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# DEDUCTIBILITY OF SPONSORSHIP EXPENDITURE

## Introduction

This interpretation statement contains guidelines that the Commissioner considers relevant in determining whether sponsorship expenditure is deductible under the general deductibility provisions in section BD 2 of the Income Tax Act 1994. This statement replaces the Commissioner's statement, *Deducting sponsorship as advertising expenditure*, in *Tax Information Bulletin* Vol 6, No 4 (October 1994) at pages 1 and 2.

All legislative references in this statement are to the Income Tax Act 1994 unless otherwise stated.

## Summary

Sponsorship expenditure will be deductible under limb (b) of section BD 2(1) where a nexus exists between the expenditure and the taxpayer's business or income-earning activity.

- There must be a nexus or necessary relationship between the expenditure and the taxpayer's business or income earning activity.
- This requires a determination of the character of the advantage sought by the taxpayer in incurring the expenditure. This is a subjective matter, depending upon the taxpayer's purpose when incurring the expenditure. The determination of the taxpayer's purpose or purposes will require an objective analysis of surrounding circumstances, including the effect of the expenditure.
- In relation to limb (b)(ii), expenditure will be deductible where it is dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business.
- Voluntary expenditure is deductible provided it is directed to business or income-earning ends.
- In the absence of associated party or avoidance concerns, the quantum of the expenditure is not material to the issue of deductibility.
- The fact that a third party may benefit from the expenditure incurred does not preclude that expenditure from being deductible.

In order for the nexus test to be satisfied, the taxpayer needs to show that he or she intended that the business would be promoted by incurring the sponsorship expenditure. In this regard, the following objective factors will support a taxpayer's contention that he or she intended that the business be promoted by the expenditure:

- The specific terms of the sponsorship arrangement, e.g. Is there a specific requirement for the recipient to promote the taxpayer's business? What is the extent and prominence of the business exposure specified in the agreement?

- The place of the sponsorship arrangement in a coherent marketing strategy. For example, if a business's market research has identified that potential customers frequently attend cultural events, then part of its marketing strategy may be to sponsor such events in return for its name and products being promoted during the event.
- The relationship between the market or potential market exposure capable of being reached and the taxpayer's business. For example, market exposure at a tennis tournament is directly related to the business of a sports equipment retailer.
- The relationship between the expenditure and the resulting income derived, i.e. can it be shown that the expenditure resulted in income being derived? For example, the sale of 10 tractors at an agricultural field-day, by a tractor manufacturer sponsoring the event in return for being able to display the tractors, shows a direct relationship between the sponsorship expenditure and the derivation of income.

Deductibility of the sponsorship expenditure is subject to section BD 2(2), which prohibits deductions for expenditure of a capital or private or domestic nature. From an analysis of case law pertaining to the capital / revenue distinction the following seven tests are identified:

- the need or occasion which calls for the expenditure;
- whether the expenditure is recurrent in nature;
- whether the expenditure creates an identifiable asset;
- whether the expenditure creates an advantage which is of an enduring benefit to the business;
- whether the expenditure is on the profit-making structure or on the profit-making process;
- 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.

The indicia developed by the Courts to distinguish between capital and revenue expenditure are not necessarily all relevant in the context of sponsorship expenditure. Of the various indicia analysed, it would appear that the identifiable asset test is the most important. While the enduring advantage test appears relevant, frequently the nature of the enduring benefit resulting from the sponsorship expenditure will not be such as to warrant a capital classification because the benefit is intrinsically linked to the means of exposure.

An outgoing is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit. Therefore, it is necessary to determine whether the sponsorship expenditure, in whole or part, relates exclusively to things of a private or domestic nature. Where a benefit of a private or domestic nature (e.g. private enjoyment) accrues to the recipient of sponsorship expenditure, or to any other person, but this benefit is incidental to the payer's income-earning or business activity, then the deduction is not prohibited.

Section EF 1 may apply to limit the deduction in any income year to that portion of the sponsorship expenditure which relates to the current income year. Where the expenditure relates to the purchase of goods, the current year deduction is effectively restricted to goods used in that year in deriving gross income. Where the expenditure relates to a payment for services, the current year deduction is effectively restricted to the amount incurred on services performed in that year. Where the expenditure relates to a chose in action, the deduction is deferred for the portion relating to the unexpired part of the period that the chose is enforceable.

If sponsorship expenditure is incurred in relation to depreciable property (as defined in section OB 1), a deduction will be allowed for depreciation as determined under section EG 2. The amount of the deduction is dependent upon whether the depreciable property is wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income.

**What is "sponsorship"?**

For the purposes of this statement it is first necessary to identify what type of expenditure is being considered, i.e. what type of expenditure constitutes sponsorship expenditure. The term "sponsorship" is used to cover a wide range of situations, with the usage reflecting considerable overlap with the concepts of "advertising", at one end of a continuum, and "donations" at the other end. At one extreme, the taxpayer's sole purpose is to "advertise" / promote the business with the amount incurred reflecting market forces and what he or she considers will best achieve the purpose of business promotion. At the other extreme, the taxpayer's "donation" is for the sole purpose of benefiting the donee and business promotion is not contemplated or is merely incidental to the philanthropic purpose.

In between these two extremes, the taxpayer intends to promote his or her business in some manner when incurring the expenditure, but the expenditure made also benefits the recipient (or some other person) in a manner unrelated to the ordinary receipt of income from his or her income-earning activities.

This statement does not consider expenditure at the extremes of the continuum, i.e. expenditure made to commercial advertising media, at one end of the continuum, and charitable donations where business promotion is not a purpose, at the other end of the continuum. Instead, the statement focuses on the deductibility of expenditure in the middle of the continuum (referred to in this statement as "sponsorship expenditure"), i.e. where the taxpayer making the expenditure intends that his or her business will be promoted in some way, but that the recipient, or some other person, will also be benefited in some manner other than by the receipt of ordinary income from business or income-earning activities.

**Legislation**

Whether or not sponsorship expenditure is an allowable deduction is determined under section BD 2 of the Income Tax Act 1994 which reads as follows:

**(1)** An amount is an allowable deduction of a taxpayer

…

(b) to the extent that it is an expenditure or loss

(i) incurred by the taxpayer in deriving the taxpayer's gross income, or

(ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or

…

**(2)** An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is

(a) of a private or domestic nature, or

…

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

…

Section EF 1 concerns accrual expenditure:

**(1)** Where any person has incurred any accrual expenditure–

(a) That expenditure is allowed as a deduction when it is incurred in accordance with this Act; and

(b) The unexpired portion of that expenditure at the end of an income year shall be included in the gross income of the person for that income year and shall be allowed as a deduction in the following income year.

…

**(5)** The amount of the unexpired portion (if any) of any amount of accrual expenditure of any person to be taken into account in any income year shall be–

(a) Where the expenditure relates to the purchase of goods, the amount of expenditure incurred on goods not used in deriving gross income:]

(b) Where the expenditure relates to payment for services, the amount of expenditure incurred on services not performed:

(c) Subject to subsection (8), where the expenditure is incurred by way of monetary remuneration for services that have been performed, the amount of the expenditure that has not been paid in the income year or within such further period as is specified in subsection (6):

(d) Where the expenditure relates to a payment for, or in relation to, a chose in action, the amount that relates to the unexpired part of the period in relation to which the chose is enforceable.

