Interpretation Statement IS 10/06

DEDUCTIBILITY OF BUSINESS RELOCATION COSTS

1. This Interpretation Statement considers the deductibility of business relocation expenditure incurred when a business relocates from one location to another location within New Zealand.

2. The Commissioner has previously published two policy statements on the deductibility of business relocation expenditure: "Costs allowable when moving business", Public Information Bulletin 51 (September 1969), p 8, and "Setting up or moving a business—what costs may be allowed", Public Information Bulletin 64 (October 1971), p 6. The content in those two items that relate to the deductibility of business relocation costs does not reflect the Commissioner's current view of the law, so, to that extent, the items have been withdrawn effective from the beginning of the 2010/11 income year and taxpayers taking a taxpayer's tax position after that date should not rely on the items in Public Information Bulletin 51 or Public Information Bulletin 64.

3. All legislative references are to the Income Tax Act 2007 unless otherwise stated. The relevant legislation is at the end of the Interpretation Statement.

Scope of this statement

4. When a business relocates within New Zealand, a business may incur a broad range of costs, costs associated with the premises being vacated, costs associated with physically moving the business and costs associated with preparing the new premises.

5. In this Interpretation Statement the Commissioner addresses the deductibility of business relocation expenditure incurred to physically move a business. That is, the costs associated with physically relocating business records, trading stock, employees, and items of depreciable property from the business' existing location to its new location. In the Commissioner's view the types of costs typically incurred to physically move a business (and those costs covered by this Interpretation Statement and referred to as "business relocation costs") are:
   - packaging and packing/unpacking costs;
   - freight costs;
   - temporary storage costs;
   - additional insurance premiums on cover acquired specifically for the move;
   - hire charges for the use of containers, forklifts and similar machinery to effect the relocation; and
   - expenditure on labour, in the form of salary or wages, or payments to contractors to effect the dismantling, relocation and re-assembly of property.

6. This Interpretation Statement does not consider the deductibility of any costs associated with vacating the old premises or preparing the new premises. In the Commissioner's view these costs although also incurred on the relocation of a business can be different in nature to the business

relocation costs set out above. The deductibility of these other costs may be determined by applying specific provisions of the Act or if necessary, by applying the capital/revenue tests. Under either scenario, the outcome (that is, whether the costs are deductible) may be different from the outcome provided for business relocation costs under this Interpretation Statement.

7. For this reason the statement does not address losses on obsolete depreciable property or demolition costs. In the Commissioner's view the depreciation provisions in subpart EE set out the circumstances in which a loss on disposal of an item of depreciable property (including through obsolescence) can be claimed. The Interpretation Statement does not cover building alteration costs or fit-out costs, except for the cost of any walls that may need to be temporarily removed to enable egress for property to be re-sited.

8. The Statement also does not consider the deductibility of lease termination or surrender payments, lessee re-instatement costs, any costs incurred in obtaining a new site (for example, the cost of obtaining any licence or other permit), legal costs, or other similar types of expenditure relating to the location itself. In the Commissioner's view these costs are one-step removed from the cost of physically relocating business property and therefore are outside of the scope of the Interpretation Statement.

9. This statement does not apply to costs incurred when a business relocates from one country to another country.

10. Discussion in this statement regarding the relocation of business property or employees is confined to relocations of property or employees occurring as a result of a business relocation. The statement does not consider the deductibility of costs incurred in respect of individual relocations of employees or plant or equipment that may occur from time to time.

11. Where employees are relocated as part of a business relocation, the relocation costs covered by this statement are confined to costs (or allowances) that relate to the actual physical relocation of the employees and their personal moveable property, rather than any inducement or compensation-type payments made to employees for relocating. It is not the purpose of this statement to address the deductibility of all relocation allowances or reimbursing payments made to employees, as they are many and varied in nature. To that end, the employee relocation costs covered by this statement are limited to the cost to the business of:

    - transporting employees to the new location (for example, removal expenses), including the cost of an allowance paid to an employee to cover such costs; and
    - temporary accommodation for employees moved to a new business location, including the cost of an allowance paid to an employee to cover such costs.

Summary

12. A business is entitled to claim a deduction for business relocation expenditure if the costs are deductible under the general permission in section DA 1(1), and if those costs are not excluded from deductibility by the capital limitation in section DA 2(1).

13. For convenience this statement considers the deductibility of business relocation expenditure collectively, rather than as a series of apportioned

amounts based on the type of underlying business property being relocated. In the Commissioner's view, the business relocation costs covered by this statement will all be incurred for the same principal reason, on the occurrence of the same event, and therefore all fall to be treated in the same way for tax purposes.

General permission

14. To qualify for a deduction under the general permission in section DA 1(1), the principal reason for relocating the business to a new location must bear a sufficient relationship and nexus to the carrying on of the business for the purpose of deriving assessable income.

15. The Commissioner expects most business relocations to satisfy the general permission. However, some business relocations may fail to have the necessary nexus and in those circumstances the relocation costs will not be deductible. Satisfying the general permission will be a question of fact in each case.

Deductible business relocation expenditure

16. 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.

Capital limitation

17. The capital limitation in section DA 2(1) will deny a deduction for business relocation costs that satisfy the general permission but that are capital in nature. Business relocation costs that are incurred for the principal purpose of extending or enlarging the structure of a business will be capital in nature. In the Commissioner's view, this situation will arise when the relocation of a business forms part of a plan or strategy to embark on a new type of business, to introduce new product lines or services, or that changes the structure of the business to enable it to operate in a new or different way. In those circumstances, where the relocation forms part of a plan that has the purpose or effect of enlarging the business structure (as distinct from enlarging the business premises or the business operations), the relocation costs will be more in the nature of "once and for all" expenditure and more akin to costs incurred when establishing a new business.

Depreciation

18. If the capital limitation in section DA 2(1) denies a deduction for business relocation costs, those costs cannot be added to the cost base of an item of depreciable property, unless the relocation results in an alteration, extension, or repair of the item that increases the capital value of the item. This means that unless the relocation costs result in an "improvement" to

the item of depreciable property being relocated (as defined in section EE 67) no depreciation loss will be available under subpart EE in respect of those relocation costs.

Analysis

General permission

19. The approach for determining whether business relocation expenditure is deductible is first to consider the general permission provision in section DA 1. Section DA 1(1) provides the general permission for a deduction for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred in gaining or producing the taxpayer's assessable income or excluded income or a combination of both (section DA 1(1)(a)), or is incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's assessable income or excluded income or a combination of both (section DA 1(1)(b)).

Nexus with income

20. The essential feature of section DA 1(1) is the requirement of a statutory nexus between the expenditure and the assessable income or the carrying on of a business by the taxpayer claiming the deduction.

21. The leading cases on deductibility under earlier income tax legislation are *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271. In both cases, the Court of Appeal highlighted the requirement for a statutory nexus to exist between the expenditure incurred and the assessable income or carrying on of a business of the taxpayer in order for the expenditure to be deductible. The Commissioner considers these decisions remain relevant to the interpretation of section DA 1(1). Earlier provisions that correspond to section DA 1(1)(b) referred to "expenditure necessarily incurred in carrying on a business". Section DA 1 preserves that requirement for nexus, notwithstanding that it has removed the word "necessarily". It is the Commissioner's considered view that the word "necessarily" did no more than indicate a requirement that there be a sufficient degree of connection between the expenditure and the business.

22. Therefore, in order to claim a deduction under section DA 1(1)(b) for expenditure incurred when relocating a business, a sufficient nexus must exist between the expenditure incurred in relocating the business and the assessable income or the carrying on of a business for the purpose of deriving assessable income of the taxpayer claiming the deduction. In every case, this will be a question of fact.

Example where a sufficient nexus has been established

23. An example of a business relocation case where a sufficient nexus was established is the Australian decision *Lister Blackstone Pty Ltd v FCT* 76 ATC 4,285. Australia has the same nexus requirement for deductibility as New Zealand.

