has led to considerable uncertainty and a significant amount of litigation on this issue over a number of years.

To reduce compliance costs, the rewritten legislation incorporates the relationships between the specific deductions and *the general permission* and *general limitations*, as reflected in judicial interpretation.

General deductibility rule and specific deductions

A key structural feature implicit in the scheme of the 1994 Act (and the 1976 Act) is the relationship between the general deduction provision and specific deduction provisions.

[11] (1990) 12 NZTC 7,183, 7,188; 14 TRNZ 713

The courts have held that the general deductibility rule is always the first point in determining whether an expenditure or loss is a deduction. If the transaction in question does not give rise to a deduction under the general deductibility rule, it is only then that the specific provisions are examined.[12]

These decisions identify that specific deductions are viewed generally by the courts as:

- Restricting the right to a deduction under the general rule.
- Authorising a deduction that would not otherwise be available.[13]

General prohibition against deductibility and deductions

Section BD 2(2) in the 1994 Act states that an amount of expenditure or loss is not an allowable deduction to the extent it falls within the categories listed in paragraphs (a) to (f).

The effect of section BD 2(2) is to prohibit generally any deduction for an expenditure or loss even if it would have been allowed as a deduction under section BD 2(1)(b)(i) and (ii). The courts have, over the years, been required to examine the relationship of specific deduction provisions, the general deduction rule and the general prohibitions.

For example, from Hill v CIR[14] it is clear that some specific deduction provisions permit a deduction for capital expenditure (this is recognised in section BD 2(2)(e)), despite that expenditure or loss not being allowed as a deduction under section BD 2(1)(b)(i) or (ii). In this case Richardson J held:

> And in policy terms it is readily understandable that Parliament should distinguish between revenue and other specific deductions allowable in the years in which they are incurred and a set off of the capital cost of timber as and when it is sold.

Position under the 2004 Act

Section DA 3 in the 2004 Act is a new provision, but does not introduce new law.

It codifies the effect of the judicial decisions on the scheme of income tax legislation as it relates to the relationship between the specific deductions and the general deductibility rule and the general prohibitions against deductibility.

The principle behind the approach in section DA 3 is for the rewritten Act to state explicitly whether a specific rule:

- narrows or expands *the general permission*
- overrides or does not override the *general limitations*.

General permission and specific deductions

Section DA 3 signals an overall approach that each specific *deduction* provision which has the effect of narrowing or expanding on *the general permission* must identify whether it:

- Overrides *the general permission*, in which case the specific provision is modifying *the general permission* by providing a limit to or a prohibition against the *deduction*—for example, section DD 1 (Entertainment expenditure).
- Allows a *deduction* that would not be available under the *general permission*, in which case the provision "supplements" the *general permission*—for example, section DB 7 (Interest). Most companies need no nexus with income.

General limitations and specific deductions

An amount that would otherwise be a *deduction* is not deductible if a *general* (or specific) *limitation* applies. Again, this codifies the effect of decisions of the courts relating to the scheme for *deductions*.[15]

The non-deductibility of an expenditure or loss having a private or domestic nature is an example of a general limitation (section DA 2(2)). The non-deductibility of bad debts, unless they are written off (section DB 23(1)), is an example of a specific limitation.

A specific *deduction* may override a *general limitation*, such as with a *depreciation loss*. The effect of section DA 3 requires each such override to be explicitly stated. In this way, the rewritten Act ensures that it is clear that the relevant *deduction* is allowed, even though the underlying expenditure or loss breaches the relevant *general limitation*. The subsection that provides for any "Link with subpart DA" also clarifies whether or not *the general permission* must be satisfied also and whether the other *general limitations* apply.

Section DA 4 is a special provision that clarifies at an early stage the relationship between the *deduction* allowed for a *depreciation loss* and the *capital limitation*.

Subject-based approach to Part D

Following the decision to group the specific *deduction* provisions according to subject matter, subparts DB to DF cover specific subject matter. Each subpart is

[12] *Richardson J in CIR v Banks [1978] 2 NZLR 472; (1978) 3 NZTC 61,236; (1978) 2 TRNZ 323* – see footnote 11 and related text.