…

**(7)** In this section–

**"Goods"** means all real or personal property; but does not include choses in action or money:

**"Services"** means anything which is not goods or money or a chose in action.

…

## General principles

The usual approach for determining whether or not expenditure is deductible is first to consider the general deductibility provision in section BD 2(1) i.e. whether the expenditure was "incurred by the taxpayer in deriving the taxpayer's gross income" (limb (b)(i)) or whether the expenditure was "necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income" (limb (b)(ii)). Having determined that the expenditure meets the criteria in section BD 2(1), it is then necessary to determine whether or not any of the prohibitions in section BD 2(2) apply.

For expenditure to be deductible under limb (b) of section BD 2(1), there must be a nexus or necessary relationship between the expenditure and the taxpayer's business or income earning activity (*CIR v Banks* (1978) 3 NZTC 61,236 at p. 61,240; *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 at p. 61,274). This requires a

determination of the character of the advantage sought by the taxpayer in incurring the expenditure (*Buckley & Young* at p. 61,274). In this regard, the character of the receipt in the hands of the recipient is not determinative (*Regent Oil Co Ltd v Strick* [1965] 3 All ER 174 at pp. 350-351).

In relation to limb (b)(ii) of section BD 2(1), the function of the term "necessarily" was considered by Dixon CJ in *FCT v Snowden & Wilson Proprietary Limited* (1958) 99 CLR 431 at p. 436:

> The word "necessarily" does, however, seem to me to require consideration. Clearly its operation is to place a qualification upon the degree of connection between the expenditure and the carrying on of the business which might suffice in the absence of such a qualification. In *The Commonwealth and The Post-Master General v Progress Advertising Agency Co Pty Ltd* Higgins J supplied an interpretation of "necessary" as not meaning essentially necessary but as meaning appropriate, plainly adapted to the needs of a department carrying out an Act. That was in another connection but the phrase was availed of by the Court in [*Ronpibon Tin NL & Tongkah Compound NL v FCT* (1949) 78 CLR 47] as throwing light on the use of the word "necessarily" in s.51 (1). Clearly the expression is used in relation to business. **Logical necessity is not a thing to be predicated of business expenditure. What is meant by the qualification is that the expenditure must be dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business.** [Emphasis added]

"Necessarily" was also considered in *Europa Oil (N.Z.) Limited v CIR (No. 2)* (1974) 1 NZTC 61,169 (CA). At p. 61,208, Beattie J reiterated that logical necessity was not predicated by business expenditure, i.e. merely because a business expends money does not mean, of itself, that the expenditure was necessarily incurred. McCarthy P at p. 61,196 stated that the determination of whether or not expenditure was necessarily incurred requires "a judgment based on common sense and business realities", but that the ordinary meaning of "necessarily" connotes that the expenditure will not be the result of an entirely free choice, but will have been dictated by the surrounding circumstances. Richmond J at p. 61,205 noted that while the term "necessarily" has a restrictive sense, it also has a sense of entitlement, in that a taxpayer who has had to incur expenditure in the course of business should be able to claim a deduction for it. Support for the view that the term "necessarily" should be read down to mean that expenditure must be directed toward business ends, as opposed to being absolutely essential, can be found in *Usher's Wiltshire Brewery Ltd v Bruce* [1915] AC 433 at p. 449 and *British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 205 at pp. 211-212 which held that voluntary expenditure may be deductible.

In the appeal from the Court of Appeal decision in *Europa (No. 2)*, reported at *Europa Oil (NZ) Limited v CIR (No. 2)*; *CIR v Europa Oil (NZ) Limited (No. 2)* (1976) 2 NZTC 61,066 (PC), the majority of the Privy Council at p. 61,071 did not focus specifically on the word "necessarily", but instead looked at what the taxpayer was legally entitled to as a result of incurring the expenditure, i.e. to use the words in *Buckley & Young*, it considered the character of the advantage sought by the taxpayer in incurring the expenditure. As the expenditure in that case had resulted entirely in trading stock, it held that the expenditure was deductible. Significantly, at p. 61,071, the majority of the Privy Council held that the amount of expenditure is not material, i.e. deductibility is not dependent upon the amount of expenditure being "reasonable", citing *Cecil Bros Ltd v FCT* (1964) 111 CLR 430. At p. 434, Owen J cited the following statement from *Ronpibon Tin NL & Tongkah Compound NL v FCT* (1949) 78 CLR 47 at p. 60, which statement was approved by the Judicial Committee in both

the *Europa Oil* cases ([1971] NZLR 641 at p. 649 and (1976) 2 NZTC 61,066 at p. 61,071):

> It is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent.

Thus, expenditure will be necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, where the expenditure is dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business. This requires a determination of the character of the advantage sought by the taxpayer in incurring the expenditure. Voluntary expenditure may be deductible, provided it is directed to business ends. In the absence of associated party or avoidance concerns, the quantum of the expenditure is not material to the issue of whether or not expenditure is deductible.

A key factor in determining whether expenditure is deductible under section BD 2(1) is determining the character of the advantage sought. This is a subjective matter, depending upon the taxpayer's purpose when incurring the expenditure (*CIR v National Distributors Ltd* (1989) 11 NZTC 6,346 at p. 6,350). In this regard, there is a distinction between purpose and effect. Thus, for example, the fact that no income is ultimately derived does not necessarily mean that it was not made for the purpose of deriving gross income. Ultimately it will be a question of fact what a taxpayer's subjective purpose or purposes were in incurring the expenditure. In this regard, a taxpayer's purpose is to be determined by an objective analysis of surrounding circumstances, including the effect of the expenditure (*National Distributors* at p. 6,351).

The phrase "to the extent that" in limb (b) of section BD 2(1) contemplates apportionment (*Buckley & Young* at p. 61,274), i.e. where part of the expenditure is incurred for a purpose unrelated to the taxpayer's business or income earning activity, or when a deduction for part of the expenditure is prohibited, then that part will not be deductible. Nevertheless, the fact that a third party may benefit from the expenditure incurred by the taxpayer does not necessarily preclude that expenditure from being deductible. This was held in *Usher's Wiltshire Brewery Ltd*, a case which concerned expenditure voluntarily incurred by a brewery company on licensed premises which it leased to publicans, who were tied to the company in that they were required to sell the company's beer. Although the lessee was obliged to keep the premises in good repair, the brewery company preferred to undertake the repairs and maintenance itself, being able thereby to ensure that the premises were maintained at a high standard. At issue, among other things, was whether or not expenditure incurred to repair the leased premises was "wholly and exclusively expenditure on repairs of premises occupied for the purpose of [its brewery] trade". The Crown contended that the premises were not occupied by the brewery company, being instead occupied by the lessee, and therefore the repair expenditure incurred by the company did not meet the criterion for deductibility. At p. 427, Lord Atkinson held that the expenditure was "wholly and exclusively expenditure on repairs of premises occupied for the purpose of [the company's brewery] trade", basing his decision on the fact that the licensed premises "were the market place for [the company's] beer and none other". He stated that the fact that the lessee benefited from the company's repair expenditure did not preclude the criterion for deductibility being satisfied.