24. In *Lister Blackstone,* the taxpayer company rented work and office space that had become too small for the size of the business operations. It acquired new premises and moved the whole of its business operations. The main deduction sought was for the cost of moving trading stock from the old premises to the new. This cost was made up of labour costs, freight charges, the hire of a forklift truck, and certain travelling expenses. Both casual and permanent employees provided the labour, and the time spent

by them in the removal of the stock was calculated in relation to their salary and wages.

25. The company claimed that the costs incurred were part of the normal expenditure related to the carrying on of the business. This was accepted by each of the courts that heard the case. In the High Court (*FCT v Lister Blackstone Pty Ltd* 75 ATC 4,165) Sheppard J held that the expenditure was necessarily incurred because the prime reasons for the move were the need to:

- have more space;
- avoid having to use the premises jointly with the lessor; and
- be able to conduct all the company's operations from one set of premises

If the company were to remain efficient and to continue to trade to the utmost advantage, the necessary consequence was that it had to move.

26. The court was satisfied that the taxpayer had established, in fact, that a sufficient nexus existed between the expenditure incurred in relocating the business and the carrying on of the business for the purpose of deriving assessable income of the taxpayer.

27. In the Commissioner's view, most business relocations are likely to have a sufficient nexus between the expenditure incurred in relocating the business and the carrying on of the business for the purpose of deriving assessable income of the taxpayer. However, it remains that where a taxpayer is unable to establish a sufficient nexus with assessable income that a deduction will not be available.

Example where nexus test may not be established

28. A sufficient nexus may not be established where a business relocates for reasons unrelated to the carrying on of the business. This might be the case where the principal reason for a business relocating is say, for the convenience of an owner or a shareholder. For example, the nexus test may not be satisfied if a business relocates for the principal reason of being closer to the owner's home.

29. Likewise, where a business relocation occurs for reasons relating to a change in ownership of the business (for example, a change in shareholding) rather than for reasons relating to the carrying on of the business, the necessary nexus may not be established. The reason for the relocation must relate to the carrying on of the business.

30. The Commissioner acknowledges that in seeking to establish whether a sufficient nexus exists the inquiry is focussed in an objective manner on what the relocation was designed to effect. The object of the expenditure is ascertained by looking not at the actual thing achieved but at the need or occasion giving rise to the expenditure. This will involve identifying the principal reason for the move and what the business is seeking to achieve by relocating. The reason or need for relocating a business will be a question of fact. The taxpayer's motive is relevant but only in so far as it may provide evidence of what the payment was designed to effect.

Capital limitation

31. Having concluded that prima facie a deduction is available under the general permission (section DA 1(1)), the next step is to determine whether the capital limitation in section DA 2(1) applies to deny a deduction for the business relocation costs.

32. On the face of it, business relocation expenditure may appear to be capital in nature; given that it relates to the premises of a business, which arguably form part of the business structure, and the fact most businesses do not move premises on a regular basis. However, balanced against this is the fact that a business relocation is often triggered by the occurrence of an ordinary commercial event such as the expiry of a lease, the natural growth of a business as it prospers, or the contraction of a business during tougher economic times. Relocations occurring as a result of such occurrences do not necessarily result in a business expanding or enlarging its business structure or gaining any advantages of enduring benefit over and above mere efficiency or profitability gains achieved through continued trading over time.

33. Therefore, to decide whether the capital limitation applies to deny a deduction for business relocation expenditure it is necessary to consider the various tests the courts have formulated for determining whether expenditure is capital or revenue in nature. Before applying those tests, it is necessary to clarify the approach to be taken when applying those tests in the context of business relocation expenditure.

Approach to applying the capital/revenue tests to business relocation costs

34. In the Commissioner's view, the best approach for determining whether the capital limitation applies to deny a deduction for business relocation costs, is to consider the business relocation costs identified in the Interpretation Statement as costs all incurred for the same reason and on the same occasion, regardless of the type of underlying business property being relocated.

35. The alternative approach is to apply the capital/revenue tests to the apportioned relocation costs associated with each underlying type of property being relocated. In the Commissioner's view such an approach is burdensome from a compliance-perspective, artificial and risks the overall reality of a relocation being overlooked in favour of a narrower application of the tests influenced by the type of property being relocated. This in turn could lead to the unsatisfactory application of the capital/revenue tests.

36. The approach outlined in this Interpretation Statement is consistent with that adopted by the United Kingdom's HM Customs & Revenue. Although it has been suggested that some statements in HM Customs & Revenue's manuals on the deductibility of relocation expenses could be taken as differing from this approach, the Commissioner understands that, notwithstanding those brief statements, HM Customs & Revenue adopts an approach that is consistent with the Commissioner's approach in this statement.

37. In particular, it is understood that in the United Kingdom most relocation costs are allowable on first principles because they are revenue in nature, being the ordinary costs of managing and looking after the business. However, HM Customs & Revenue makes a distinction between ordinary business operations where the relocation is to enable the business to operate in as efficient a manner as possible and a relocation that is part of an expansion programme. Where a relocation is part of an expansion programme, then it is understood that HM Customs & Revenue treats the whole cost as coloured with a capital character (not just the expenditure associated with the plant or machinery). In those circumstances, there is no deduction for the costs on first principles. However, capital allowances may be available in respect of the cost of relocating plant and machinery.

38. In contrast, the Australian courts have taken a narrower approach to relocation costs. The full High Court of Australia in *Lister Blackstone* considered the deductibility of the cost of relocating trading stock separately from the cost of relocating fixed assets. The Australian legislation specifically recognises relocation costs in respect of fixed assets as being a "second element of cost" for depreciation purposes, so supports and requires the apportionment of relocation costs by reference to the type of property being relocated. That is, the court in *Lister Blackstone* simply followed the approach already contemplated by the Australian legislation.

39. New Zealand's legislation is different, and, in the Commissioner's view, our depreciation rules do not contemplate relocation costs being an addition to the cost base of items of depreciable property. (The reasons for this view are discussed further in paragraphs 126–133.) The New Zealand legislation (unlike the corresponding Australian legislation) does not support or require apportionment of relocation expenses by reference to the type of property being relocated. Therefore, the decision in *Lister Blackstone*, while relevant and useful in some regards, can be distinguished in New Zealand as authority for an apportionment approach to the deductibility of relocation costs.

40. In the Commissioner's view, the better approach is to treat business relocation costs as being incurred for the same reason and on the same occasion, regardless of the type of property being relocated. This approach is also preferred from a practical viewpoint, as in many cases businesses will not distinguish between the cost of relocating its trading stock, assets or business records. It seems artificial and onerous in a compliance sense to require businesses to apportion their relocation costs according to the types of underlying property being relocated before applying the capital/revenue tests.

General principles

41. The authoritative tests in New Zealand for determining whether expenditure is capital or revenue in nature are derived from the Australian decision *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337. In *Sun Newspapers* Dixon J described (at page 359) the distinction between expenditure on capital account and expenditure on revenue account 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.

42. Dixon J also identified three matters to be considered (at page 363):

- a consideration of the character of the advantage sought (and in this its lasting qualities may play a part);
- the manner in which the advantage is to be used, relied on or enjoyed (and in this and under the previous point recurrence may play its part); and
- the means adopted to obtain the advantage, 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.

43. The matters referred to in *Sun Newspapers* were adopted by the Privy Council in *BP Australia Ltd v FCT* (1965) 14 ATD 1 and followed in New Zealand in *CIR v L D Nathan & Co Ltd* (1972) NZLR 209, *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271*, CIR v McKenzies NZ Ltd* (1988) 10 NZTC

5,233, *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206, and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981.