[13] CIR v Brierley [1990] 3 NZLR 303; (1990) 12 NZTC 7,184; 14 TRNZ 713 – "That statutory approach suggests that the Legislature viewed the positive deduction provisions of s 106 as independent of section 104. There is too the further consideration noted earlier that in some cases the deductions contemplated under section 106 would not be available if section 104 also had to be satisfied. Paragraph (h) itself is an extreme example. It would be extraordinary if, in a paragraph containing no reference to section 104, subpara (ii) provided an independent self-contained test of deductibility of interest while subpara (i) of the same paragraph was subject to section 104."

[14] (1994) 16 NZTC 11,037; (1994) 18 TRNZ 522

[15] *CIR v Mitsubishi Motors NZ Ltd* [PC] [1995] 3 NZLR 513; [1996] AC 315; (1995) 17 NZTC 12,351; 20 TRNZ 89, Lord Hoffman said: "In addition, … there is section 106, which prohibits the deduction of various enumerated items of expenditure even if they come within section 104."

arranged to list the rules from the more commonly applicable provisions to the less commonly applicable.

Subparts DN to DV list *deduction* rules for specific groups.

Subpart DY notes that there are provisions in other parts of the Act that make items a *deduction*, and subpart Z covers terminating provisions.

Employee and contractor expenditure

The specific *deduction* provisions for employers in subpart DF of the 1994 Act now appear in subpart DC (Employee and contractor expenditure) of the 2004 Act. Each provision's relationship to *the general permission* has been made clearer.

The rules limiting *deductions* for expenditure on entertainment in subpart DG and schedule 6A are now located in subpart DD (Entertainment expenditure) of the 2004 Act.

STRUCTURE OF PART E

Introduction

In the absence of specific timing rules, the core provisions timing rules (sections BD 3 and BD 4) provide for timing to be determined on the basis of when *income* is "derived" or expenditure is "incurred". Sections BD 3 and BD 4 state that the meaning of "derived" and "incurred" is to continue to be determined by case law.

Part E is the location for sets of rules that have a predominant focus on matching or allocation. These rules apply where the policy is to provide a timing result that differs from the result arising from the time at which *income* is "derived" or expenditure or loss is "incurred".

As a number of the existing sets of such rules also deal with quantification, it is appropriate to signal that in the title of the Part.

Scope of Part E

Likewise, Part E now contains a range of provisions and sets of rules with differing operative effects. No general timing provisions exist, other than the generic rules relating to derivation and incurrence set out in the core provisions (sections BD 3 and BD 4 of the 2004 Act).

Nor has every element of a specific provision that has a timing aspect been shifted to Part E—such as a simple ancillary rule that clarifies for the avoidance of doubt when an amount is derived or incurred. From a reader's perspective, to shift such a simple ancillary rule would not provide sufficient benefit, since some *income* and *deduction* provisions have a close linkage to their timing element. When this occurs, the timing rule remains with the specific provision creating *income* or a *deduction*.

This approach has involved an exercise of judgment as to what is "ancillary", bearing in mind that the ultimate aim is to simplify access to the correct conclusion or application of the legislation.

> For example, in section CG 6 (2004 Act), the income is allocated to the income year in which the recovery is received.

In addition to the rules on depreciable assets, trading stock and revenue account property, Part E also covers areas within which the timing, *income* and *deduction* rules cannot easily be separated, such as the accrual rules, the international rules and many of the life insurance rules. However, these groups of rules have been drafted to identify the timed and quantified amount that a provision in Part C or D then makes, respectively, either *income* or a *deduction*.

Specific timing rules

Specific timing rules generally defer all or part of the *income* or *deduction* to one or more subsequent *tax years* or, conversely, permit the *income* or *deduction* to be allocated to an earlier income period.

Some timing rules do not allocate *income* or *deductions* as such, but merely have the effect of modifying the allocation that would otherwise occur.

> An example is the trading stock valuation rules, which provide for an adjustment through the treatment of the opening and closing values of trading stock as, respectively, a deduction and income.

The most significant specific timing rules are:

- Revenue account property (section EA 2 Other revenue account property).
- Accrual expenditure (section EA 3 Prepayments).
- Depreciation (subpart EE and section FB 7).
- Financial arrangement rules (subpart EW) and the old financial arrangement rules in sections EZ 30 to EZ 49.
- Valuation of trading stock, livestock, and bloodstock (section EA 1 and subparts EB, EC and ED).

