

**INTERPRETATION STATEMENT**

# **Income Tax – deductibility of costs incurred due to COVID-19**

Issued: 14 April 2022

**IS 22/01**

This statement considers whether a business may claim an income tax deduction for costs it incurs due to the COVID-19 pandemic. The Commissioner is aware that there has been some uncertainty about whether COVID-19-related costs incurred by businesses are deductible. This statement aims to help businesses decide whether these costs are deductible.

This statement applies to a business that is being carried on. If your business has ceased operating (either temporarily or permanently) due to the COVID-19 pandemic, please see [IS 21/04](#) "Income tax and GST – deductions for businesses disrupted by the COVID-19 pandemic", *Tax Information Bulletin* Vol 33, No 9 (October 2021): 8.

All legislative references are to the Income Tax Act 2007.

**RELATED ITEMS**

- [IS 21/04](#): Income tax and GST – deductions for businesses disrupted by the COVID-19 pandemic

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## Summary

1. The COVID-19 pandemic has caused significant disruption to businesses. Many businesses have had to incur additional costs (that might be described as unusual or abnormal) due to the pandemic. In addition, businesses may be incurring depreciation loss or other holding costs on assets that they cannot use because of COVID-19 restrictions or temporary downsizing.
2. The fact a cost is unusual does not, of itself, mean the cost is not deductible. Ordinary deductibility principles apply. Whether a cost is deductible depends on its relationship (or nexus) with the business and the way the business earns its income. A cost will be deductible where it has a relationship with the way the business earns its income, and

also where it is not disallowed by one of the general limitations (such as the capital limitation).<sup>1</sup>

3. Deductions are still available in situations where assets are not being used in the business temporarily (due to COVID-19 restrictions or temporary downsizing). This is provided the assets remain available for use in the business when restrictions ease.
4. This item discusses the following types of costs a business might incur due to the pandemic:
  - costs relating to its employees, such as:
    - bringing employees into New Zealand or retaining teams who are unable to work
    - providing accommodation to keep teams housed together in a bubble (during COVID-19 restrictions)
    - providing employees with vouchers or incentive payments
    - redundancy payments
  - costs incurred on terminating contracts and legal fees
  - repairs and maintenance costs or depreciation loss on assets or equipment not being used (due to COVID-19 restrictions or a temporary reduction in business activities)
  - premises costs including lease break fees and costs incurred to keep people appropriately distanced within a work place.
5. This item sets out principles to help a business decide whether a particular cost has a relationship with the way the business earns its income, and also whether the cost might be capital (and non-deductible). These principles can also be applied to other costs incurred due to COVID-19 that are not specifically mentioned.
6. Examples included from [88] explain how the law applies to certain scenarios involving a hotel chain, café, construction company, tourism business and an office.

## Introduction

7. Businesses have incurred a wide range of additional costs due to the COVID-19 pandemic. Common examples include costs incurred to set up premises for physical distancing, cancel or vary contracts or to enable employees or contractors to enter or

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<sup>1</sup> The necessary relationship (or nexus) with a business is set out in s DA 1. The general limitations are set out in s DA 2.

remain in New Zealand. In addition, businesses are still incurring ongoing costs such as depreciation loss on assets that are temporarily unable to be used due to COVID-19 restrictions.

8. There has been some uncertainty on how these costs are treated for tax purposes. This statement explains whether such costs are generally deductible. Deductibility depends on whether the cost has the required relationship or nexus with the carrying on of the business and whether the cost is capital in nature. In cases concerning depreciable property or repairs and maintenance, it is not clear whether the property is still used or available for use by the business in deriving its income.

## Whether the cost has a relationship with the way the business earns its income

### Section DA 1 – general rule allowing deductions

9. Section DA 1 contains the general rule allowing deductions. This rule is known as the general permission:

#### DA 1 General permission

##### *Nexus with income*

- (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
  - (a) incurred by them in deriving—
    - (i) their assessable income; or
    - (ii) their excluded income; or
    - (iii) a combination of their assessable income and excluded income; or
  - (b) incurred by them in the course of carrying on a business for the purpose of deriving—
    - (i) their assessable income; or
    - (ii) their excluded income; or
    - (iii) a combination of their assessable income and excluded income.

##### *General permission*

- (2) Subsection (1) is called the general permission.