44. The courts have extracted various indicia from these cases, and have identified seven tests to assist in determining whether expenditure is capital or revenue in nature:

- The **need or occasion** that calls for the expenditure: This test focuses on the principal reason or need for incurring the expenditure. In the context of this test the object of the expenditure is ascertained by looking not at the actual thing achieved, but the reason or need for making the expenditure. Clear and accurate application of this test is important, because it will often form the basis for applying the other capital/revenue tests accurately.
- Whether the expenditure is **recurrent** in nature: This test involves a consideration of whether the expenditure is recurrent or a once and for all payment. If the expenditure is recurrent and made to meet a continuous demand this suggests the payment is part of the cost of ordinary business operations and will be a revenue outlay, whilst capital expenditure is going to be spent once and for all.
- Whether the source of the payment is from **fixed or circulating capital**: This test focuses on whether the source of the payment was from fixed or circulating capital, rather than whether the payment affects the fixed or circulating capital of the business in question. This test is not as useful as other tests in determining whether expenditure is capital or revenue in nature because of the ease with which a taxpayer can choose between financing an asset from circulating capital and financing it from fixed capital, irrespective of the nature of the asset financed. This test has been questioned judicially: *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17, 017 and *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834.
- Whether the expenditure creates an **identifiable asset**: This test indicates that expenditure will be on capital account where an asset of a capital nature has been acquired by the expenditure, and where money is spent on improving the asset or making it more advantageous.
- Whether the expenditure is a **once and for all** payment producing assets or advantages that are of an **enduring benefit**: Under this test, expenditure will be regarded as capital where it brings into existence an asset or advantage for the enduring benefit of the business. This test combines aspects of the recurrence and identifiable asset tests. This test is one of the more relevant and persuasive tests for deciding whether expenditure is on capital or revenue account.
- Whether the expenditure is on the **business structure** or **business process**: This test focuses on the distinction between expenditure on the business structure set up for the earning of profit, and expenditure on the process by which such an organisation operates to obtain regular returns by means of regular outlay. This test is also one of the more relevant and persuasive tests used to determine whether expenditure is on capital or revenue account.
- What the treatment of the expenditure is according to the **ordinary principles of commercial accounting**: The test of applying ordinary principles of commercial accounting to the expenditure, although of some assistance, is not usually determinative. It needs to be remembered that tax and accounting have different aims, and the treatment for one may differ from the treatment for the other.

While this test will often be used to support an approach that the other tests have come to, it is not a sufficiently conclusive test by itself to determine the issue of whether the expenditure is on capital or revenue account.

Qualifications when considering and applying the capital/revenue tests

45. Many of the above indicia will overlap and some factors will carry more weight than others in given circumstances. Therefore, while these indicia are helpful as a starting point, it is necessary to make a final judgement as to whether the expenditure is capital or revenue in nature by analysing the facts as a whole and weighing up which factors carry the most weight in light of these facts. Generally, no case will be decided under one test, and some cases do not refer directly to any of the tests.

46. One of the leading New Zealand cases on the capital/revenue distinction is the Court of Appeal decision in *McKenzies*. The Court of Appeal endorsed the dicta of Pearce LJ in *BP Australia*. Richardson J stated (at page 5,236):

> In deciding whether expenditure is capital or income the approach generally favoured by the courts in recent years is exemplified in the following observations of Lord Pearce in *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 244 at pp 264-265:
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>> The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances, some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features, which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
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>>> "depends on what the expenditure is calculated to effect from a practical and a business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process". Per Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634, 648.
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>> As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other; but those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors, which may incline the scale in the particular case after a balance of all the considerations has been taken.

47. The Privy Council in *CIR v Wattie* (1998) 18 NZTC 13,991 espoused the same approach to capital/revenue questions described in *Hallstroms Proprietary Ltd v FCT* (1946) 72 CLR 634, 648 (per Dixon J), *BP Australia*, *Regent Oil Co Ltd v Strick* [1965] 3 All ER 174 (HL), *British Insulated and Helsby Cables Ltd v Atherton* [1925] All ER Rep 623, and *McKenzies*.

48. Other more recent New Zealand cases have taken a consistent approach to the cases discussed above. In *Poverty Bay Electric Power Board v CIR* (1998) 18 NZTC 13,779, Ellis J endorsed the approach of the courts in *BP Australia*, *Sun Newspapers*, and *McKenzies*. On appeal (*Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001) the Court of Appeal referred to the approach of *BP Australia*, *Hallstroms*, and *British Insulated and Helsby*. In addition, the Court of Appeal in *Birkdale* endorsed the approach of the Privy Council in *Wattie* and *BP Australia*.

49. The cases cited above have recognised that although past cases can be useful in assisting with the resolution of a new case, there are dangers involved in this approach. For example, Viscount Radcliffe in *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* [1964] 1 All ER 208, 212 (PC) said that it was almost unavoidable to argue from analogy when considering allocations of expenditure between capital and income accounts:

> Nevertheless, it has to be remembered that all these phrases, as, for instance, "enduring benefit" or "capital structure" are essentially descriptive rather than definitive, and, as each new case arises for adjudication and it is sought to reason by analogy from its facts to those of one previously decided, a court's primary duty is to inquire how far a description that was both relevant and significant in one set of circumstances is either significant or relevant in those which are presently before it.

50. Notwithstanding these judicial expressions, it is true that case law analogies are sometimes the only way, or at least the safest way, to proceed: *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801.

51. Based on the comments made in the leading cases, the Commissioner considers that the next step to determine the nature of business relocation expenditure is to apply the tests set out by the courts, with judgement and common sense.

Applying the capital/revenue tests

Need or occasion test

52. The need or occasion test is an important test for determining the deductibility of business relocation costs. The outcome of this test can form the basis for applying some of the other capital/revenue tests effectively. In the context of this test, the object of the expenditure is ascertained by looking not at the actual thing achieved but the reason or need for making the expenditure. The reason or need for relocating a business will be a question of fact.

53. A business may relocate and incur relocation expenditure for more than one reason. In these situations, the taxpayer's principal motivation must be determined. In *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206 Gallen J noted (at page 10,210):

> The judge in this case accepted that there might be more than one reason for making a payment but considered that the principal motivation was what in the end coloured the expenditure and determined its nature. I think he was right in that conclusion. It is consistent with the illustration given by Lord Donovan [in *IRC v Land Securities Investment Trust Ltd* (1969) 2 All ER 430, 433]. On this basis, the need or occasion which covers the nature of the payment was a capital expenditure and did not cease to be one merely because there was an additional but secondary motive which had it stood alone or been the principal motive, would have allowed the payments to be deductible.

54. It is important when discerning the reason or need for a business relocation to take a view that is sufficiently wide so as not to ignore the reality of the situation. Taking a narrow view may result in the essential nature of the payment being wrongly determined.

55. In *Commissioners of Inland Revenue v Carron Company* (1966–1969) 45 TC 18, the House of Lords held (at page 70) that expenditure incurred from changing the company's charter was deductible because:

> the real value and purpose inherent in the alteration was to facilitate trading opportunities of the company.

56. Lord Reid said (at page 68):

> In a case of this kind what matters is the nature of the advantage for which the money was spent ... Its true purpose was to facilitate trading.

57. To illustrate the difference between a wide view and a narrow view of the need or occasion for incurring business relocation expenditure, the Commissioner considers that the following descriptions of possible scenarios are examples of taking a wide view:
    - The business moved to larger premises to facilitate a planned expansion of the business into a new field of trading.
    - The business relocated so it could continue trading following the expiry of its lease.
    - The business relocated to a better location to improve its profitability.
    - The business relocated to cheaper premises as part of plan to reduce overheads to enable the business to continue trading in challenging economic times.

58. These examples consider the commercial reasons for the relocation rather than the mere fact that a relocation has occurred. In contrast, an example of a narrow view of the need or occasion for incurring business relocation expenditure might be "to maintain the taxpayer's existing business structure". Such a description provides no insight into the true purpose or commercial rationale for the relocation, making it no easier to determine whether the expenditure is capital or revenue in nature.