In order to reconcile the decisions in *Buckley & Young* and *Usher's*, it is necessary to distinguish between the situation where there are two or more distinct purposes for making the expenditure, not all of which relate to the taxpayer's business or income earning activity (apportionment will be required here), and the situation where the third party benefit is incidental to the purpose relating to the taxpayer's business or income earning activity (no apportionment is required here).

Having established that the expenditure is deductible under either limb (b)(i) or (b)(ii) of section BD 2(1), it is then necessary to determine whether or not the deduction is prohibited by section BD 2(2). Relevant prohibitions are those relating to expenditure of a private or domestic nature (limb (a)) and expenditure of a capital nature (limb (e)).

**Prohibition – capital expenditure**

Concerning the capital prohibition in limb (e) of section BD 2(2), a number of different tests have been formulated by the Courts. The most commonly used test in New Zealand is derived from the Australian decision of *Sun Newspapers Limited and Another v FCT* (1938) 61 CLR 317 where Dixon J formulated the following indicia:

- the character of the advantage sought (for which the lasting qualities may play a part);
- 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
- the means adopted to obtain the advantage, e.g. 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.

The indicia put forward in *Sun Newspapers* were adopted by the Privy Council in the decision of *BP Australia Limited v FCT* (1965) 14 ATD 1. The *BP Australia* formulation was adopted in New Zealand in cases such as *CIR v L D Nathan & Co Limited* [1972] NZLR 209, *Buckley & Young*, *CIR v McKenzies New Zealand* (1988) 10 NZTC 5,233, *Christchurch Press Company Limited v CIR* (1993) 15 NZTC 10,206, *CIR v Wattie* (1998) 18 NZTC 13,991, *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001, and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981.

In *McKenzies,* the Court of Appeal extracted five indicia from the Privy Council decision in *BP Australia*, which were themselves applied in *Christchurch Press*. Those five indicia are as follows:

- a consideration of the need or occasion which calls for the expenditure (recurrence may play a part here);
- whether the sums were paid out of fixed or circulating capital;
- whether the payments were of a once and for all nature, producing assets or advantages which were of an enduring benefit;
- a consideration of ordinary principles of commercial accounting; and

- whether the sums were incurred on the structure, within which the profits were to be earned, or whether they were part of the income earning process.

The Court of Appeal in *L D Nathan* at p. 214 extracted several indicia from the *BP Australia* case:

- recurrence;
- whether the expenditure was from fixed or circulating capital;
- whether the expenditure related to the business entity or structure (or profit/yielding subject) or whether it related to the process by which such a structure is operated in order to obtain regular returns;
- whether the expenditure was made once and for all, with a view to bringing into existence an asset or advantage for the enduring benefit of the trade;
- whether the expenditure was ordinary expenditure in the course of the regular income-earning conduct of the business; and
- the nature of the asset obtained or sought in which its enduring character may play a part.

The most recent New Zealand Privy Council case in this area, *Wattie*, adopted the same approach as that described in *Hallstroms Proprietary Limited v FCT* (1946) 72 CLR 634 at p. 648. The Privy Council also endorsed the approach taken in *BP Australia, Regent Oil, British Insulated and Helsby,* and *McKenzies*. In *Poverty Bay Electric Power Board*, the Court of Appeal referred to the approach of *BP Australia, Hallstroms*, and *British Insulated and Helsby*. The Court of Appeal in *Birkdale* endorsed the approach of the Privy Council in *Wattie* and *BP Australia*.

However, these cases 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, North P in the *L D Nathan* case at p. 214 stated that where the distinction between capital and revenue expenditure was not clear-cut, the indicia should be weighed up in the context of the whole set of circumstances. This principle was confirmed by Richardson J at p. 5,235 of the *McKenzies* case, citing *BP Australia*:

> 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:
>
> > "**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 agree. That answer:
> >
> > '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. 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." [Emphasis added]

Similar statements were made by Viscount Radcliffe in *Commissioner of Taxes v Nchanga Consolidated Copper Mines Limited* [1964] 1 All ER 208 at pp. 212-213, and by Templeman J in *Tucker v Granada Motorway Services Limited* [1977] 3 All ER 865 at p. 869. However, when the latter case was appealed to the House of Lords (reported at *Tucker (Inspector of Taxes) v Granada Motorway Services Ltd* [1979] 2 All ER 801), Lord Wilberforce noted at p. 804 that sometimes applying analogies is the only available option:

> There are a number of tests which have been stated in reported cases which it is useful to apply, but we have been warned more than once not to seek automatically to apply to one case words or formulae which have been found useful in another (see *Comr of Taxes v Nchanga Consolidated Copper Mines Ltd*). Nevertheless reported cases are the best tools that we have, even if they may sometimes be blunt instruments.

From the various indicia formulated by the Courts, subject to the warning that the whole set of circumstances must be considered, the following tests or indicia may be identified:

- **the need or occasion which calls for the expenditure:** This test considers what prompted or necessitated the taxpayer to incur the expenditure and whether the surrounding circumstances and ultimate objective of the expenditure support a capital or revenue classification.
- **whether the expenditure is recurrent in nature**: This test, which is closely aligned to the previous one, states that recurrent expenditure is often of a revenue nature and that one-off expenditure is often of a capital nature. This test is not determinative, e.g. irregular expenditure may be of a revenue nature. To conclude that recurrent expenditure is of a revenue nature, it is necessary to establish that it is an ordinary incident of carrying on a business.
- **whether the expenditure creates an identifiable asset:** This test states that expenditure will be of a capital nature if an identifiable capital asset was acquired by the expenditure.
- **whether the expenditure creates an advantage which is of enduring benefit to the business:** This test is similar to the previous one, but instead focuses on whether an enduring advantage was acquired by expending the money. If it was, then the expenditure is likely to be of a capital nature. An enduring benefit can arise from expenditure made to relieve the business of an onerous asset. In this regard, an enduring benefit is to be distinguished from where the expenditure merely relieves the taxpayer from making revenue payments for a period of time. This test is often linked to the test of recurrence, i.e. expenditure made once-for-all with a view to acquiring an advantage of enduring benefit to the business is likely to indicate that the expenditure was of a capital nature.
- **whether the expenditure is on the profit-making structure or on the profit-making process:** This test aims at distinguishing between expenditure which relates to the business's structure (i.e. assets which are used in order to carry on the business) and the business's operation (i.e. the means by which the assets are

organised in order to carry on the business). In this regard, in some businesses the structure may mainly consist of intangible assets, e.g. goodwill. This test is often linked to the identifiable asset and enduring advantage tests. For example, combining the tests enables to the correct classifications to be made where expenditure is made, as an ordinary incident of the business, to maintain the profit-making structure (likely to be of a revenue nature, despite relating to the profit-making structure), or expenditure is made to enable the business to operate differently (likely to be of a capital nature, despite relating to the profit-making process).