10. 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.
11. A person (whether or not they are in business) may claim deductions for expenditure incurred in deriving their income under the first limb of s DA 1. This item addresses deductions that are available to businesses, which could be under either the first or the second limbs of s DA 1. Accordingly, businesses could claim a deduction under the first limb for expenditure or loss incurred in deriving their income, or under the second limb for expenditure or loss they incur in the course of carrying on their business for the purpose of deriving income.
12. Under the second limb, the expenditure or loss must be incurred "in the course of carrying on" a business. A sufficient relationship (or nexus) must exist between the expenditure and the business that is being carried on (*CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)).

## General deductibility principles for costs incurred by a business

13. The following general principles are drawn from case law on s DA 1.<sup>2</sup>
14. For a cost to be deductible, a relationship (or nexus) must exist between the cost and the person's income-earning process. It is a question of fact and degree in each case (*Banks* and *Buckley & Young*).
15. The true character of the cost and its relevance to the taxpayer's income-earning process are relevant for deciding whether that relationship exists. This includes looking at the scope of the taxpayer's income-earning process (that is, how their income is earned) and the factual situation at the time the cost is incurred (*Banks* and *Buckley & Young*).
16. For a cost to be deductible, it does not need to be linked to a particular item of income. Also, income does not need to be produced in the same year the cost was incurred (*Commissioner of Taxation (NSW) v Ash* (1938) 5 ATD 76 (HCA) and *Eggers v CIR* (1988) 10 NZTC 5,153 (CA)).
17. The business must incur the cost as part of its operations to earn its income (*FCT v Wells* 71 ATC 4,188 (HCA) and *John Fairfax and Sons Pty Ltd v FCT* (1959) 101 CLR 30

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<sup>2</sup> For more detail on deductibility principles, see IS 14/04: Income tax — deductibility of company administration costs", *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5.

(HCA)). Whether a business incurs a cost as part of its operations to earn income is usually determined objectively. However, subjective matters may be relevant where the cost was incurred by choice and the relationship between the cost and the business operations is more indirect and remote (*Banks; Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4,542 (FCAFC); *Fletcher v FCT* 91 ATC 4,950 (HCA); *Putnin v FCT* 91 ATC 4,097 (FCAFC) and *Schokker v FCT* 99 ATC 4,504 (FCAFC)).

18. Longer-term objectives can be considered. In relation to expenditure incurred in carrying on a business, a deduction is allowed for costs incurred to protect or advance a business, or to avoid or reduce expenditure (*Europa Oil (NZ) Ltd (No 2) v CIR* (1974) 1 NZTC 61,169 (CA) and *Cox v CIR* (1992) 14 NZTC 9,164 (HC)).
19. Applying these concepts in the context of costs incurred due to the pandemic:
  - how the business earns its income and whether the cost relates to that process is important
  - the factual situation at the time the cost is incurred is relevant
  - a cost does not need to be linked to a particular amount of income, or even be incurred in the same year
  - costs incurred to protect a business can be deductible.

## Whether any limitations to deductibility apply

20. If a cost satisfies the nexus test above, the next step is to consider whether any general limitations apply to deny a deduction.

### Overview of the limitations to deductibility

21. Even where a deduction is available under s DA 1, it may be disallowed under the limitations to deductibility set out in s DA 2. Relevantly, under s DA 2(1) a person is denied a deduction to the extent the cost is of a capital nature (the capital limitation).
22. This statement focuses on the capital limitation as this is the most common limitation to deductibility for businesses incurring additional costs due to the pandemic. However, there are other limitations to deductibility such as the private limitation. Businesses need to ensure no other limitations apply to their particular fact situation.

## When the capital limitation applies

23. In *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 (HCA), Dixon J described (at 359) the distinction between capital and revenue expenditure as corresponding with the distinction:

... between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.

24. Dixon J identified three matters to be considered (at 363):

- (a) the character of the advantage sought, and in this its lasting qualities may play a part,
- (b) the manner in which the advantage is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and
- (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure further use or enjoyment.

25. Dixon J considered the character of the advantage sought, the manner in which it is to be used, and the means to obtain it were relevant factors for deciding whether an expense was capital in nature.

26. In *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA), Dixon J again summarised the distinction between capital and revenue expenditure (at 647):

The contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organisation and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.

27. His Honour stated (at 648) that determining whether expenditure was capital or revenue:

depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process.

28. Similarly, in *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 (PC), Viscount Radcliffe stated (at 960):

Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve...