59. Therefore, in the Commissioner's view, applying the need or occasion test when determining the deductibility of business relocation expenditure, helps clearly identify the principal reason for incurring the expenditure. When applying the test it is better to take a wide view of the circumstances giving rise to the relocation. In each case, the principal reason or need for the relocation will be a question of fact.

Recurrence test

60. In general terms, the recurrence test involves determining whether expenditure is a recurrent expense or a once and for all payment. If the expenditure is recurrent this suggests it is part of the cost of ordinary business operations, so would be a revenue outlay. A once and for all payment suggests an outgoing of a capital nature. However, some one-off payments may be deductible, if they are the type of payment that might arise time and again over the duration of a business.

61. In *W Nevill and Co Ltd v FCT* (1937) 4 ATD 187, the full High Court of Australia held that a one-off amount paid to a retiring managing director was properly deductible. Rich J, when discussing whether the expenditure was recurrent or once and for all, said (at page 195) that the expenditure might be described as one-off in respect of the managing director level, but it was the sort of payment that would arise time and again for businesses with many employees.

62. Rich J focused on the fact that employing people is an ordinary incident of a company's business and, presumably, this includes the necessity from time to time to pay money to remove employees. His Honour concluded that the payments were made genuinely in the course of business in the interests of the efficiency of the business. This was backed up by the facts where the court found the company believed abolishing the system of joint management would improve the company's efficiency.

63. Dixon J believed that the payment was made for organising the staff and was part of a necessary expenditure of conducting the business. It was not

made for acquiring new plant or for any permanent improvement in the material or immaterial assets of the business.

64. In *BP Australia Ltd v FCT* (1965) 14 ATD 1 the Privy Council felt the taxpayer's payment of trade ties to service station owners was recurrent, and a broad view should be taken of the general operation under which the expenditure was incurred. Their Lordships thought the payments were made to meet a continuous demand in trade and were prima facie matters connected with the ever-recurring question of a business's marketing and its customers.

65. These cases demonstrate that in certain circumstances a once and for all payment will be deductible where it is made in response to an event that arises time and again in the course of carrying on a business.

66. This principle is reflected in the Australian decision *Associated Minerals Consolidated Ltd v FCT* 94 ATC 4,499 where the full Federal Court held that a company was entitled to a deduction for costs associated with the removal and storage of major mining plant. The court stated (at page 4,504):

> If the nature of the activity of sand mining be considered for a moment, carried on as it is at successive locations where mineral sands exist, subject to interruption from time to time as deposits are exhausted, with a recurring possibility that a particular interruption may be lengthened by the lack of an immediately available fresh mining site, it is apparent that expenses of relocation, and on occasion also of temporary storage of the dredge and concentrator, are an inevitable part of the regular cost of the conduct of the business.

67. *Associated Minerals* is an example of a business relocating in response to an event that arises recurrently in the course of it carrying on its business. The decision supports a revenue classification of relocation expenses when relocations are recurrent.

68. Business relocation costs are a type of expenditure that arise for many businesses from time to time, and that in some cases may be recurring. If a business can demonstrate that relocation costs are an inevitable part of the regular cost of the conduct of the business, as in *Associated Minerals*, the test indicates that the costs will be more in the nature of revenue expenditure.

69. This leads the Commissioner to conclude that business relocation costs incurred as a result of a business lease expiring (or some other ordinary and reasonably predictable business event that can be expected to recur) may be more in the nature of recurring expenditure, and therefore deductible. On the other hand, relocation costs incurred as part of an event occurring outside the regular conduct of the business, for example, relocation costs incurred when an established business expands into a new field of trading, will be in the nature of once and for all expenditure, and therefore capital expenditure.

70. The Commissioner's view is that such an interpretation reflects the commercial reality of many business relocations.

Fixed or circulating capital test

71. In recent years the fixed or circulating capital test has not played an important part in determining whether expenditure is on capital or revenue account. This is because of the difficulties the courts have in applying the test consistently. As a result, some differences have evolved in how the test is defined, which in turn makes it even more difficult to apply (ie, whether the test is a use of funds test or a source of funds test). The use

of funds test determines whether the expenditure relates to the fixed or circulating capital of the business; the source of funds test determines whether the payment is made from fixed or circulating capital.

72. The source test has been criticised because it is very easy for a business to switch between financing an asset from circulating capital to financing it from fixed capital, irrespective of the nature of the asset being financed. Such substitution undermines, to an extent, the usefulness of the test.

73. The courts have concluded that the fixed or circulating capital test, in either of its forms, provides little benefit as an indicator of whether expenditure is capital or revenue in nature.

74. In *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017, Wild J stated that the fixed or circulating capital test was of little relevance. He considered the test provided no logical or reliable nexus to determine the character of the expenditure. Wild J stated (at page 17,025):

> The second test, described at p 219 in *BP* [[1965] 3 All ER 209], is whether the expenditure was from fixed or circulating capital. The two different forms of capital are described in *BP*. With all respect to the eminent economists and Judges who have propounded this test, I am unable to view it as compelling, or even useful. It is essentially a "source of funds" test. I cannot see any logical or reliable nexus between the source of moneys, and what they are spent on. It is well established that the character of expenditure (capital or revenue) by a payer taxpayer does not determine its character as a receipt in the hands of a payee taxpayer: *Tasman Forestry Ltd v CIR* [1999] 3 NZLR 129; (1999) 19 NZTC 15,147 (CA) at p 137; p 15,154. Although the moneys here are within a single taxpayer's business, the position seems to me analogous. Thus, **where the moneys came from is no reliable guide in determining the nature of their expenditure**. Here, both Mr Reeves, General Manager, Finance, of Milburn, and Professor Trow, who gave expert accounting evidence for the taxpayers, said that the payments were from circulating rather than fixed capital. That points to the expenditure being of a revenue character. But it is also indicative of the long and soundly established nature of the business of both taxpayers. Mr Frankham shared my misgivings as to the relevance of this test, at least in 2001. I prefer to disregard this test and wonder whether it might not be given a quiet burial?
>
> [Emphasis added]

75. In *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834, Baragwanath J supported the approach taken in *Milburn*. When considering the application of the approach, he commented (at page 18,841):

> A fifth [test] of whether the expenditure is from fixed or circulating capital – has proved difficult to apply: see *BP Australia* [[1965] 3 All ER 209] at 269 and *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017, at 17,025-17,026 para 48 per Wild J. The abandonment of the concept of nominal capital by the Companies Act 1993 points to the unreality of treating the source of funds as a significant guide to whether for tax purposes the acquisition is to be treated as on capital or revenue account. As Richardson J indicated in *CIR v McKenzies (NZ) Ltd* [1988] 2 NZLR 736, 746, the classification of the items in respect of which the payment is made is likely to be critical. **What matters is rather the purpose of the expenditure than its source**.
>
> [Emphasis added]

76. Following the approach outlined above, the Commissioner considers that the fixed or circulating capital test is of little relevance when determining the deductibility of business relocation expenditure. Therefore, the Commissioner places little weight on this test.

Identifiable asset test

77. The identifiable asset test requires that there be an acquisition of a capital asset, a disposition of an onerous asset, or a modification to an existing asset to improve it or make it more advantageous for a payment to be

capital in nature. If there is no resulting identifiable asset, the payment is more likely to be of a revenue nature.

78. In many circumstances, the property and employees of a business will be relocated without any new identifiable asset being created or any capital asset being improved. The identifiable asset test may be satisfied where a business relocation results in a significant and contemporaneous increase in business goodwill (for example, if a relocation is part of a plan to acquire or enter into a new field of trading or to merge with another business that results in the addition of a new customer base). In those cases, where the addition of a new asset can be identified as an effect of incurring the relocation expenditure, then the relocation costs would tend to be capital in nature. However, if the incurring of the relocation expenditure merely has the effect of gradually increasing the business' profitability over time (for example, gains attributable to operating from an enhanced trading location) or improving operating efficiency (for example, lower overheads as a result of operating from cheaper premises) it is difficult to identify an asset that has been acquired or improved in a capital sense. In these circumstances the Commissioner considers that test indicates the business relocation expenditure is not capital expenditure.