- **whether the source of the payment is from fixed or circulating capital:** This test states that expenditure made from fixed capital (i.e. capital on which a return is sought by the business's operation) is more likely to be of a capital nature, and expenditure made from circulating capital (i.e. capital which returns to the business as a result of the business's operation) is more likely to be of a revenue nature. The test is not now given much weight by the Courts, as it is easy for a business to choose whether to finance an asset, say, from fixed capital or to finance it from circulating capital, irrespective of the nature of the asset financed.
- **the treatment of the expenditure according to the ordinary principles of commercial accounting:** How expenditure is classified according to ordinary commercial accounting principles may support the classification made from applying the other indicia. However, this test is not usually determinative, since tax and accounting have different aims and the respective treatments may consequently differ from each other.

Many of these indicia overlap and some factors will carry more weight in given circumstances. Therefore, while these indicia are helpful as a starting point, it is nevertheless necessary to make a final judgment of whether the expenditure is of a capital or revenue nature by analysing the facts as a whole, weighing up which factors carry the most weight in the light of these facts.

**Prohibition – private or domestic expenditure**

The prohibition of deductions for expenditure of a private or domestic nature (limb (a) of section BD 2(2)) was considered in *CIR v Haenga* (1985) 7 NZTC 5,198. This case concerned whether or not contributions to a welfare society, which were required by statute to be made, were deductible (the case related to an income year before deductions were prohibited for expenditure incurred in deriving income from employment). At p. 5,207, Richardson J stated:

**An outgoing is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit.** While ordinarily health care is uniquely personal to the individual concerned and affects his private life as well as his work potential, there may be such emphasis under the employment contract in attaining and maintaining a particular standard of fitness (or even grooming) that expenditure directed to that end cannot fairly be characterised as private or domestic or for that matter as other than work-related. That is not this case but it suggests that it is overly simplistic to brand these contributions to this welfare society as inherently of a private rather than an employment character. On the contrary, in the very unusual circumstances of this case I have come to the conclusion, not without hesitation, that the required nexus exists between the expenditure in question and the gaining of the employment income. That expenditure is imposed on the employee by Statute. It reflects a recognition by the employer and the unions endorsed by the Legislature that the availability of the benefits afforded by membership of the welfare society has a perceived if not readily quantifiable impact on the work performance of the

employees concerned. It is more than a prerequisite to the earning of income. It is directed to the income earning process itself. Clearly all those immediately concerned in the employment relationship have bona fide regarded that expenditure as work-related being directed to preserving and enhancing the employee's performance of his duties and in the end I have concluded that we would not be justified in taking a different view. [Emphasis added]

In coming to this conclusion of the application of the law to the particular facts in question, Richardson J held that expenses properly characterised as consumption (e.g. food, clothing and shelter) are not incidental and relevant to the derivation of income merely because they are required in order for a person to be able to earn income.

In several Taxation Review Authority cases (*Case E87* (1982) 5 NZTC 59,455; *Case F30* (1983) 6 NZTC 59,704; *Case F159* (1984) 6 NZTC 60,358), whether or not expenditure was of a private or domestic nature was determined by ascertaining whether anybody received a benefit of a private or domestic nature. However, by solely focusing on the recipient of the benefit resulting from the expenditure, it would prohibit a deduction for wages paid, for example, where the recipient of the wages used the money received to purchase food and accommodation. It is not considered, therefore, that this is the correct approach. Rather, as Richardson J did in *Haenga*, it is necessary to determine whether the expenditure, in whole or part, related exclusively to things of a private or domestic nature. Where a benefit of a private or domestic nature accrues to the recipient, but this benefit is incidental to the income-earning or business activity of the payer, then it follows from the approach in *Usher's* – where expenditure was held to be deductible because the third-party benefit was incidental – that the deduction is not prohibited.

In summary, then, an outgoing is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit. Where a benefit of a private or domestic nature accrues to the recipient, but this benefit is incidental to the income-earning or business activity of the payer, then the deduction is not prohibited. Where the private or domestic benefit accrues from a purpose of the taxpayer distinct from the business promotion purpose, then apportionment will be necessary.

**Apportionment**

By virtue of the definition of "sponsorship" used in this statement (i.e. benefits contemplated to the taxpayer and to some other party), and because of the inclusion of the phrase "to the extent that" in sections BD 2(1) and BD 2(2), the issue of apportionment must be considered. Apportionment will be required where the expenditure may partly be on revenue account and partly on capital account. Apportionment will also be required where a sponsorship agreement is entered into to achieve more than one end (e.g. income-earning and private) – whether or not the dual purposes are evident on the face of the relevant documentation. It will also be required where part of the sponsorship expenditure is not deductible at all e.g. preliminary expenditure incurred before the business began (*Calkin v CIR* (1984) 6 NZTC 61,781 at p. 61,786). Merely because it may be difficult under a sponsorship arrangement to determine what part of the expenditure relates to business promotion, or which part is prohibited by virtue of section BD 2(2), this does not preclude the need for apportionment where, in fact, more than one purpose was envisaged by incurring the expenditure (*Buckley & Young* at p. 61,274).

**Accrual expenditure**

Even if a deduction is allowed for expenditure under limb (b) of section BD 2(1), and is not prohibited under section BD 2(2), it needs to be considered whether the expenditure is accrual expenditure such that section EF 1 applies to limit the deduction in any income year. Section EF 1(1) states that "accrual expenditure" is deductible when incurred, but (subject to section EF 1(3)) any "unexpired portion" of it at the end of the income year is included in the taxpayer's gross income for the year but is allowed as a deduction in the following income year. The term "accrual expenditure" is defined in section OB 1 to mean any expenditure deductible under the Act (with certain exceptions specified in the definition in section OB 1). The "unexpired portion" of an amount of accrual expenditure is defined in section EF 1(5) which reads as follows:

> The amount of the unexpired portion (if any) of any amount of accrual expenditure of any person to be taken into account in any income year shall be–
>
> (a) Where the expenditure relates to the purchase of goods, the amount of expenditure incurred on goods not used in deriving gross income:
>
> (b) Where the expenditure relates to payment for services, the amount of expenditure incurred on services not performed:
>
> (c) Subject to subsection (8), where the expenditure is incurred by way of monetary remuneration for services that have been performed, the amount of the expenditure that has not been paid in the income year or within such further period as is specified in subsection (6):
>
> (d) Where the expenditure relates to a payment for, or in relation to, a chose in action, the amount that relates to the unexpired part of the period in relation to which the chose is enforceable.

Essentially, the unexpired portion of accrual expenditure is that portion of the expenditure which relates to future income years.