29. The principles from these cases were adopted by the Privy Council in *BP Australia Ltd v FCT* [1965] 3 All ER 209 (PC) which in turn was adopted in several New Zealand cases.<sup>3</sup> In *Wattie* (PC) the Privy Council noted that the approach adopted in *Hallstroms* had been recognised as exemplifying the “governing approach” in New Zealand.<sup>4</sup>

30. The courts have identified various factors to help decide whether a cost is capital or revenue:

- the need or occasion for the expenditure
- whether the expenditure is recurrent
- whether the expenditure creates an identifiable asset
- whether the expenditure creates an advantage that is of enduring benefit to the business
- whether the expenditure is on the profit-making structure or on the profit-making process of the business
- whether the source of the payment is from fixed or circulating capital
- the treatment of the expenditure according to the ordinary principles of commercial accounting.

31. Many of these factors overlap and some carry more weight in different circumstances. Also, these factors are helpful as a starting point, but a judgement must still be made about whether the expenditure is capital or revenue. This can be done by looking at the facts as a whole and determining which factors carry the most weight in light of those specific facts. Also some of the above factors may now have limited relevance.

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<sup>3</sup> For example, *CIR v LD Nathan & Co Ltd* [1972] NZLR 209 (CA), *Buckley & Young, CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA), *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206 (HC), *CIR v Wattie* (1998) 18 NZTC 13,991 (PC), *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA), and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981 (CA).

<sup>4</sup> This general approach was similarly recognised by the Court of Appeal in *CIR v Trustpower* [2015] 3 NZLR 658 (and was not discussed in any further detail by the Supreme Court on appeal in *Trustpower v CIR* [2017] 1 NZLR 155).

32. For example, as stated by the Court of Appeal in *CIR v Trustpower*, accounting treatment is not determinative because the Income Tax Act 2007 prescribes what deductions are permissible for taxation purposes, irrespective of financial accounting principles. In this respect, it is noted that accounting may treat some abnormal expenses on capital assets as not able to be capitalised for accounting purposes. This treatment is not determinative for tax purposes, and general deductibility principles need to be applied, as outlined in this statement.

## Deductibility of specific types of costs

33. The above analysis is now applied to certain types of costs a business may incur due to the COVID-19 pandemic. The costs mentioned in this statement are generally ones that a business would not typically incur before the pandemic (although some costs such as legal fees would be incurred in other situations). The statement also discusses more common costs such as depreciation loss, where the pandemic has impacted on the use of property. This statement does not cover every type of cost that arises from the pandemic but sets out general principles that may be applied to other situations.

## Employee costs

34. Due to the pandemic, a business might incur the following types of costs on its employees:
- relocating new or existing employees to New Zealand, including obtaining visas, exemptions, places at managed isolation and quarantine facilities and transport
  - retaining teams in New Zealand where they may be unable to work (such as paying retainers to contractors) or keeping teams housed together in a bubble
  - payments to employees such as vouchers for going back to the office, incentive payments for vaccinations or the provision of mental health and wellbeing services
  - redundancy payments.
35. In general terms, costs that relate to the employees of a business will likely have a relationship with how the business derives its income.

## Costs for relocating employees, paying retainers or providing accommodation

36. Whether costs incurred to bring employees (or contractors) into New Zealand are deductible depends on the facts. Costs relating to hiring new employees relate to the

carrying on of the business, and so the general permission would be satisfied. The question turns on whether the capital (or any other) limitation would apply.

37. For example, deductibility will depend on whether the person is engaged to undertake work to bring into use a capital asset for the business. In that case, the payments also take that capital nature. This occurred in *Christchurch Press*. In that case, the taxpayer was a newspaper publisher who employed tradespeople to service and maintain printing presses and other machinery used in producing the newspaper. Some were employed to install and wire up new capital equipment and replace electrical wiring. The court found that the purpose of the labour for which wages were paid was the installation of a capital asset. Gallen J concluded that the expenditure on the employees was as much a part of the capital asset as it would have been if a contractor was paid to install the equipment. He said that if a contractor had been so paid, it could not have been said that the payment was not a capital payment. In addition, the regular payment of the wages did not mean that the expenditure was necessarily of a revenue nature. The work was done to bring into use new equipment that was both an asset and intended to be of enduring benefit.
38. The same reasoning applies for costs incurred in keeping contractors in New Zealand (such as paying a retainer when they are unable to work due to COVID-19 restrictions), and in housing employees together as a bubble when there are COVID-19 restrictions in place. That is, generally these costs would be deductible unless the employee or contractor is engaged to bring into use a capital asset for the business. Whether these costs are deductible will depend on the specific fact situation, applying the principles previously discussed.
39. Further information on employee relocation costs can be found in IS 10/06, "Deductibility of business relocation costs" *Tax Information Bulletin* Vol 22, No 8, September 2010 at 20. There are also specific provisions a business should be aware of in relation to the relocation of employees in subpart CW of the Act, and in relation to accommodation costs in subparts CE and CW.