79. This Interpretation Statement is only considering the deductibility of business relocation costs relating to the physical relocation of a business. The Interpretation Statement is not considering the deductibility of costs associated with the old or new premises, for example, any lease payments or fit out costs.

80. Lord Wilberforce in *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 said that the identifiable asset test meant that money spent on the acquisition of an asset was capital expenditure. Money spent on getting rid of a disadvantageous asset was also capital expenditure, as was money spent on improving the asset or making it more advantageous. In *Granada Motorway Services*, a lump sum payment made to improve the terms of a lease was held to be capital.

81. Lord Wilberforce reiterated in *Granada Motorway Services* comments he had earlier made on the identifiable asset test in *Commissioners of Inland Revenue v Carron Company* (1966–1969) 45 TC 18. *Carron* involved the deductibility of expenditure incurred to alter a company's charter. In referring to *Carron,* Lord Wilberforce said (at page 805):

> There the expenditure was incurred in order to procure a modification of the company's charter in such a way as to enable it to trade more properly and to facilitate day-to-day operations. This House held that the payment had a revenue character. Unless indeed it could be said that the charter was a capital asset, it is difficult to see what other decision could have been given. In the course of my opinion I used these words (1968 SC (HL) 47 at 65, 45 Tax Cas 18 at 75):
>
>> ... the disposition of a source of liability may be equivalent to the acquisition of a source of profit—an extension perhaps of, but not an exception to, the principle that in some sense or other, an asset of a capital nature, tangible or intangible, positive or negative, must be shown to be acquired. If this is correct—and until a case arises which constitutes a true exception, I shall continue to think that it is—the present expenditure cannot be brought within the capital class.
>
> With due caution against using these words as if they were statutory, I adhere to them. They were, of course, directed to excluding cases where no capital asset could be 'seen' or identified, which was so in that case; I had not intended to narrow the conception of capital payments to the case of the acquisition of an asset. Clearly expenditure on a capital asset may fall within the principle.

82. There has been some criticism that too much emphasis was placed on the identifiable asset test in *Carron* and *Granada Motorway Services*. In *McKenzies* it was argued that the courts were seeking to elevate the identifiable asset test above the other capital/revenue tests, and in so doing the courts risked creating an artificial distinction between leases (which are treated as capital assets, as in *Granada Motorway Services*) and other contracts under which payments are made (such as the charter in *Carron*, which was held not to be a capital asset). However, Richardson J responded by saying (at page 5,241):

> In short, in some circumstances it is appropriate to give very great weight to the ready identification and classification of the item in respect of which the payment is made as itself being held on capital account. It is in that sense that we understand Lord Wilberforce in *Granada Motorway Services* to endorse the identifiable asset test, and no doubt it, too, will yield in special cases where there are sufficient indicators pointing the other way, …

83. These comments are important when considering the weight that should be given to the identifiable asset test when deciding whether business relocation expenditure is capital. As there frequently will be no new or modified asset to be "seen" or "identified" as a result of incurring relocation expenditure, this situation is analogous to the situation in *Carron*. Applying Lord Wilberforce's comments in *Granada Motorway Services,* failing the identifiable asset test creates a strong prima facie case for excluding relocation costs from being capital. As Richardson J notes in *McKenzies,* in some circumstances it is appropriate to give great weight to the identifiable asset test.

84. The Commissioner, therefore, considers that if no capital asset can be readily identified as being acquired as a result of incurring the relocation costs, the identifiable asset test will support the expenditure being revenue in nature. However, this test still remains to be balanced with the other capital/revenue tests.

Enduring benefit test

85. The source of the enduring benefit test is acknowledged as the House of Lords decision in *British Insulated and Helsby Cables Ltd v Atherton* [1925] All ER Rep 623. It was in this case that Viscount Cave LC commented (at page 629):

> But when an expenditure is made, not entirely once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade,
> I think that there is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

86. In *McKenzies*, Richardson J endorsed the enduring benefit test and Viscount Cave LC's well-known comment. He referred to Lord Wilberforce's judgment in *Granada Motorway Services* and the explanation of enduring benefit given by Rowlatt J in *Anglo-Persian Oil v Dale (Inspector of Taxes)* (1929–1932) 16 TC 253.

87. Lord Wilberforce in *Granada Motorway Services* commented on Viscount Cave LC's test (at page 804):

> many discussions start from the well-known phrase of Viscount Cave LC in *British Insulated and Helsby Cables Ltd v Atherton* ([1926] AC 205 at 213, [1925] All ER Rep 623 at 629, 10 Tax Cas 155 at 192): "… when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade." These words were regarded as having quasi-statutory force until, in a later case, it was revealed that they might cover an advance more of a revenue character. So Rowlatt J in *Anglo-Persian Oil Co v Dale (Inspector of Taxes)* ((1931) 16 Tax Cas 253 at 262) explained the phrase as meaning:

> a benefit which endures, in the way that fixed capital endures; not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. It means a thing which endures in the way that fixed capital endures. It is not always an actual asset, but it endures in the way that getting rid of a lease or getting rid of onerous capital assets ... endures.

88. Richardson J (in *McKenzies*) discussed Rowlatt J's explanation of the meaning of enduring benefit in *Anglo-Persian.* Richardson J commented (at page 5,239):

> In *Anglo-Persian Oil Co Ltd v Dale* the payment was made in order to free the company from a long term agency agreement which had become onerous to the company. It was held to be deductible. **Applying Lord Cave's test the payment in question did not bring any asset into existence and could not properly be said to have brought into existence an advantage for the benefit of the company's trade within the meaning of that expression as used by Lord Cave**. Two points about the decision should be noticed. The first is that the distinction between fixed and circulating capital reflected in the *Staveley Coal and Iron Co Ltd* case was expressly recognised, and the agency agreement in question was held not to be a fixed capital asset of the company. The second is that Rowlatt J at p 262 explained Lord Cave's phrase "for the enduring benefit of a trade" as meaning:
>
> > a benefit which endures, in the way that fixed capital endures; not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. **It means a thing which endures in the way that fixed capital endures. It is not always an actual asset, but it endures in the way that getting rid of a lease or getting rid of onerous capital assets ... endures**.
>
> On appeal in that case Romer LJ emphasised (at p 146) that the advantage need not be of a positive character: "The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in *Mallett v Staveley Coal & Iron Co*".
>
> [Emphasis added]

89. Lord Wilberforce also considered the enduring benefit test in the earlier decision of *Carron*. As noted above, that case centred on a dispute about the deductibility of expenditure incurred in relation to changing a company's charter. Amendments to the charter were required to enable the company to increase its borrowings and alter the shareholding restrictions on voting partners. The House of Lords held that expenditure to modify the company's charter was a revenue expense and an allowable deduction.

90. Initially, in the First Division (*Commissioners of Inland Revenue v Carron Company* 1967 SC 204), Lord Guthrie commented (at page 216) on the changes to the company's charter:

> In the present case the fixed capital was left untouched. No tangible asset was created by the expenditure which could appear in its balance sheet. No new trading sphere was acquired ...
>
> Therefore, although an advantage was obtained by the expenditure in question, and although that advantage conferred enduring benefit upon the company, I am of the opinion that the special circumstances of this case lead to the conclusion that the advantage was not a capital asset ...