Depreciation

Introduction

These provisions cover the various methods that are available for calculating depreciation for tax purposes. Depreciation is unusual from a legislative perspective in that it provides a deduction in relation to a capital item and, therefore, overrides the capital limitation rule in section DA 2(1).

Approach used in rewriting the depreciation rule

Deductibility under the 1994 Act

Under the depreciation rules in the 1994 Act, the interaction of section EG 1 with section EG 2(1)(e) (both of the 1994 Act) meant that the owner of a depreciable asset had to satisfy a test of deductibility in order to obtain a deduction for depreciation.

The test of deductibility in section EG 2(1)(e) of the 1994 Act produces a result that is almost identical to the outcomes under the general deductibility rules in BD 2(1)(b)(i) and (ii) (1994 Act). This meant the rule could be rationalised in the 2004 Act.

Deductibility under the 2004 Act

To be consistent with the approach adopted for other sets of rules in Part E, the depreciation rules preserve for Parts C and D the role of specifying what is *income* or a *deduction*. (See in the 2004 Act section CG 1 (depreciation recovery income) and section DA 1, where the *deduction* for *depreciation loss* is incorporated into *the general permission*.)

The relationship in the 2004 Act between *the general permission* (section DA 1) and section FB 7 (depreciation: partial income-producing use) operates to identify the extent to which a *deduction* is allowed for a *depreciation loss*. In addition, section DA 4 of the 2004 Act applies to override the *capital limitation* for a *depreciation loss*.

The amount of *depreciation loss* is determined under subpart EE of the 2004 Act, provided that the property is used or available for use in the *income year*.

Hence, the focus of the subpart EE depreciation rules is on the quantification of an amount of *depreciation loss* for an *income year* rather than on whether the *depreciation loss* is a *deduction* or not. This approach also clarifies the relationship between the depreciation rules and the general rules relating to deductibility of expenditure and loss.

From a drafting perspective, this rationalisation avoids the duplication of wording in the 1994 Act that required a similar link with income production in both the general rules (section BD 2(1)) and the depreciation rules (section EG 2(1)(e)).

Definitions

Because the depreciation rules have a broad application to the taxpaying community, specific depreciation-related definitions have been brought into subpart EE to be close to their operative provisions. However, the section OB 1 "dictionary" continues to list the definition (but cross-refers to the actual definition in subpart EE). In the 1994 Act, the definitions are spread between subpart EG and section OB 1.

Examples of these changes are:

- The definition of "adjusted tax value", located in section EE 46 of the 2004 Act.
- The provisions relating to ownership have been combined, and now specifically allow for joint ownership. These provisions are located in sections EE 2 to EE 5 of the 2004 Act. In the 1994 Act, the only express acknowledgement of the possibility of joint ownership is in section EG 19(8), which refers to disposals by partnerships.
- For reasons of clarity, the concept of disposals distinguishes between actual disposals and other events that are deemed to be disposals (sections EE 37 to EE 44 of the 2004 Act).

PARTS F TO END OF 2004 ACT

Consequential changes

Parts F to N have not been rewritten.

Even so, a number of consequential changes have been made to these parts, as well as to the schedules to the Act as a result of new and redefined terminology. The most common consequential changes required were those relating to the new or redefined core concepts of *income*, *excluded income*, *the general permission*, *tax year* and *income year*.

Discretions and self-assessment principles

In the 1994 Act, various discretions of the Commissioner of Inland Revenue are, in substance, objective tests. Therefore these discretions have been drafted as objective tests in the 2004 Act. This drafting approach is consistent with the principles of self-assessment and is not intended to change the effect of the law.

Depreciation

The apportionment rule formerly located in section EG 2(1)(e) of the 1994 Act is now located in section FB 7 of the 2004 Act.

Fringe benefit tax

Fringe benefit tax provisions that relate to the calculation and payment of fringe benefit tax have been relocated to subpart ND.

Part O

In section OB 1, there are a number of new definitions and some existing terms have been omitted or redefined. In the light of the select committee's comments on the rewritten Act in their commentary on the reported-back bill, it is important that readers check the definitions.

Inland Revenue Department (Feb 2008). Timing of Deduction for Accounting Services. *Tax Information Bulletin (TIB)*, Vol 20, No 1 pp 53-54.