## **Incentive payments and vouchers**

40. Incentive payments to employees are generally deductible to an employer if they are made in relation to the employee's employment in the business. For example, a business may wish to incentivise employees to get vaccinated to lessen the risk of future business disruption. Such payments would form part of the employee's employment income.
41. In addition, non-monetary benefits provided to employees (which may be subject to fringe benefit tax – such as vouchers encouraging staff back to the office) are also generally a deductible expense to an employer (including any FBT payable).

## Redundancy payments

42. Payments made to an employee could include redundancy or termination payments. These types of payments are specifically deductible to a business where they satisfy s DC 1 (which allows deductions for certain lump sum payments paid by businesses for ending employment or service).

## Contract and legal costs

43. Due to the pandemic, a business might incur the following types of costs relating to contracts or legal fees:

- costs for terminating contracts, including any settlement payments for breach of contract
- legal costs incurred in contractual or employment disputes.

44. Where a person's total legal expenses are equal to or less than \$10,000 in an income year, the person is allowed a deduction under s DB 62 for the expense provided that the nexus requirement in s DA 1 is satisfied. This provision overrides the capital limitation.

45. Contractual and legal expenses incurred on an income-producing aspect of the business would satisfy the nexus test. However, deductions are not available in situations where legal expenses (exceeding \$10,000) or contractual expenses relate to capital items. This will depend on the nature of the contract or the matter to which the legal services relate.

46. While in the context of taxability of receipts, in *The Federal Coke Co Ltd v FCT* 77 ATC 4255 Brennan J said:

the character of a cause of action discharged by a payment will ordinarily determine, unless it be a sham transaction, the character of the receipt of the price or payment. ... Thus, when moneys are received in consideration of surrendering a benefit to which the recipient is entitled under a contract, it is relevant to enquire whether or not that benefit was a capital asset in his hands.

47. For payments for cancelled contracts and legal fees, the underlying cause of action or contract is what determines whether a payment is capital or revenue. While the above comment relates to receipts, it applies equally to expenditure incurred.
48. In *Fullers Bay of Islands Ltd v CIR* (2006) 22 NZTC 19,716 (CA) the taxpayer provided sea and land transport services and wanted to expand its business. The taxpayer submitted a tender for a passenger ferry service and was initially the preferred bidder. However, a competitor's bid was accepted, and the tender round was cancelled. The

taxpayer sought damages or the transfer of the ferry service contract. The taxpayer's claims were dismissed, and the taxpayer claimed a deduction for its legal fees. The court considered that the need or occasion for the expenditure was the taxpayer's desire to expand its business. The cost of creating, acquiring or enlarging the permanent structure by which income is produced was capital in nature. Accordingly, the legal fees were not deductible.

49. The character of a settlement payment can be determined by the nature of the claim for payment. The nature of such claims could be for the cancellation of a supply contract, a loss of an ability to earn profits or the loss of a capital asset.
50. The courts have tended to focus their enquiry on whether 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. The more fundamental to the taxpayer's activity a particular contract is, the more likely it is that a payment relates to an enduring asset that forms part of the profit making structure. For example, in *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9,101 (CA) the key to categorising a supply and marketing contract as capital or revenue was the nature and significance of the contract in the operations of the business.
51. 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. This will depend on the nature of the contract or the underlying cause of action and its relationship to the business.
52. In summary, a payment made to cancel a contract is generally deductible if the contract is an ordinary trading contract such as for the sale or purchase of trading stock, or for services that are supplied or purchased in the ordinary course of the business.

## Assets and equipment

53. Due to the pandemic, a business might incur the following types of costs on their assets or equipment:
  - repairs and maintenance on assets or equipment not being used due to COVID-19 restrictions or a temporary reduction in business activities
  - re-activating costs so equipment can be put back into use
  - ongoing depreciation loss for depreciable assets that are not being used due to COVID-19 restrictions or a temporary reduction in business activities
  - security costs.