**Depreciation**

If a deduction is prohibited because of the capital prohibition in section BD 2(2), a deduction for depreciation may be allowed under subpart EG. Broadly, for a deduction to be allowed for depreciation the taxpayer must own the "depreciable property" (section EG 1(1)), which is defined in section OB 1 to mean:

> … any property of [the] taxpayer which might be reasonably expected in normal circumstances to decline in value while used or available for use … in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Where there is depreciable property, the amount of the deduction allowed for depreciation is determined under section EG 2 and is dependent upon whether the depreciable property is wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income.

**APPLICATION TO SPONSORSHIP EXPENDITURE**

Having considered the general principles relating to sections BD 2(1) and BD 2(2), it is necessary to apply these principles in the context of sponsorship expenditure. This will be approached as follows:

- is the sponsorship expenditure deductible pursuant to section BD 2(1);

- do any of the prohibitions in section BD 2(2) apply (the need for apportionment will considered under this head);
- if a deduction is prohibited because of the capital prohibition in section BD 2(2), is a deduction for depreciation allowed;
- does section EF 1 apply to limit the deduction in any given income year.

**Deductibility under section BD 2(1)**

Concerning the general deductibility provision in section BD 2(1), the following principles were identified:

- There must be a nexus or necessary relationship between the expenditure and the taxpayer's business or income earning activity.
- This requires a determination of the character of the advantage sought by the taxpayer in incurring the expenditure. This is a subjective matter, depending upon the taxpayer's purpose when incurring the expenditure. The determination of the taxpayer's purpose or purposes will require an objective analysis of surrounding circumstances, including the effect of the expenditure.
- In relation to limb (b)(ii), expenditure will be deductible where it is dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business.
- Voluntary expenditure is deductible provided it is directed to business or income-earning ends.
- In the absence of associated party or avoidance concerns, the quantum of the expenditure is not material.
- The fact that a third party may benefit from the expenditure incurred does not preclude that expenditure from being deductible.

For the purposes of this statement, sponsorship expenditure has been defined to mean expenditure where the payer intends that his or her business will thereby be promoted in some way, but that the recipient, or some other person, will also be benefited in some manner other than by the receipt of ordinary income from business or income-earning activities.

Expenditure of the type which meets this definition was held to have been incurred in deriving income in the Australian case, *Cliffs International, Inc v FCT* 85 ATC 4374. In this case, the taxpayer contributed to the annual running of a golf tournament in which the taxpayer's joint venture partners and key Japanese customers participated. Another case where sponsorship expenditure, as so defined, was held to be incurred in deriving income is the South African case, *Income Tax Case No. 696* 17 SATC 86. This case concerned a company which dealt in agricultural equipment. It purchased some footballs which it endorsed with words associated with the equipment in which it traded, and then gave them to various school football clubs. It also acquired two silver trophies which it donated to agricultural societies, having engraved them with the company's name and the names of various pieces of equipment in which it traded. All three members of the Cape Income Tax Special Court held that the expenditure incurred on the footballs was deductible (one member held that the expenditure on the

cups was capital in nature). In relation to the expenditure on the footballs, Newton Thompson J put it this way at p. 87:

> I am satisfied that this expenditure is for advertisement purposes, that it has that effect; that it assists in selling articles in which the appellant deals; that it is incurred in the production of income…

Two issues immediately arise from the definition of sponsorship adopted in this statement. Firstly, what evidence supports a taxpayer's contention that particular expenditure meets this definition? Secondly, what effect does the third-party benefit have upon deductibility?

In relation to the first issue, in order for the nexus test to be satisfied, the taxpayer needs to show that he or she intended that the business would be promoted by incurring the sponsorship expenditure. In this regard, the following objective factors will support a taxpayer's contention that he or she intended that the business be promoted by the expenditure:

- The specific terms of the sponsorship arrangement, e.g. is there a specific requirement for the recipient to promote the taxpayer's business? What is the extent and prominence of the business exposure specified in the agreement?
- The place of the sponsorship arrangement in a coherent marketing strategy. For example, if a business's market research has identified that potential customers frequently attend cultural events, then part of its marketing strategy may be to sponsor such events in return for its name and products being promoted during the event.
- The relationship between the market or potential market exposure capable of being reached and the taxpayer's business. For example, market exposure at a tennis tournament is directly related to the business of a sports equipment retailer.
- The relationship between the expenditure and the resulting income derived, i.e. can it be shown that the expenditure resulted in income being derived? For example, the sale of 10 tractors at an agricultural field-day, by a tractor manufacturer sponsoring the event in return for being able to display the tractors, shows a direct relationship between the sponsorship expenditure and the derivation of income.

In *Case 696* (SA), the evidentiary support for the expenditure on the cups being deductible was described like this (Mr Galbraith at p. 91):

> … the company annually incurs expenditure on advertising the agricultural implements in which it deals. This advertising takes various forms, such as circulating pamphlets, distributing calendars, pocket-books, copper ash-trays, etc. It never takes the form of press advertising because the potential and actual customers of the company are too few to warrant advertising in newspapers.

This description illustrates the company's marketing strategy and the cups and footballs donated fitted within this strategy, being articles on which the names of pieces of equipment were endorsed.

*Case P16* (1992) 14 NZTC 4,107 illustrates that evidence of a relationship between the potential market exposure capable of being reached and the taxpayer's business is support for the expenditure being deductible, and that the amount of expenditure was not relevant to the determination of whether or not the expenditure was deductible. In

response to the company's contention that the racing promotion was intended to associate the company with speed and efficiency, Keane J stated at p. 4,114:

> … the company's decision was inherently logical from a business perspective, and the related steps taken wholly explicable from that perspective even if the level of expenditure ultimately incurred was greater than was first anticipated.

Similarly, in the Australian Board of Review case, *Case F67* 74 ATC 397, evidence of a relationship between the potential market exposure capable of being reached and the taxpayer's business was support for the expenditure being held to be deductible. That case concerned a consulting engineer who also derived commission income as the sole representative of several foreign boat designers in Australia. In order to promote commission sales, the taxpayer had a power boat built to one of the designs for which he was the Australian representative. He had the names of his business and the designer painted on the hull, along with his address and contact telephone number. The boat was then raced. Despite incurring the sponsorship expenditure, no commission sales were made in the income year in question, but this did not preclude deductibility of the revenue expenditure. Nor did the relatively high cost involved stop the Board of Review from finding that the revenue expenditure was deductible.

In *Cliffs International*, sponsorship expenditure was held to be deductible on the basis of evidence showing the place of the sponsorship arrangement in a coherent marketing strategy, and the relationship between the market exposure capable of being reached and the taxpayer's business. As noted earlier, in this case the taxpayer contributed to the annual running of a golf tournament in which the taxpayer's joint venture partners and key Japanese customers participated. In finding that the sponsorship expenditure was deductible, Kennedy J stated at p. 4,392:

> This event was a carefully planned annual function, which was specifically directed to enhancing the relationship between the Robe River joint venture and its customers in Japan, being six of the major steel mills. It was the only formal social function held each year and was carefully adapted to the nature of the Japanese business. It was attended by senior executives from Cliffs, whilst Mitsui & Co. was represented by the highest ranking personnel within its iron ore department, together with one of its corporate executive vice presidents. Each of the mills was represented by its highest ranking purchasing officer and two or three of his subordinates. The day was meticulously planned, so that those whom it was desired to bring together for business reasons were brought together. The day concluded with formal speeches of goodwill and presentations.