TIMING OF DEDUCTION FOR ACCOUNTING SERVICES

Case:	TRA Decision Number 14/07
Decision date:	23 November 2007
Act:	Income Tax Act 1994, sections BD2, BD4 and DJ5(1)
Keywords:	expenditure incurred, definitively committed, legal obligation to make payment, income year

Summary

The taxpayer is allowed a deduction in the income tax year which the expenditure is incurred. Expenditure is incurred when the taxpayer is definitively committed to the expenditure, a legal obligation to make payment in the future has accrued, the expenditure must be more than impending, threatened or expected and theoretical contingencies can be disregarded. The taxpayer did not incur the expenditure (accounting fees for the 2003 financial statements and returns of income) until 2004 and accordingly, could only deduct those fees in 2004 – not 2003 as claimed.

Facts

This case concerns the timing of deductibility of accounting fees.

The Disputant is a limited liability company. It entered into an agreement with its chartered accountants on 6 March 2000 which confirmed "the terms of our continuing appointment to provide accounting services; the nature of those services". In relation to the annual financial statements, the accountants would "bill as the work is performed. These progress billings will be shown in the final bill which will detail the total cost for those statements".

On 31 March 2003 the Disputant accrued $2,285.00 as "being estimate of 2003 fees" and subsequently claimed a deduction in it's 2003 income tax return. The accounting services for the $2,285 were, however, performed and invoiced in the 2004 income tax year.

Decision

The Taxation Review Authority ("TRA") confirmed that it is settled law that expenditure can only be deducted if it can be brought within the terms of the Tax Acts and, referring to both the Privy Council and Court of Appeal in *Mitsubishi Motors Ltd v The Commissioner of Inland Revenue*, accounting principles and good commercial practice cannot be substituted for the statutory test of deductibility.

A deduction must be allocated to the income year in which it is incurred. The principles of "incurred" are also settled law and the principles can be summarised as:

- Expenditure is incurred in an income year even if there is no actual disbursement.
- Expenditure is incurred if the taxpayer has "definitively committed" itself to that expenditure.
- It is not sufficient that the expenditure be merely "impending, threatened or expected".
- There must be an "existing obligation" and whether, in light of all the surrounding circumstances, a legal obligation to make a payment in the future has said to have accrued.

Where the expenditure arises under a written agreement, whether or not it constitutes an existing obligation is a question of the construction of the deed or agreement.

On the facts of this case, the Disputant may have had statutory obligations to prepare financial accounts and returns of income but it did not have a statutory obligation to pay its accountants to prepare those financial statements and returns of income. The contractual relationship was only that, if the accountants performed work, they would bill the Disputant as the work was performed. As at 31 March 2003, the Disputant was not contractually bound to have the accountants prepare the financial statements and returns of income. On 1 April 2003 the Disputant could have ceased using the accountants and used other means (itself or other agents) to prepare the financial statements and returns of income. This is reinforced because, if contractually bound, the Disputant would be liable here for an unquantified rate of payment.

As the legal obligation to make payment only arose upon work being completed and invoiced for, the Disputant was not definitively committed to the expenditure at 31 March 2003. Accordingly, it had not incurred the expenditure in the 2003 income tax year and was not entitled to the deduction in that year.

The TRA noted that it seems basic that if a taxpayer seeks to deduct accountancy fees in a particular year, then as a general rule that service needs to have been provided in that particular year. Any accounting practice to deduct fees in an earlier year for work done some months later is, as a matter of law, a wrong practice. The TRA left open the possibility that there may be merit in the argument that a pre-commitment on a commercial basis for accounting services to be provided after the end of revenue year in question creates a debt incurred in the earlier year

Inland Revenue Department (November 2008). No Deduction for Fines. *Tax Information Bulletin (TIB)*, Vol 20, No 9 pp 15-16

Decision

Simon France J set out the provisions of CG 23(5), regarding them as the crux of this dispute:

> For the purposes of this Act, where at any time in an income year a Person disposes of any property which is, with respect to the period immediately before disposition, an interest of the person in a fund with respect to which the person uses the comparative value method or the deemed rate of return method, **for no consideration or for consideration which is less than the market value of the property at the time, the person shall be deemed to have derived from the disposition consideration equal to the market value of the property at the time.**

His Honour held that the forfeiture operates as a purchase price adjustment. However he did not consider that the arrangement mattered in terms of the FIF rules; and stated:

> [50] In tax year 2001 Dr Saha declared his interest in a foreign investment fund to be 7566 shares, such shares having been acquired by him at a cost of $3,497,552. For tax purposes, Dr Saha therefore had that degree of interest in the foreign company. Thereafter, any adjustments in the number of shares had to be reflected in the relevant tax year. Acquisition of further shares would be treated as a deductible cost but of course, the year end value would also reflect the greater number of shares. Disposition of shares would be treated as an assessable gain, but again the year end value would reflect the lesser number of shares now owned.