## Repairs and maintenance expenditure

54. Repairs and maintenance of capital assets that do not improve the asset are generally deductible. However, where they result in an improvement, then the costs are capitalised.<sup>5</sup> Where the assets are temporarily unavailable for use in deriving income due to COVID-19 restrictions or temporary downsizing of the business, deductions for repairs and maintenance are still generally available.<sup>6</sup>
55. Similarly, costs incurred in re-activating equipment so it can be put back to use would also generally be deductible (provided it did not result in an improvement of the asset). Also, costs involved in ensuring the asset remains secure when not being used (such as security or monitoring costs) would similarly generally be deductible.
56. The above principles apply on the basis that the business is still being carried on and any disuse of the asset is only temporary due to effects of the pandemic.

## Depreciation loss

57. Section DA 1 clarifies that a deduction is available for an amount of depreciation loss, to the extent to which it is incurred in deriving income, or in the course of carrying on a business for the purpose of deriving its income.
58. Depreciation loss deductions effectively allow deductions for the cost of a capital asset, which are spread over the life of the asset. Subpart EE applies to quantify the amount of depreciation loss that is deductible. Section EE 1 provides that a person has an amount of depreciation loss where the person owns an item of depreciable property which is used or available for use by the person in the income year, and the amount of loss is calculated under subpart EE.
59. "Depreciable property" is defined in s EE 6 as property that might be expected to decline in value while used or available for use in either deriving assessable income or carrying on a business for the purpose of deriving assessable income. Generally, most assets of a business and building fit-out would be depreciable property, and so depreciation loss deductions for such property are calculated under subpart EE.
60. An important step is to identify whether the particular item of property is a separate asset or part of a larger asset. This could be relevant for assets such as protective

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<sup>5</sup> See for example, *Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702 (PC), *Auckland Trotting Club v CIR* [1968] NZLR 967 (CA), *Poverty Bay Electric Power Board, Case T43* (1998) 18 NZTC 8,287 (TRA), *Case L68* (1989) 11 NZTC 1,398 (TRA).

<sup>6</sup> See Example 1 in "IS 12/03 Income tax - deductibility of repairs and maintenance expenditure", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68. See IS 12/03 more generally for more information on deductibility of repairs and maintenance expenditure.

plastic barriers that may be erected in a workplace (e.g. at reception desks). If the item is part of a larger depreciable asset, then expenditure on that item is either depreciable as part of the cost of the larger asset or may be deductible if it comprises repairs and maintenance of that asset. If the item is a separate asset, then expenditure may be either deductible or depreciable, depending on the circumstances.

61. The Commissioner has provided guidance for doing this by way of a three-step test set out in [IS 10/01](#) "Residential rental properties – Depreciation of items of depreciable property".<sup>7</sup> While that statement relates to residential property, the same principles apply for other assets. In summary, the steps are to determine whether the item:
- is in some way attached or connected to the larger asset
  - is an integral part of the larger asset (such that the larger asset would be incomplete or unable to function without it)
  - is built-in or attached or connected in such a way that it is part of the "fabric" of the larger asset.
62. As noted earlier, this statement applies only to businesses that are being carried on. It does not apply to businesses that are ceasing (temporarily or permanently). For such businesses, see [IS 21/04](#): Income tax and GST – deductions for businesses disrupted by the COVID-19 pandemic", *Tax Information Bulletin* Vol 33, No 9 (October 2021): 8. Accordingly, the relevant depreciation loss is still incurred in the course of carrying on a business for the purpose of deriving income until such time as a business ceases (or the asset is no longer used or available for use in the business). This is the case even if a business may be temporarily ceasing in the sense that income is not being derived at that particular point in time due to COVID-19 restrictions, as long as the business is still being carried on for the purpose of deriving income. Ultimately, whether a business has ceased is a question of fact. Examples three, four and seven of [IS 21/04](#) illustrate this point and depreciation loss would remain available.
63. Where property is no longer used or available for use in the business then deductions for depreciation loss are no longer available. This requires a change of use calculation. Under the change of use calculation, the property is treated as being disposed of for its market value. The losses claimed are compared with the loss that the taxpayer would incur on the deemed disposal of the property. If the loss is less than the depreciation deductions claimed, an adjustment must be made to recover that amount.
64. This gives rise to an issue where property is not being used by the business due to COVID-19 restrictions or temporary downsizing. While it might be clear that the

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<sup>7</sup> *Tax Information Bulletin*, Vol 22 No 4 (May 2010), 16.

property is not being used, the question is whether the property is still available for use during this time.