The issue of the relationship between the expenditure and the resulting income was referred to in *Case 696* at p. 92, but in that case the absence of any supporting evidence was given little weight by the majority of the Court:

> With regard to this expenditure being too remote from the income to be an allowable deduction, I consider that it can fairly be stated that it is normally impossible to connect any particular sales with any particular advertising, though many companies go to considerable lengths in an endeavour to ascertain which media of advertisements produce the best results.

The issue of the remoteness of sponsorship expenditure from income derived was also referred to in the Canadian case *No 511 v MNR* 19 Tax ABC 248, a case concerning a taxpayer in the lumber business which sponsored a local baseball team with the intention of building up its declining sales through promoting its name and products. In that case, as with *Case 696*, the fact that sponsorship was not direct advertising was not sufficient to preclude deductibility provided there was evidence that the company intended to advertise itself by sponsoring the baseball team.

A New Zealand case where there was evidence of a direct relationship between the sponsorship expenditure and the taxpayer's income was *Case P16*. The taxpayer in this case was a national courier which had acquired and raced a Jaguar motor car, having marked it with the company's logo. Evidence that showed that there was a marked increase in turnover as a result of the racing promotion supported the conclusion drawn by Keane J that the related revenue expenditure was deductible.

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**Example 1**

Andrew is a sole trader who operates a motor mechanic business. He sponsors the local rugby league team. Under the terms of sponsorship agreement, which covers the year to 31 March, Andrew agrees to pay up-front a sum of $3,000 towards the team's running costs. In return, the team agrees to display Andrew's business logo on all rugby uniforms, bags and vehicles used by the team during the year.

Is the expenditure incurred by Andrew under the sponsorship agreement deductible?

The expenditure incurred by Andrew will be fully deductible. The requirement that the team display his business logo and name on the uniforms etc indicates that the expenditure was incurred to promote his business and is therefore deductible.

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**Example 2**

Elizabeth operates a business in Wellington as a sole-trader. She gives $500 to the boarding school which her son attends in Auckland in the name of her business. She makes no stipulations about how the school is to use the money or that her business is to be promoted in return for the payment. Nevertheless, her business's name subsequently appears in a list of donors on the back page of the school's annual magazine. In all, there were 20 donors and Elizabeth's business name is not distinguished in any way from the other 19 donors.

It is considered that no deduction under section BD 2 is allowed for the $500 expenditure (although a rebate may be available under section KC 5). There was no stipulation that Elizabeth's business be promoted. The fact that there was some business promotion in the form of her business's name appearing in the magazine is not determinative unless Elizabeth can show that such promotion was a purpose of the expenditure. While every case must be considered on its particular facts, it is considered that any marketing exposure resulting from the business name appearing on the back page of an annual school magazine is most likely to be minimal since it one of 20 donors with no prominence given it compared to the names of the other donors. This supports the view that it is incidental to other purposes (e.g. private) of making the payment. As well, the fact that her son's school is in Auckland is likely to mean that little, if any, increase in revenue would be expected to result to her business since it operates in Wellington. Therefore, based on an objective analysis of the surrounding circumstances, it is considered that the expenditure does not have the requisite nexus with the earning of her business's income.

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The second issue which arises from the definition of sponsorship expenditure is the effect on deductibility, if any, of a third-party benefiting from the expenditure. In this regard, as noted earlier in this statement, this fact does not of itself preclude deductibility (*Usher's Wiltshire Brewery Ltd* at p. 427). Rather, in order to determine whether apportionment is needed, it is necessary to determine whether the third-party benefit resulted from a purpose distinct from the business promotion purpose (apportionment will be required here), or whether the third-party benefit was only incidental to the purpose relating to the taxpayer's business (no apportionment required). This will be a question of fact. The distinction between incidental purposes and separate purposes will be illustrated by examples following the application of the law relating to the private or domestic expenditure prohibition.

Other issues, which may appear relevant to whether or not sponsorship expenditure is deductible, arise where the expenditure is voluntary or where the amount expended is higher than seems reasonable. However, as noted earlier in this statement, the fact that the taxpayer may have voluntarily entered into an agreement whereby someone else is benefited by the expenditure will not, of itself, preclude deductibility since voluntary expenditure is deductible provided it is directed to business or income-earning ends. Nor, of itself, will deductibility be precluded by the fact that the taxpayer expended more than they would have done if the third party benefit were not contemplated. This is because the quantum of the expenditure is not material (*Ronpibon Tin* at p. 60; *Cecil Bros* at p. 434; *Europa Oil* [1971] NZLR 641 at p. 649; *Europa Oil* (1976) 2 NZTC 61,066 at p. 61,071). *Case F67*, considered earlier in this statement, was a case where relatively high expenditure did not preclude deductibility.

If it has been determined that the sponsorship expenditure is prima facie deductible under section BD 2(1), it is then necessary to ascertain whether or not any of the prohibitions in section BD 2(2) apply. The two prohibitions potentially relevant to sponsorship expenditure are the capital prohibition in limb (e) and the prohibition of expenditure of a private or domestic nature in limb (a).

**Prohibition – capital expenditure**

From an analysis of case law pertaining to the capital / revenue distinction the following seven tests were identified:

- the need or occasion which calls for the expenditure;
- whether the expenditure is recurrent in nature;
- whether the expenditure creates an identifiable asset;
- whether the expenditure creates an advantage which is of an enduring benefit to the business;
- whether the expenditure is on the profit-making structure or on the profit-making process;
- 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.

In the context of sponsorship expenditure, some of the indicia will be more relevant than others. In relation to a given set of facts, it will be necessary to weigh up the factors in order to determine whether all or part of the sponsorship expenditure is of a capital nature. These factors will now be considered in turn.

***The need or occasion which calls for the expenditure***

This test considers the need or occasion calling for the expenditure and whether the surrounding circumstances and ultimate objective of the expenditure support a capital or revenue classification. When considering the general deductibility provision in section BD 2(1), the taxpayer's purpose in incurring the expenditure needed to be ascertained. However, in determining whether or not the capital prohibition applies, it is necessary to consider what prompted or necessitated the taxpayer to incur the expenditure in the first place.

In this regard, all the cases analysed when considering the general deductibility provision in section BD 2(1) illustrated that business promotion was the purpose of incurring the sponsorship expenditure. In none of the cases was it held that the underlying reason which prompted or necessitated the expenditure indicated that the expenditure was of a capital nature. It would appear, then, that this test will be of limited use in the context of sponsorship expenditure, although arguably it would be relevant where the facts point to the business promotion being related to establishing a market for a new business. However, in such a case as this, the expenditure is likely to have not even been deductible under section BD 2(1), it being preliminary expenditure which would not have been incurred in the course of carrying on that business (*Calkin* at p. 61,786).