His Honour considered that there was no consideration for the disposal and it was therefore deemed by section CG23 (5) to amount to a disposal at market value:

> [51] In tax year 2002 Cap Gemini has not paid anything for the shares. No consideration at the time of the disposal has passed from Cap Gemini to Dr Saha. Rather, it is, as the taxpayer contended, an adjustment to the original purchase price. Accordingly, I would see CG23 (5) as directly engaged, as the Commissioner contends.

NO DEDUCTION FOR FINES

Case	TRA 105/05 Dec 9/2008
Decision date	17 September 2008
Act	Income Tax Act 1994
Keywords	Fines, deductibility

Summary

The TRA accepted that there was no nexus to income earning and good policy reasons to disallow fines incurred by a trucking firm.

Facts

The taxpayer is a trucking firm which transported timber from forests for processing. In the course of this activity the firm had received fines for overloading its trucks. The firm sought to deduct these fines in the 2000 to 2002 income years inclusive.

A good deal of expert evidence regarding the loading and weighing of trucks was adduced by both sides. The taxpayer argued that while they did not accept the fines could not be successfully challenged in court (on the basis of various statutory defences including a "no fault" defence) it was simply better business to pay the fine than to challenge it [par 6]. The Commissioner took the view that the taxpayer had failed to take reasonable steps to avoid the fines [par 42]. Noting that the relevant legislation "built in" a five percent tolerance before a truck driver would be fined the Commissioner submitted that the taxpayer was "cavalier" in its attitude [paragraphs 49 and 57-58].

Decision

Barber DCJ concluded that the fines were not deductible.

His Honour reviewed the case law in the area identifying that in major Commonwealth countries (Australia, England and New Zealand) fines were not usually deductible (paragraphs [71] to [104]). He noted the Canadian case law to the opposite effect was overridden by statute to prohibit the deductibility of fines and penalties (par [107].

Despite observing that New Zealand cases were "not clear" upon the issue of whether or not fines and penalties had sufficient nexus to be deductible, his Honour continued:

[109] However, it seems to me that a business should operate within the law. The disputant's business of carting logs on large trucks and trailers is able to comply with the law, but there is expense involved in weight-of-load compliance and such non-compliance can involve a relatively modest amount of annual fines. It seems to me to be illogical to seek to deduct fines relating to a breach of the law as if they were a business expense, because they relate to activities which do not conform to the law and so are not within the permitted scope of the business. I consider that a penalty/fine arising from a taxpayer's illegal activities (ie, transporting too-heavy a load) cannot have a sufficient nexus with the taxpayer's income earning process so as to create deductibility for that cost of the fine.

He also noted that he was bound by the earlier High Court decision of *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213 in which Justice Sinclair held fines were not allowable deductions for reasons of public policy (par [111]) :

[111] In any case, under the doctrine of precedent I am bound, by the 1989 High Court decision of *Nicholas Nathan Ltd and Anor v CIR* where Sinclair J held that deductibility of fines should not be allowed on the grounds of public policy. It would be contrary to public policy to allow such fines paid by logging transport companies to be deducted from their revenue earnings. It makes no difference to my reasoning whether the objector company incurred the fines or whether its drivers incurred them but the objector paid them. The public policy approach readily leads to denial of deductibility for fines but the nexus approach is not so easy to apply.

While sympathetic to the taxpayer, the Taxation Review Authority confirmed the assessments

JUDICIAL REVIEW GRANTED FOR DELAY

Case	Peter Allan Harris v The District Court at Auckland and CIR
Decision date	4 September 2008
Act	Income Tax Act 1994
Keywords	Judicial review, delay, informations and income tax

Summary

The taxpayers were granted application for judicial review, holding that, considering the total time taken in the prosecution, there had been undue delay, and that in the circumstances, the District Court Judge should have exercised his inherent power to prevent an abuse of process and to direct a stay of the proceedings.