65. The *Concise Oxford English Dictionary* (11th ed, 2012) defines the terms as follows:

**available** adj **1** able to be used or obtained. **2** not otherwise occupied. free

**use** take, hold or deploy as a means of achieving something.... Treat in a particular way.

66. Accordingly, provided that property is not otherwise being used and is able to be used by the business, then it appears the property will be “available for use” in the business for the purposes of the depreciation regime.

67. While in a different context, the Court of Appeal in *Trustpower* discussed the meaning of “available for use” at [27]:

Clearly, once the resource consents were granted, they were “available for use” by Trustpower. The fact that they were not being used and would not be used unless and until Trustpower decided to use them and obtained land access did not mean that they were not “available” for use. The expression “available” simply means “capable of being used”. Once Trustpower decided to use them and obtained land access, they would be used. Prior to that they were available for that purpose.

68. In *Hunter v C of T* [1937] NZLR 204 (HC) Smith J noted that the question was whether the depreciable property “remains a part of the whole producing asset for the time being”. Smith J noted that a manufacturer may be unable to use machinery due to supply issues but that machinery still makes up his manufacturing asset “ready to play its part so soon as supplies became available”.

69. In *Mason v C of T (NSW)* (1935) 3 ATD 181, it was held that depreciation for a fleet of buses was available even though the buses were kept off the roads. The court said that the buses were used “as far as they were able to” for the purpose of carrying on a business, and compared it to the situation where cars were available for hire but there was no custom. The court noted that there was still wear and tear on the buses, which may result from “simply keeping them available for custom in the course of the business”.

70. Consistent with this, s EE 10 provides that an item of depreciable property is treated as being available for use while subject temporarily to repair or inspection, if it was used or available for use immediately before going for repair or inspection.

71. Also, s EE 39 applies when a person has depreciable property that is no longer used nor intended to be used, and is not disposed of. The section provides that a person will have an amount of depreciation loss if:

- they no longer use the item in their business

- they do not intend to use the item in carrying on the business for the purpose of deriving assessable income and
  - the costs of disposing of the item would be more than any consideration they could derive from disposing of it.
72. This section indicates that an intention to use the property in the business is sufficient for the property to still be considered available for use.
73. This, combined with the nature of change of use calculations, imply that the change of use is intended to be a permanent one. The change of use calculation applies to ensure that the person has not claimed a higher or lower deduction than they are entitled to at the time the property is removed from the tax base. It operates to ensure that the property owner was appropriately taxed in relation to that asset while it was used for business purposes.
74. Where property cannot be used either due to COVID-19 restrictions or where businesses have temporarily reduced some of their operations due to the pandemic, any disuse of the property is temporary. However, this does not mean that the property is unavailable or there is no intention to use the property in the business. This is contrasted to where the property has left the tax base (e.g. it is sold, discarded or used for private use). For instance, where the business decides to sell the property or downsizes more permanently and no longer requires some assets, there is no question that there will be a change of use of that property.
75. Accordingly, where depreciable property is available for the business to use but cannot be used due to temporary COVID-19 restrictions, that property is still considered to be available for use in the business for the purposes of the depreciation regime. This is because, as soon as the restrictions are lifted, that property will be able to be used in the business again. It is not otherwise being used. It would make no sense to treat this property as having been taken out of the tax base when any disuse is merely temporary.
76. 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 whether the business intends to use 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. However, where the business intends the downsizing to be permanent and does not intend to use the property in the business again, then it would likely be considered to no longer be available.

## Premises expenses

77. Due to the pandemic, a business might incur the following types of costs in relation to its premises:
- payments made to terminate a lease (by the lessee)
  - incentive payments to encourage new tenants (by the lessor)
  - additional costs incurred to keep teams appropriately distanced within a work place, including changes to relevant fitout (such as erecting barriers)
78. Section DB 20C provides that a person who pays an amount for the surrender or termination of a lease is allowed a deduction for the amount (provided that nexus is satisfied).
79. Similarly, s CC 1B confirms that consideration for the grant, renewal, extension or transfer of a lease is income to the recipient of a payment, and s DB 20B provides that a deduction is available to the payer.
80. Costs incurred to keep teams appropriately distanced at work would likely form part of the general operational costs of a business, but this depends on whether the measures put in place involve capital assets.
81. For example, costs incurred in rearranging workspaces or costs of providing face masks, hand sanitisers, rapid antigen tests and cleaning equipment would likely be deductible. See Example 5 regarding these types of costs.
82. However, some costs would relate to capital assets. An example of capital expenditure is the erection of barriers at reception desks. This could be a depreciable asset in itself, form part of another depreciable asset (e.g. when permanently attached to a reception desk) or even potentially become a building fixture. See Example 1 below, regarding when a barrier would form a separate item of depreciable property.
83. Accordingly, deductibility or the availability of depreciation loss would depend on the particular item of property and general principles would apply.
84. A business may also choose or need to relocate due to the pandemic. There are various expenses that may be incurred when a business relocates, and generally deductibility depends on whether the relocation is undertaken to expand the business operations (which would be capital). Where a relocation does not expand the business operations and is not for the owner's private reasons, then expenses are likely deductible.
85. IS 10/06: "Deductibility of business relocation costs", *Tax Information Bulletin* Vol 22, No 8 (September 2010): 20 states:

On balance, the Commissioner concludes that business relocation expenditure will be deductible where the principal purpose of the relocation is to maintain and preserve the existing structure of the business. The Commissioner does not consider that a move to new, and possibly larger, premises is necessarily expansionary (and therefore capital expenditure). Where the principal purpose of a relocation is merely to enable a business to carry on operating in much the same way as it did before the move, and not to extend or enlarge the structure of the business, then the capital limitation will not prevent a deduction. This will be the case even if the new premises are larger or if there is a possibility that the business may make profitability gains over time as a result of the relocation. The Commissioner does not consider that business relocations that are made to take account of the organic growth or decline of a business are made for the purpose of extending or enlarging the structure of the business.

86. For more details of deductibility of business relocation costs generally, see IS 10/06.

## Examples

87. The principles discussed above are applied in the following five examples to illustrate how they affect the deductibility of COVID-related expenditure incurred by businesses.

### Example 1 - Boutique hotel chain temporarily reduces operations

Hine's Hotels Ltd (HHL) is a boutique hotel chain with four hotels across the North Island.

In late 2020, HHL was planning on constructing a fifth hotel in Queenstown and had a site, relevant plans and consents, and had engaged a construction firm to begin work. Foundations and the concrete base were laid in July 2021.

Shortly after beginning this initial work, HHL realised it would be months before tourism would pick up, so cancelled the construction contract (although was hoping to restart work again in the future). The contract set out how to calculate a termination fee, and HHL paid the agreed amount.

The other hotels were running at reduced capacity and the Auckland hotel had no guests due to COVID-19 restrictions. HHL decided to temporarily close the Auckland hotel for three months while restrictions were in place. HHL set up monitored security cameras with a security firm and continued to pay rent, rates, power, water and insurance. HHL had to make some of the positions in Auckland redundant.

HHL engaged a cleaning company to keep the Auckland premises clean and check equipment was usable, and put up temporary removable plastic barriers at the reception desks. When restrictions eventually eased, the Auckland hotel re-opened.

HHL can claim deductions for these costs:

- redundancy payments
- security and cleaning costs for the temporarily closed hotel
- rates, power, water and insurance on the temporarily closed hotel
- depreciation loss on depreciable property in the temporarily closed hotel provided the depreciable property was available for use before being closed and remains usable.

For depreciation purposes, HHL applied the three step test and identified that the removable temporary barriers did not form part of the reception desks but were separate depreciable assets.

The expenditure incurred on cancelling the contract is not deductible as it relates to a capital asset. If the hotel construction was abandoned, HHL may be able to claim deductions for feasibility expenditure under ss DB 66 and DB 67.

### **Example 2 - Cafe downsizing and relocating**

Paolo's Pies Ltd is a café and pie bakery business in central Auckland that was a quick lunch stop for office workers. During strict COVID-19 restrictions, the café was unable to open. Once restrictions eased, Paolo's Pies opened for takeaways and sold cook-at-home family pie packs. The pie packs were a success and after several months Paolo's Pies decided it could operate out of a smaller kitchen.

Paolo's Pies found a smaller commercial kitchen to operate from out of the city centre and relocated the pie bakery there to save costs. Paolo's Pies terminated the central city lease, and had to pay an early termination fee.

Paolo's Pies had a supply contract under which it supplied pies to Timmy's Takeaways Ltd. Paolo's Pies tried to cancel that contract to focus on the pie packs. The contract was only a supplement to Paolo's Pies' income and had not been substantial to the business. However, it was a substantial supply contract to Timmy's Takeaways, who would be left without any pies to sell if the contract were cancelled.