91. *Carron* was then appealed to the House of Lords, which upheld the decision of the First Division. Their Lordships acknowledged that an advantage will generally always flow from a business decision, and stressed that what was important was the nature of that advantage. They emphasised that the payment by Carron created no new asset, but simply enabled the company to carry on its day-to-day trading more efficiently. In this regard, Lord Reid stated (at page 68):

> Of course they obtained an advantage: companies do not spend money either on capital or income account unless they expect to obtain an advantage. And

> money spent on income account, for example on durable repairs, may often yield an enduring advantage. In a case of this kind what matters is the nature of the advantage for which the money was spent. This money was spent to remove antiquated restrictions which were preventing profits from being earned. It created no new asset. It did not even open new fields of trading which had previously been closed to the company. Its true purpose was to facilitate trading …

92. Lord Wilberforce similarly found that the changes to the Carron charter did produce an advantage, but an advantage of a revenue character. He noted (at page 75):

> It procured indeed an advantage – important and not of a transitory nature – but one essentially of a revenue character in that it enabled the management and conduct of the Company's business to be carried on more efficiently.

93. In the context of the enduring benefit test, it is also interesting to consider Latham CJ's comments in *Hallstroms Proprietary Ltd v FCT* (1946) 72 CLR 634 (at page 641) in relation to the deductibility of legal fees paid to defend a competitor's action:

> In my opinion, the expenditure by the company was not made for the purpose of acquiring an asset or of adding to the profit-yielding subject which constituted the capital structure of the business but as Lord Hanworth MR said in *Mitchell v B W Noble Ltd*, the expenditure was made "not in order to secure an actual asset to the company but to enable them to continue, as they had in the past, to carry on" the same business, unfettered by a particular difficulty which had arisen in the course of the year.
>
> …
>
> Nor can it be said that the company by making the expenditure gain "an enduring advantage". **It gained nothing – it merely succeeded in maintaining an existing position**.
>
> [Emphasis added]

94. In the Commissioner's view, these cases suggest that, although an advantage (even an enduring advantage) may arise from incurring expenditure, that advantage needs to secure something more than efficiency gains or the maintenance of an existing position for it to be capital expenditure.

95. Therefore, in the context of business relocation expenditure, the Commissioner concludes that where a business relocation is entered into to enable the business to carry on as usual, to preserve or maintain the current business, even with the potential of making profitability or efficiency gains over time, the enduring advantage gained is unlikely to be sufficient for the expenditure to be capital in nature.

96. On the other hand, the Commissioner concludes that where expenditure is incurred to relocate a business as part of an expansion or clear move by the business into a new field of trading or as part of a plan that changes the structure of the business to enable it to operate in a new or different way, then the enduring advantage arising from that move will be capital in nature and the relocation costs will not be deductible.

97. Notwithstanding these conclusions, in the Commissioner's view, the enduring benefit test alone is not determinative in deciding whether this type of expenditure is deductible; the other capital/revenue tests need to be applied to determine the true nature of any enduring advantage.

Business structure or business process test

98. The business structure or business process test, in the Commissioner's view, considers the effect the expenditure has on the existing structure of the business or the reason for incurring the expenditure. The cases have variously described the effect as strengthening, maintaining, preserving,

extending, or enlarging the business structure. Where the effect of the expenditure is to maintain or preserve the business structure, the cases have found the expenditure is more revenue in nature. Where the effect of the expenditure is to strengthen, enlarge, or improve the business structure, the cases suggest the expenditure is more capital in nature.

99. The operation of this test is best illustrated by the cases. In *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337, Dixon J stated (at page 364) that:

> [for expenditure to be capital] in principle the transaction must be regarded as strengthening and preserving the business organisation or entity and affecting the capital structure.

100. Lawrence LJ stated in *Anglo-Persian* (at page 270) that:

> It follows that the Company by cancelling the agency agreement, and itself undertaking the future management of its business in Persia, **neither enlarged the area of its operations, nor improved its goodwill, nor embarked upon a new enterprise; it merely effected a change in its business methods and internal organisation**, leaving its fixed capital untouched.
>
> [Emphasis added]

101. In *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206, 10,211, Gallen J referred to the observations of Dixon J in *Hallstroms* when deciding whether expenditure on installation work of new assets was deductible, and noted:

> it was I think open to the Authority to conclude that the expense was directed principally to the acquisition of the means of production rather than the use of them; to establishing or extending a business organisation rather than carrying on the business.

102. In *Fullers Bay of Islands Ltd v CIR* (2006) 22 NZTC 19,716, the Court of Appeal confirmed (at page 19,722) that the addition of a new ferry contract would have been an addition to the capital structure, so the legal fees incurred in respect of that acquisition were capital:

> The third test referred to by Baragwanath J [in the High Court] was the distinction between the business structure, which is a capital item, and the ordinary process by which it is operated to obtain regular returns, which is a matter of revenue. The ferry contract would have constituted a major addition to the structure of Fuller's business which it would operate to obtain regular returns from passenger fares. The objective was to secure monopoly rights which are capital in nature.

103. These cases demonstrate the approach the courts have taken to distinguishing expenditure that relates to the business structure from expenditure that relates to the business process. The courts look at the effect of the expenditure and consider whether the result affects the business structure or the business process.

104. It is the Commissioner's view that on many occasions a business relocation will not make the business any more valuable or strengthen or extend the business structure. It is quite possible for a business to incur relocation costs, even when moving into larger or better premises, without necessarily expanding its business structure.

105. Likewise, a business relocation made to take account, or in contemplation, of organic growth occurring within a business (that is, growth arising from a prospering business), in the Commissioner's view, may not signify an expansion or enlargement of the structure of the business.

106. Similarly, a business relocation made to take account of contractions in the operations of a business will not have the effect of enlarging or extending the business structure. Usually when a business downsizes, relocation costs will be incurred to preserve or maintain the business structure. This

is particularly so when the contractions are in response to declining market conditions.

107. Therefore, by way of illustration, under the business structure/business process test, relocation expenditure incurred on the occasion of a business relocation will be **revenue** in nature in the following circumstances:

- The relocation is primarily undertaken in response to external factors (such as the expiry of a lease) and is not part of any planned expansion of the business structure, with the effect that the existing business continues operating unchanged but in a new location.
- The relocation is part of a strategy to improve the profitability of existing business operations or to make efficiency gains within the existing business structure, but without expanding or enlarging the business' structure. This could include a move to a better trading location to improve profitability.
- The relocation is a response to organic changes within the business (for example, the natural growth of staff numbers as a business prospers). This could include a relocation in contemplation of such growth, where the growth is not the result of a planned expansion into some new field of trading or a particular business expansion strategy that involves changing the business structure.
- The relocation is as a result of downsizing the business, possibly in response to changes in market conditions. This could include a move to smaller or cheaper premises to enable the business to continue operating.

108. For business relocation expenditure to be capital under the business process/business structure test, the business relocation must have the effect of strengthening, extending, or enlarging the business structure. The Commissioner considers that the structure of a business will be enlarged or extended when the relocation forms part of a plan or strategy:

- to embark on a new type of business or enter into a new field of trading, including the introduction of a new and different product line or service; or
- that changes the structure of the business to enable it to operate in a new or different way (for example, a switch from an exclusively home-based business to a single retail store or a business relocation involving major restructuring of the business so that the business is carried on in a significantly different way).

109. In many ways, relocation expenditure will be capital under this test when it is akin to expenditure incurred on the establishment of a new business.

Ordinary principles of commercial accounting test

110. Ordinary principles of commercial accounting, while of some assistance, are not determinative in deciding whether expenditure is capital or revenue in nature.

111. The accounting treatment of relocation costs is that all relocation expenditure is expensed in full in the year it is incurred. The Commissioner will take this conclusion into account when balancing the capital/revenue tests and reaching a conclusion on the overall nature of relocation expenditure, but the accounting treatment is not determinative.

Balancing the capital/revenue tests

112. Having considered the general permission and each of the capital/revenue tests in the context of business relocation expenditure, the Commissioner considers that some clear indicia exist to assist in determining the deductibility of business relocation expenditure.