***Recurrence***

As noted earlier in this statement, this test is not determinative as irregular expenditure may be of a revenue nature. To conclude that recurrent expenditure is of a revenue nature, it is necessary to establish that it is an ordinary incident of carrying on the business.

In the context of sponsorship expenditure, it is possible for some types of sponsorship expenditure to be once and for all (e.g. a once-only sponsorship of a sports event), and for other types to be recurrent (e.g. regularly sponsoring the sports event). Thus, recurrence, of itself, would not be determinative of the expenditure being of a revenue nature. An example of where recurrence would have supported a finding of sponsorship expenditure being of a revenue nature, had it been at issue, is *Cliffs International*. Here the golf tournament was held annually.

An example of once-only sponsorship expenditure being of a revenue nature is *Case 696* (SA) considered earlier in this statement. In that case, the two silver cups constituted a one-off payment. Nevertheless, the majority judgment was that the expenditure incurred on these cups was of a revenue nature. While this finding was principally based on the fact that no enduring asset was acquired by the company, since it divested itself of the ownership of the cups, it nevertheless indicates that recurrence is not determinative.

However, while recurrence of itself is not determinative, as noted above, it is also necessary to establishing that expenditure is an ordinary incident of carrying on a business for that expenditure to be of a revenue nature. In the context of sponsorship expenditure, as it is defined in this statement, it is not considered that much weight should be placed on this test. This is because a taxpayer's business promotion purpose, necessary to establish that the expenditure is deductible under section BD 2(1), would appear to be sufficient to show that the expenditure was an ordinary incident of business. That is, whatever third-party benefit may arise from sponsorship expenditure, it would appear that the business promotion purpose is sufficient evidence of the expenditure being an ordinary incident of business. In the Canadian case, *No. 608 v MNR* 21 Tax ABC 396, at p. 400, Mr Boisvert put it this way:

> Nowadays business advertising takes on a wide variety of forms and, as long as it can be linked with a business, whether the latter profits from it or not, it is a deductible expense … **Advertising has become a necessity in the business world.** [Emphasis added]

### *Identifiable asset*

Where the expenditure results in an identifiable asset owned by the taxpayer, the capital prohibition is likely to apply.

The majority decision in *Case 696* (SA) is an example of where no identifiable asset being retained by the taxpayer was the basis for finding that the capital prohibition did not apply. Distinguishing cases where an identifiable asset was retained by the taxpayer, and the expenditure incurred to acquire it was held to be of a capital nature (*Income Tax Case No. 217* 4 SATC 137; *Income Tax Case No. 469* 11 SATC 261), the majority stated at p. 93:

> In my opinion this case is clearly distinguishable. Appellant company purchased cups and immediately presented them to agricultural societies, **thereby divesting itself of ownership. It had no asset as a result of this advertising expenditure** … [Emphasis added]

Thus, if the sponsorship expenditure results in an identifiable asset, and the taxpayer does not divest itself of the ownership of the asset, then the capital prohibition will apply.

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**Example 3**

Consider the facts in example 1, above. Suppose Andrew also agreed to reimburse the team for the purchase of their van (i.e. the team owns the van) provided his business logo is prominently displayed on the van. Would this expenditure be deductible? Alternatively, what if he instead purchased the van himself, retaining ownership of it, but allowed the team to have full use of it provided his business logo is prominently displayed on it – would the expenditure be deductible?

Where Andrew reimburses the team for the purchase of their van, although the van is a capital item it is not considered that the capital prohibition applies since the van is not owned by Andrew, nor was it acquired by him. Therefore, no enduring asset results to Andrew from this expenditure.

However, if Andrew purchased the van himself and retained ownership of it, the capital prohibition would apply as the expenditure results in an enduring

asset (i.e. the van) owned by him (although a deduction for depreciation may be allowed under section EG 2).

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**Example 4**

John Jones runs a sports goods store called *Jones's Sports*. Being particularly interested in soccer, John sponsors an annual soccer competition for the three local primary schools, to be named the *Jones Competition*. He considers that the sponsorship arrangement will result in increased sales. He supplies the necessary sporting equipment to each school (all of which is clearly labelled with his business's name) as well as a trophy to be presented to the winner of the competition. The trophy is labelled the *Jones Competition sponsored by Jones's Sports*, and each year the trophy is engraved with the winner's name. He incurs a total of $5,000 in the first year of this arrangement.

Here there is a relationship between John's business and the sponsorship, both being related to sport. Therefore, even though it may be impossible to identify what sales, if any, resulted from the sponsorship arrangement, John's contention that the expenditure was incurred in order to increase sales is reasonable. Therefore, it is considered that the expenditure is deductible under limb (b)(i) of section BD 2(1). As well, the fact that the business name appears on the sporting equipment donated, as well as on the trophy, supports the conclusion that the expenditure would be deductible under limb (b)(ii) of section BD 2(1) being necessarily incurred in the course of carrying on his business. In this light, it is considered that John's private enjoyment of soccer is incidental and therefore a deduction for the expenditure will not be prohibited by limb (a) of section BD 2(2). Further, although the cup is an enduring asset, it is not owned by John and so the capital prohibition in limb (e) of section BD 2(2) will not apply. This conclusion is consistent with the finding in *Income Tax Case 696* 17 SATC 86 (South Africa).

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***Enduring advantage***

This test focuses on whether an enduring advantage of benefit to the business is acquired by expending the money. If it is, then the expenditure is likely to be of a capital nature. Other than cases where an identifiable asset is acquired by expending the money, this test would appear to be the most relevant in the context of sponsorship expenditure. This test is often linked to the test of recurrence, i.e. expenditure made once and for all with a view to acquiring an advantage of enduring benefit to the business is likely to indicate that the expenditure was of a capital nature.

However, in order to determine whether or not an enduring advantage arises such that the capital prohibition would apply, it is first necessary to distinguish between long-term advertising and goodwill / branding that may arise from such advertising. In the case of the former, any expenditure to obtain the long-term advertising merely relieves the taxpayer from making revenue payments for a period of time. It is not considered that this type of "enduring advantage" is of a capital nature (*Anglo-Persian* at p. 262). However, section EF 1 may apply to limit the deduction in any income year because part of the expenditure relates to future income years (section EF 1 is considered more fully later in this statement).