Timmy's Takeaways engaged a lawyer to enforce the remaining period of the contract and Paolo's Pies also had to engage a lawyer. They ultimately settled on Paolo's Pies providing pies for a further two months so Timmy's Takeaways could find a new supplier.

Paolo's Pies can claim deductions for these costs:

- legal costs incurred on the cancelled pie contracts, since these contracts were not an enduring asset of the business and did not form an integral part of its profit making structure.
- relocation costs to smaller premises, as Paolo's Pies is not expanding the business structure but simply finding more fit-for-purpose premises
- the payment made for terminating the existing lease.

Timmy's Takeaways can deduct its legal costs as its total legal costs for the income year were less than \$10,000. However, if its total legal costs exceeded this amount, the fees would not be deductible if the pie supply contract was capital in nature.

### Example 3 - Construction company with employee expenses

Carla's Construction Company Ltd (CCCL) is a medium-sized construction company that hires a mix of employees and short-term contractors on particular sites.

CCCL was working on a difficult build site that required specialised engineers, but was struggling to find appropriately qualified staff in New Zealand during the pandemic.

CCCL found two new employees based in Australia. CCCL obtained work visas and border exemptions for them along with two spots in managed isolation and quarantine facilities. CCCL paid these costs to help the new employees with their relocation to New Zealand.

CCCL had a contractor in Auckland who was unable to work during the COVID-19 lockdown. This contractor was involved across multiple projects and couldn't be replaced, so CCCL paid him a retainer so he did not look for other contracting work in the meantime.

CCCL also had a group of young labourers on a site in Hamilton. To ensure they could continue working once alert levels allowed, CCCL put them up in temporary accommodation during the lockdown.

CCCL can claim deductions for these costs:

- relocation expenses for employees moving to New Zealand and the cost of managed isolation and quarantine facilities
- the retainer for the contractor
- accommodation expenses to temporarily keep labourers in a bubble.

Note that deductions are not available to the extent that any contractors or employees were engaged in constructing a new capital asset for CCCL. That was not the case, so the full deductions were available.

#### **Example 4 - Jetboat operator with maintenance expenses and depreciation**

Jed's Jetboats Ltd (JL), is a jet boat tourism business in Queenstown. During the last two years, JL had a considerable decrease in customers because of the pandemic. During the COVID-19 restrictions JL could not operate at all, but even when restrictions were eased the business struggled. JL was still busy in the school holidays and over summer, but for the rest of the year most of the boats were in storage. Jed hoped business would pick up, but supplemented his income by taking on other jobs over winter.

JL paid for a secure storage facility to store the unused jetboats until there were enough customers to bring them back out. JL kept the boats regularly maintained and serviced so they would be able to immediately be used when needed. Jed did not have the mechanical skills to do the maintenance himself, so JL paid for regular maintenance work to be undertaken. Just prior to re-using the jet boats JL paid for additional maintenance and tests to ensure the boats were safe.

JL can claim deductions for these costs:

- maintenance costs
- storage costs
- additional maintenance and tests before re-using the boats (to the extent that this work did not result in improvements to the boats).

The stored boats, while not used, are still available for use as soon as business picks up so deductions for depreciation loss remain available. However, when JL makes a decision to retire or sell a boat, it will need to make a change of use calculation for depreciation purposes.

#### **Example 5 - Web company with employee expenses**

Wanda's Web Services Ltd (WWSL) is a small business that creates and runs websites for other small businesses. WWSL employs five full-time staff and they have a small office space on the outskirts of Wellington city.

WWSL's staff all worked from home during the lockdowns in the pandemic. To show appreciation to the staff, WWSL offered them vouchers for a discounted rate on mental health and wellbeing support with therapists.

Once staff were allowed back in the office, WWSL gave them all prezy cards and meal vouchers to encourage them back. WWSL also ensured the office, while small, enabled staff to be socially distanced by changing the layout of desks and also supplied the office with hand sanitiser, masks and rapid antigen tests.

One of WWSL's clients required all visitors to be vaccinated. WWSL had one staff member, Sherry, who was critical to the work being done for that client but was not yet vaccinated. WWSL offered Sherry an inducement payment of \$100 per vaccination, which Sherry ultimately accepted.

WWSL can claim deductions for these costs:

- prezy cards and vouchers for mental health and wellbeing support and to encourage workers back into the office
- masks, hand sanitiser and rapid antigen tests to ensure a healthy workplace
- vaccination incentive payments.

FBT may be payable on the provision of some benefits to employees. If so, any FBT paid is also deductible to WWSL.

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## About this document

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