113. The indica can be summarised as follows:

- It is important to determine the need or occasion for the relocation. The test should not be applied too narrowly, so that the true reality of the situation is not overlooked. Where there is more than one reason for incurring the relocation expenditure, the principal reason for the relocation needs to be identified. This will be a question of fact.
- Relocation expenditure must first satisfy the general permission before the capital/revenue tests are applied. To qualify for a deduction under the general permission, the cost of relocating the business must bear a sufficient relationship to the carrying on of the business. This is irrespective of whether the business expands or contracts as a result of the relocation.
- In some circumstances, relocations may be a recurrent incidence of carrying on business, and in those circumstances, support for treating relocation costs as deductible will be stronger. Where business relocations are not a recurrent incidence of carrying on business, and the relocation costs are more in the nature of once and for all expenditure, then that is indicative of the costs having more of a capital nature.
- The fixed or circulating capital test is difficult to apply. Accordingly, little weight should be given to this test.
- Usually, no new or modified asset will be "seen" or "identified" as a result of relocation expenditure being incurred.
- If a relocation is principally for the purpose of maintaining or preserving an existing business, it is unlikely any advantage obtained will be of sufficiently enduring benefit for the costs to be treated as capital expenditure. On the other hand, if a business relocation is made as part of a plan to extend or enlarge the structure of the business, any resulting advantage is more likely to be of enduring benefit to the business.
- In some circumstances a business relocation will have an effect on the structure of a business. Where the relocation forms part of a planned enlargement or extension of the business then the costs will be capital in nature. A move to larger premises or a move to take account of a natural increase in the size of the business are not necessarily indicative of an enlargement of the structure of the business.
- The accounting treatment of relocation costs supports their being revenue in nature.

114. The cases require that these indicia be balanced in a commonsense way to determine, from a practical and business viewpoint, the true nature of the expenses for tax purposes. To this end, the Commissioner sets out his approach, based on the cases, for deciding whether business relocation expenditure is deductible:

- The cost of relocating a business must have sufficient nexus to the carrying on of the business to satisfy the general permission in section DA 1. Where the reason for relocating is not sufficiently related to the carrying on of the business, the expenditure will not be

deductible. Where the nexus test is satisfied (and this will be the result in most cases), the question becomes whether the relocation costs are capital costs excluded from deductibility by the capital limitation.

- Relocation costs will not be capital costs (and so will be deductible) where the principal need or occasion for the business relocation is to maintain and preserve the business, without extending or enlarging the existing structure of the business. The Commissioner does not consider that a move by a business to new, and possibly larger, premises is necessarily expansionary (and therefore capital expenditure). Similarly, the Commissioner does not consider business relocations made to take account of organic growth or contraction within an existing business to be made for the purpose of extending or enlarging the structure of the business.
- The capital limitation will apply to prevent a deduction for relocation costs that satisfy the general permission only if the business relocation forms part of a plan or strategy to:
  - embark on a new field of business or introduce a new product line or service; or
  - change the structure of the business to enable it to operate in an new or different way (for example, a switch from an exclusively home-based business to a single retail store or a business relocation involving major restructuring of the business so that the business is carried on in a significantly different way);

  with the effect that the:
  - business structure (as distinct from the business premises or the business operations) is enlarged or extended by the relocation; and
  - relocation costs are more in the nature of once and for all expenditure and are akin to the costs incurred when establishing a new business.
- It is acknowledged that the tests will inevitably require an element of judgment by the Commissioner as to whether a relocation is principally due to natural growth or gaining efficiency/profitability in a business, or to a significant change in the way a business is carried on. In any move there may be a multiplicity of reasons giving rise to the relocation but in every case it is the principal need or occasion for the relocation which must be determined and that will be question of fact.

Examples

Example 1 - Enhanced trading location

115. Gloria's Gorgeous Gift Shop operates from retail premises at the rear of a shopping arcade. A lease has become available at the front entrance to the arcade. Gloria decides to move to the front shop to improve the profitability of her business. The structure of Gloria's business is unchanged by the move, even though she hopes to benefit from increased profits. Although Gloria will gain a new and possibly more valuable lease, the expenditure incurred to relocate the business' property is not for the acquisition of that new lease. The expenditure is incurred to relocate the property and so to enable the shop to trade more profitably. On balance, the relocation costs will be deductible.

Example 2 - New location offering benefits

116. For the past few years Kiwi Exports Limited has chosen to use rail to transport its goods to the port for shipping overseas, even though the goods must first be transported by road to the rail yards for this to occur. However, now, a new site with a direct rail link to the port has become available. Taking into account the handling and freight cost savings that could be achieved, Kiwi Exports Limited decides to relocate its business to the new site. The relocation will reduce the company's operating costs and improve its efficiency. The relocation will not expand or extend the structure of the company's business. The cost of relocation will be deductible.

Example 3 - Organic growth within a business

117. Business has been going well for Green, Grey, and White Limited, a law firm. Client numbers are increasing and it has recently taken on new staff. The firm's current lease is due to expire, and it is keen to move to bigger offices. The firm has found some offices more suited to its current size and that will also give it room for further growth, assuming the business continues to prosper. The need for relocating has arisen from the expiry of the firm's current lease and the firm's internal growth. In such circumstances the structure of the business is unaffected by the relocation. It is simply that the same law firm has grown and is now being conducted from larger premises. Therefore, the relocation costs are deductible.

Example 4 - Recurring relocations

118. Project Support Limited provides engineering support services to businesses involved in large infrastructure projects. The company needs to operate its workshop close to where an infrastructure project is being carried out. This means that periodically, depending on the duration of its contract, the company must relocate. For Project Support Limited, relocating is an inevitable and recurring cost of it carrying on business. The cost of relocating is a deductible expense.

Example 5 - Planned expansion of business into new field of trading

119. Trusty Car Repairs Limited, a well-established mechanical garage, has decided to expand its business by also becoming a used car dealer. As a result, Trusty Car Repairs Limited needs to relocate its workshop and office to larger and more prominent premises. Any relocation expenditure Trusty Car Repairs Limited incurs will be capital expenditure because the relocation expenditure is incurred to effect a planned expansion by the business into a new field of trading. The relocation costs will not be deductible.

120. Bluett and Grayson Limited, an accounting firm, has decided to branch out into providing human resources and job placement services. In order to maximise the opportunity, the company must move to larger premises, with more meeting rooms and better client parking. The relocation expenditure the company incurs will be capital expenditure because it is incurred to implement the company's planned expansion into a new field of trading. Therefore, the relocation costs are not deductible.

121. In contrast, if Bluett and Grayson Limited decided to expand the existing audit arm of its business, such an extension would not be a move into a new field of trading, because the company is already providing those services. Therefore, unless the expansion plan involves the company significantly changing the way it delivers those services, such an expansion

will not alter the structure of the business. Therefore, the relocation costs would be deductible.

Example 6 - Relocating divisional operations to one centralised site

122. Frozen Foods New Zealand Limited has determined that if it combines and relocates its various local manufacturing divisions to one new purpose-built industrial site that is linked by rail to the local port, the company will be able to significantly expand its production capacity as well as make efficiency savings and reduce freight costs. While the efficiency and profitability of the business will improve, the principal driver for this relocation is the expansion of the company's production capacity. This expansion is achieved through the company centralising and fundamentally reorganising its various manufacturing processes to one centralised site. In this case, the structure of the business will be affected by the relocation. While the nature of the business remains essentially the same, the relocation of the business forms part of a plan to carry on the business in a significantly different (and expanded) way. The relocation costs incurred to relocate to the new site will be capital and not deductible.

Example 7 - Competing reasons for relocating business

123. Electrical Engineering Limited manufactures commercial fuse boxes. They have been thinking about relocating for some time. The business is prospering, their current lease will expire shortly and they can see benefits from being located closer to their local suppliers. They also have developed a plan to expand the business by starting to manufacture some of the specialist components used in the fuse boxes themselves. Currently the components are imported from overseas. As part of its plan the company has made inquiries about purchasing some new machinery and is recruiting new staff as they do not have the necessary manufacturing expertise in-house. Their investigations suggest that there will be a good market in New Zealand and possibly overseas for the components. While there are a number of reasons for the company moving, in this case, the principal reason is the need for larger premises to implement the planned expansion of the business. The fact that the lease is expiring and the business needs more space whether it expands or not, are not considered to be the principal reasons for the move in this case. The relocation costs will be capital and not deductible.