Facts

On 8 November 2004, Notices under section 17 of the Tax Administration Act 1994 (TAA) were sent requesting information in support of certain returns filed by Mr Harris personally and on behalf of three companies. This resulted in a box of documents being supplied by Mr Harris to the Department; however, much of the information requested was allegedly not supplied.

From 30 November 2004 to 9 February 2005, further correspondence was issued to Mr Harris and/or his companies giving notice of intention to prosecute unless the default was remedied, which led to four informations under section 143A(1)(b) of the TAA being sworn on 25 July 2005. Those informations were replaced by fresh informations on 25 November 2005, which also alleged offences under section 143A (1) (b) of the TAA.

After various procedural steps, on 12 February 2007, the informations were ruled to be nullities as not coming within section 150A TAA and not laid within time.

Shortly after, on 16 February 2007, fresh informations were sworn in terms of section 143 (1)(b) of the TAA. After various procedural steps, the accused applied to have the informations dismissed at the 3 April 2008 fixture. Judge Burns ruled against Mr Harris, which led to these judicial review proceedings.

Shaw, M (2009, April 13) Bach owners beware – the IRD is tightening the rules *The Dominion Post* p.C2

Bach owners beware – the IRD is tightening the rules

Mike Shaw
COMMENT

WHILE enjoying your Easter break, perhaps relaxing at the family bach, spare a thought for how you plan to return any rental income received from your holiday home to Inland Revenue this year.

Inland Revenue recently finalised its guidance on the tax treatment of rental income received from holiday homes. While in the past, many holiday home owners may have been a little lax on the tax obligations arising from their holiday home rentals, the latest guidance specifies stringent rules around allowable deductions. All holiday home owners should sit up and take note.

The new guidance is the IRD's response to its apparent frustration with taxpayers who have claimed large losses – mostly due to interest deductions – for holiday homes that are purportedly primarily used to derive rental income. The starting point is that all rental income received from holiday homes is taxable, and should be returned in your tax return each year.

The question then arises as to which expenses are deductible. From bitter experience, holiday homes are expensive. Many owners incur significant expenses, including interest, insurance, rates, depreciation, general repairs, security, utilities – some of which arise irrespective of use. Against this there is often a relatively small amount of rental income received, so the upshot is that large losses can accumulate.

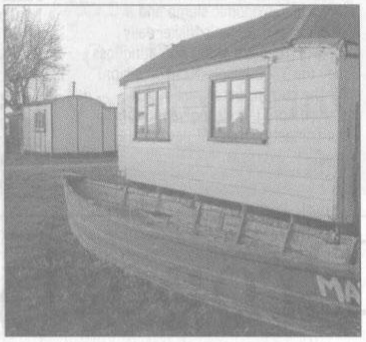
The key tax issue is determining the proportion of the costs that is deductible. Is it based on the weeks the holiday home is actually rented out, or is it based on the weeks when it is available for rent? Invariably, the second option results in a greater share of the expenses being tax-deductible, whereas the first option generally limits the deductions to an insignificant amount.

In order to get the deductions for expenses based on the "availability" of your holiday home for rent, Inland Revenue wants evidence of active and regular marketing of the property.

It states that this must be "more than a mere statement of its availability, sporadic or limited advertising, or advertising that is unlikely to attract many customers".

This may require a change in attitude by some holiday home owners, especially those who will be seeking to continue taking large tax losses.

Note, too, that Inland Revenue will not allow large losses for holiday homes where the property is only available for rent to third parties on a limited basis or at non-competitive rates. So if you only advertise your beach house for rent over the winter months at summer rates, you should be battening down the hatches in preparation for a dispute.



Costly getaway: The expense of holiday homes lies in the fact that many costs are often irrespective of actual use.

Inland Revenue also clarifies the correct treatment where a holiday home is "rented" to family and friends at mates' rates. In these situations, Inland Revenue will accept deductions relating to this rental period, but only up to the amount of rent received for that period, again negating any large tax loss.

The crux of all this is that Inland Revenue has sent out an early warning notice to taxpayers not to be too creative. In some respects, this echoes one sent out earlier in the year about effectively renting your own home to yourself and claiming material deductions.

In both cases, it's best to take heed, as Inland Revenue is actually right on the money (this time at least).

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