

9 March 2022

Public Consultation
Inland Revenue Department

By email: public.consultation@ird.govt.nz

Re: PUB00432 – Income Tax – Deductibility of costs incurred due to COVID-19

1 Introduction

- 1.1 The New Zealand Law Society | Te Kāhui Ture o Aotearoa welcomes the opportunity to comment on the draft interpretation statement: PUB00432 – Income Tax – Deductibility of costs incurred due to COVID-19 (**draft statement**).
- 1.2 The Law Society is generally in agreement with the law as summarised in the draft statement, subject to the following comments.

2 The two limbs of section DA 1(1)

- 2.1 At paragraph 10, the draft statement explains the two limbs of s DA 1(1) as follows:

A person is allowed a deduction for an amount of expenditure or loss to the extent they incur it in deriving their income, or in the course of carrying on a business for the purpose of deriving their income. These are referred to as the first and second limbs of s DA 1.

- 2.2 This is correct. However, paragraph 11 then elaborates as follows:

Businesses usually claim deductions under the second limb (s DA 1(1)(b)). That is, a person in business is allowed a deduction for an amount of expenditure or loss they incur in the course of carrying on a business for the purpose of deriving income.

- 2.3 While it might be that most claims for deductions are made under the first limb, rather than the second limb, the statement in paragraph 11 may be misleading.
- 2.4 In most cases it might not matter whether a claim for a deduction is made under the first limb (incurred in deriving assessable income) or the second limb (incurred in carrying on a business for the purpose of deriving assessable income), because most routine business expenditure satisfies both limbs. But the first limb is logically prior to the second limb (which is why Parliament put it first), because it does not require the taxpayer to be carrying on a business. That is, the first limb will allow a deduction for both:
 - (a) Expenditure incurred, in the course of carrying on a business, for the purpose of deriving assessable income; and

(b) Expenditure incurred, by a taxpayer not carrying on a business at all, for the purpose of deriving assessable income.

- 2.5 As for the second limb, its purpose is to allow a deduction for expenditure that is not incurred in deriving assessable income (and so is not deductible under the first limb) but is incurred in carrying on a business for the purpose of deriving assessable income. In other words, so long as the business is carried on for the purpose of deriving assessable income, the expenditure is deductible under the second limb, even if it would not be deductible under the first limb.
- 2.6 The draft statement, by concentrating on the second limb, attaches too much significance to whether the taxpayer is carrying on a business. For instance, paragraph 58 seems to suggest that an expense will only be deductible (or depreciable, as the case may be) if the taxpayer is carrying on a business. That is misleading, because expenditure is deductible under the first limb so long as it is incurred in deriving assessable income, even if the taxpayer is not carrying on a business (and even if the taxpayer has never carried on a business). Thus, the fact that a taxpayer has ceased to carry on business will not necessarily deprive it of its entitlement to deduct its expenditure. It would be helpful if the draft statement could be revised accordingly.

3 Likelihood and intention

- 3.1 Paragraph 73 begins (emphasis added):

Where a business is reducing its activities and so temporarily stops using the property for deriving its income, then whether there has been a change of use will depend on the facts. Whether the property is still available for use in that case depends on the **likelihood** of the business using that property again and whether the property is actually available to be used. If the business intends to only temporarily restrict its activities, then the property could be said to still be available for use.

- 3.2 It is often the case that an objective factor – such as the likelihood of a business using an asset again – is powerful evidence of the taxpayer’s intention. However, the test is the intention, not likelihood.

4 Employees working on capital assets

- 4.1 At paragraph 36, the draft statement refers to the principle illustrated by the Christchurch Press case: that, although wages are usually deductible, they are not deductible if they are effectively part of the cost of acquiring or creating a capital asset. However, some of the language used in the draft statement is potentially misleading. For instance, paragraph 36 begins:

Deductibility will also depend on whether the person is engaged to undertake work on a capital asset for the business.

- 4.2 This is potentially misleading in that, for example, a person employed to maintain a capital asset could be said to be working on it. The draft statement could be interpreted as meaning that the wages paid to persons employed to maintain capital assets are not deductible –

which is not the case. It would be helpful if the draft statement could be revised to define more precisely the circumstances in which wages are not deductible.

5 Cancellation of contracts

5.1 Paragraphs 42 to 50 of the draft statement deal with where a taxpayer has incurred expenditure in connection with the cancellation of a contract. It is correct, as the draft statement says at paragraph 49, that expenditure is generally not deductible if:

... the cancelled contract was of such a nature and significance to the taxpayer's activity so as to form part of the taxpayer's profit-making structure.

5.2 As to expenditure that is deductible, paragraph 50 states:

Accordingly, a business can deduct costs for cancelling or breaching contracts and on its legal fees where the contract or cause of action relate to the income earning process of the business and are not capital.

5.3 This, too, is correct, but it could be clarified. The principle could be more simply stated as being:

A payment made to cancel a contract is generally deductible if the contract is an ordinary trading contract, most obviously a contract:

- (a) for the sale of trading stock, or
- (b) for the purchase of trading stock, or
- (c) for the supply of services which it is the taxpayer's business to supply, or
- (d) for the purchase of services in the ordinary course of the taxpayer's business.

6 Separate assets

6.1 Paragraph 58 of the draft statement begins:

An important step is to identify whether the particular item of property is a separate asset or part of a larger asset.

6.2 The draft statement could be improved by making it more precise as to the consequences that flow from this distinction. If the item is part of some larger depreciable asset, then the expenditure should be treated as part of the cost of the larger asset and depreciable accordingly. But if the item is not part of a larger asset, the expenditure might be either deductible or depreciable, depending on the circumstances. The draft statement currently deals with the second possibility, but not the first.

7 Examples

7.1 The examples may not be as useful as intended, as they concern individuals carrying on businesses that would likely, in the real world, be carried on by companies.

7.2 For example, "Carla's Construction Company" is presumably a company incorporated under the Companies Act, though its name does not include "Ltd". The conclusion that "Carla can claim deductions" (in respect of some of the expenditure in the example) suggests that

perhaps Carla herself can claim deductions. We assume this is because Carla's Construction Company is a corporation, and she can claim deductions on its behalf, but this seems unnecessarily unclear.

Nāku noa, nā

A handwritten signature in cursive script, appearing to read "Arti Chand".

Arti Chand
Vice-President