Example 8 - Shift from home-based business to commercial premises

124. Gabriella has been manufacturing umbrellas at home in her garage and successfully selling them online and by mail order for some time. Business is flourishing and she wants to expand her business by having a retail store. Gabriella's expansion strategy includes engaging two new workers and shifting from her garage to commercial premises from which she can both manufacture and sell her umbrellas directly to the public. The relocation will result in Gabriella carrying on her business in a different way with the effect that the structure of Gabriella's business will be enlarged. The relocation is part of a planned expansion strategy. The relocation costs will be capital. Therefore, the relocation costs are not deductible.

Example 9 - Relocation on merger

125. Local Trucking Limited has wanted to expand their operations for sometime and has been actively seeking businesses to takeover. The company recently entered into a deal to acquire a competitor company, Fast Fleet Limited. As part of its takeover plan, Local Trucking Limited has agreed to merge its operations with Fast Fleet Limited. This includes the company

relocating its operations to Fast Fleet's larger premises as they have more storage space and better loading facilities. As the relocation forms part of an expansion plan the cost of relocating will be capital and not deductible.

Depreciation

126. Business relocation costs incurred to relocate business property will not be deductible if they are of a capital nature. However, a question arises as to whether those capital costs can be added to the "cost" of an item of depreciable property to the extent they relate to the relocation of that item.

127. Subpart EE provides that a person has a depreciation loss, if the person owns an item of depreciable property that is used or available for use. The Act defines what is meant by ownership and depreciable property and prescribes how amounts of depreciation loss are to be calculated. It also specifically provides for depreciation losses in respect of improvements to items of depreciable property: section EE 37. However, the Act does not define the meaning of "cost" for depreciation purposes.

Meaning of "cost"

128. The standard formula for calculating amounts of depreciation loss is set out in section EE 16. The formula relies on a person determining the "value or cost" of an item of depreciable property. However, no definition of the term "cost" is provided. Section EE 16(4)(c) does provide for two variations to the term "cost" for the purposes of the standard calculation. These variations are set out in sections EE 18 and EE 19, but neither is relevant to determining whether relocation costs can form part of the "cost" of an item of depreciable property.

129. The Commissioner acknowledges the comments of Kitto J in the Australian High Court case *BP Refinery (Kwinana) Ltd v FCT* (1960) 12 ATD 204. He interpreted the word "cost" as bearing the meaning it has in the business life of the community. At page 207 he states:

> Embracing the whole sum which, according to accepted accountancy practice as applied to the circumstances of the case, ought to be considered as having been laid out by the taxpayer in order to acquire the subject matter as plant, that is to say installed and ready for his use as plant for the purpose of producing assessable income.

130. In the Commissioner's view, Kitto J's interpretation supports the inclusion of initial assembly and installation costs as part of the "cost" of an item of depreciable property. However, the Commissioner does not consider that Kitto J's comments go so far as to support the inclusion of subsequent relocation costs as also forming part of the "cost" of an item. This is especially so when the term "cost" is considered in the context of New Zealand's depreciation rules.

131. In the Commissioner's view the term "cost" as it is used in the depreciation rules is effectively restricted to the initial cost of an item of depreciable property. Case law and commercial practice dictate that included in the initial cost are set-up and installation costs. However, the scheme of the depreciation rules seems to prevent any costs incurred subsequent to the initial setting up of the item from coming within the "cost" of that item unless they qualify under sections EE 18 and EE 19 (variations to cost) or section EE 37 (improvements). If subsequent costs can be implicitly added to the cost of an item of depreciable property it becomes difficult to understand the need for sections EE 19 and EE 37 in the depreciation rules.

132. Accordingly, the Commissioner's view is that under the depreciation rules relocation costs cannot be subsequently added to the cost of an item of

depreciable property except where the relocation costs result in an "improvement" to the item. This means no depreciation loss is available for those costs.

Improvements

133. In order for a depreciation loss to be available in respect of relocation costs, the costs would need to result in an improvement to the item of depreciable property. Section EE 67 defines an "improvement" as an alteration, extension, or repair of an item of depreciable property that increases its capital value.

134. In the Commissioner's view the relocation of an item of depreciable property does not necessarily result in the depreciable property having an increased capital value. This will be a question of fact.

Comments on technical submissions received

135. In the course of producing this statement, various technical submissions were received.

136. The Commissioner does not consider that an across the board deduction for all relocation expenditure can be supported by case law. There will be circumstances where the general permission will not be met, and there will be circumstances where the expenditure has the purpose or effect of enlarging or expanding the structure of a business.

137. The Commissioner recognises that the exclusion of business relocation costs from the cost base of items of relocated depreciable property will result in the recognition of "black hole expenditure" when the costs incurred are found to be capital in nature. Although, such an outcome is unfortunate, in the Commissioner's view, the cases, on balance, indicate that in certain circumstances costs incurred to expand or enlarge the structure of a business will be capital. In those situations the depreciation rules do not allow the cost base of items of depreciation property to be increased by the relocation costs, unless there is an "improvement" of the item.

138. It may seem incongruous in the case of a business expansion to treat the cost of relocating existing property as non-deductible expenditure and yet allow a depreciation loss for the cost of acquiring and installing new property as part of the same expansion. Arguably, the cost of relocating existing business property as part of an expansion in the structure of a business is revenue expenditure on the basis that no enduring advantage or benefit arises in respect of the existing property as a result of the move and, to the extent of that property, the business structure remains unchanged.

139. However, the Commissioner is not convinced by this argument. He considers the better view in such circumstances, based on the various cases, is that the need or occasion for relocating the existing property is the expansion of the business structure. The costs flow from the decision to expand the business. If it were not for the business structure expanding, the existing property would not be relocated, and likewise, the existing property needs to be relocated if the business is to expand. As a result, in those circumstances the relocation costs do give rise to an enduring advantage for the business and do have the purpose and effect of expanding or enlarging the business structure even though the costs relate to existing property.

Legislation

140. Section DA 1 is the general permission that allows a deduction for expenditure. Section DA 1(1) and (2) provides:

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**.

141. Section DA 2 sets out the limitations to the general permission in section DA 1 that may prevent a deduction. Section DA 2(1) provides:

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

142. The depreciation rules in subpart EE set out how an amount of a depreciation loss is calculated. Section EE 16(4) specifies the value or cost to be used to calculate depreciation. Section EE 16(1), (2) and (4) provides:

EE 16 Amount resulting from standard calculation

Amount

(1) For the purposes of the comparison of amounts required by section EE 14(1), the amount dealt with in this section is calculated using the formula**—**

$$\text{annual rate x value or cost x } \frac{\text{months}}{12}$$

Definition of items in formula

(2) The items in the formula are defined in subsections (3) to (5).

...

Value or cost

(4) **Value or cost** is,**—**

(a) when the person uses the diminishing value method, the item's adjusted tax value at the end of the income year before the deduction of an amount of depreciation loss for the item for the income year:

(b) when the person uses the straight-line method,**—**

(i) for a patent or plant variety rights in relation to which the person has been allowed a deduction for an amount of depreciation loss for the relevant application, the item's adjusted tax value at the start of the month in which the person acquires it:

(ii) for other items, its cost to the person excluding expenditure for which the person is allowed a deduction under a provision of this Act outside this subpart:

(c) for the purposes of paragraph (b), variations to cost are in sections EE 18 and EE 19.

143. A depreciation loss can be deducted when a person makes an improvement to an item of depreciable property. Section EE 67 defines "improvement" as meaning:

> **EE 67 Other definitions**
>
> In this Act,—
>
> ...
>
> **improvement** means an alteration, extension, or repair of an item of depreciable property that increases its capital value