As to whether the capital prohibition would apply because the expenditure resulted in an enduring advantage of branding or goodwill, it is considered that any "branding / goodwill" advantage gained is intrinsically linked to the business exposure itself. The advantage is not one that results from the business's prior operation (in contrast to goodwill acquired when the business is purchased, which would be a capital asset). Although the advantage may endure beyond the end of the sponsorship agreement, this is no different from ordinary advertising. In both cases, any "branding" gained will usually dissipate rapidly unless the exposure or advertising is repeated in order to maintain it. For this reason, it is considered that any incremental contribution to long-term goodwill or brand value is properly to be regarded as incidental, as similar increments can be achieved by ordinary advertising, good customer service, product quality, etc. Therefore, it is considered that the expenditure on it is of a revenue nature and the capital prohibition does not apply. This conclusion is in line with the majority judgment in *Case 696* (SA):

There is little doubt that the benefit of this advertising was not confined to the year of assessment, but the same can probably be said about most advertising except in connection with special "bargain sales". With regular advertising in various forms it is normally impossible to state when and for how long any benefit may be received and if, to be allowable as a deduction, its effect must be confined to the year of assessment, it appears to me that very little advertising expenditure could be allowed as a deduction. **I am of the opinion that all successful advertising must inevitably tend to increase the goodwill of the advertiser or of the merchandise advertised, but I am unable to agree that, therefore, such advertising becomes expenditure of a capital nature.** [Emphasis added]

***Profit-making structure or profit-making process***

This test aims at distinguishing between expenditure which relates to the business's structure (i.e. assets which are used in order to carry on the business) and the business's operation (i.e. the means by which the assets are organised in order to carry on the business).

As noted earlier in this statement, this test is often linked to the identifiable asset and enduring advantage tests. As such, in the context of sponsorship expenditure, this test would not appear to add anything to the analyses under these heads. In particular, however, it is noted that the business promotion aspect of sponsorship expenditure, as it is defined in this statement, would appear ordinarily to be related to the profit-making process rather than to the profit-making structure. The principal exception would be where an identifiable asset is acquired as a result of expending the money in which case, as noted earlier in this statement when considering the identifiable asset test, the profit-making structure is enhanced by the sponsorship expenditure, and the capital prohibition would apply.

***The source of the payment***

This test states that expenditure made from fixed capital (i.e. capital on which a return is sought by the business's operation) is more likely to be of a capital nature, and expenditure made from circulating capital (i.e. capital which returns to the business as a result of the business's operation) is more likely to be of a revenue nature.

As noted earlier in this statement, the test is not now given much weight by the Courts, as it is easy for a business to choose whether to finance an asset, say, from fixed capital or to finance it from circulating capital, irrespective of the nature of the

asset financed. In the context of sponsorship expenditure, also, a business may finance it from either fixed or circulating capital, without thereby changing its inherent nature. Therefore, it is considered that this test is unhelpful.

***The treatment of the expenditure according to the ordinary principles of commercial accounting***

How expenditure is classified according to ordinary commercial accounting principles may support the classification made from applying the other indicia. In this regard, sponsorship and promotional expenditure would ordinarily be classified as being of a revenue nature according to generally accepted accounting practice. This supports treating sponsorship expenditure as deductible. However, this test is not usually determinative since tax and accounting have different aims and the respective treatments may consequently differ from each other. Nevertheless, in the context of sponsorship expenditure, if for some reason a taxpayer treated such expenditure as being of a capital nature for accounting purposes, there may be some grounds for analysing whether or not this accounting classification should be followed for tax purposes.

***Conclusion – capital prohibition***

The indicia developed by the Courts to distinguish between capital and revenue expenditure are not necessarily all relevant in the context of sponsorship expenditure. Of the various indicia analysed, it would appear that the identifiable asset test is the most important. While the enduring advantage test appears relevant, frequently the nature of the enduring benefit resulting from the sponsorship expenditure will not be such as to warrant a capital classification because the benefit is intrinsically linked to the means of exposure.

**Prohibition – private or domestic expenditure**

An outgoing is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit (*Haenga* at p. 5,207). In particular, expenses properly characterised as consumption (e.g. food, clothing and shelter) are not incidental and relevant to the derivation of income merely because they are required in order for a person to be able to earn income. In this regard, it is necessary to determine whether the expenditure, in whole or part, relates exclusively to things of a private or domestic nature. Where a benefit of a private or domestic nature accrues to the recipient, but this benefit is incidental to the income-earning or business activity, then the deduction is not prohibited.

In the context of sponsorship expenditure, the key will be to determine whether or not any private or domestic benefit accruing as a result of the sponsorship expenditure is incidental to the business promotion purpose. Where a separate private or domestic purpose is identifiable, then apportionment will be necessary.

A number of Taxation Review Authority cases have involved situations where someone (usually an employee of the taxpayer) gained private enjoyment from the

sponsorship expenditure. In *Case L7*, the taxpayer was a radiator manufacture and repair company whose principal was interested in go-kart racing. The company decided to become involved in go-kart racing as a means of promoting the business. The go-kart bore the name of the company, the principal drove the go-kart, the pit crew (company employees) wore company colours, and the company was promoted on a billboard at the racetrack and in the racing program. The issue before the Taxation Review Authority was whether the associated expenditure should be apportioned between business promotion (deductible) and private enjoyment (no deduction allowed). At p. 1,055, Barber DJ concluded that the expenditure was fully deductible, with the private enjoyment being purely incidental:

> I agree with the submission of Mr Nation, that the fact that Mr S obtained substantial enjoyment from the kart racing is not a significant factor in deciding whether or not the expenses incurred in that activity should be tax deductible. In my view, the issue is whether the expenditure is bona fide advertising expenditure in character, or is wholly or partly expenditure in the pursuance of go kart racing as a sport or recreational pastime. That factual issue pivots on the credibility of the evidence. I accept Mr S as an honest witness. I find that although he enjoyed his involvement in kart racing and had previously been quite strongly interested in racing in general, he made a calculated decision to boost his business enterprise by participating in kart racing with a high business profile. He sought business contacts in the motor trade and work from those contacts and from the general public. I am satisfied that these aims were achieved, and continue to be retained, in a substantial manner. I do not suggest that advertising must have good results to be deductible. I appreciate that, after much consideration, the respondent took the view that there were two equal factors in relation to the advertising expenditure, namely, the obtaining of personal pleasure in go kart racing and the attracting of business from that activity. **On the evidence which I have heard, I find on the balance of probability that the business expended money on go-kart racing predominantly to advertise the business and that any private intentions or purposes of Mr S were quite incidental to the predominant objective of business expansion.** In other words, I am satisfied that there was a sufficient link between the expenditure and the income earning process of the radiator manufacturing and repair business, with regard to the entire expenditure and not merely to 50% of it. [Emphasis added]

The same approach was taken in *Case P16*, where the company's principal was interested in car racing. In that case, at p. 4,114, Keane J held that he saw no reason to elevate the principal's private enjoyment of racing the car to the status of a competing purpose.

In *Case M131* (1990) 12 NZTC 2,850, Bathgate DJ approved of the approach in *Case L7*. The taxpayer in this case owned a building business that had a substantial connection, both business and private, with the racing industry. To maintain and extend the business relationship, the taxpayer purchased and raced a horse and sponsored several races in return for the business name appearing on the race books of the races sponsored. While the horse was raced under the names of the individual owners, it was soon identified with the company. The percentage of income derived from the racing industry increased following the increased promotional activity. While the deductibility of the sponsorship expenditure was not at issue in this case, in relation to remaining revenue expenditure, Bathgate DJ held that the statutory nexus was satisfied and that the element of private enjoyment was incidental to the main purpose of business promotion.

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**Example 6**

Bruce is in business as a sole-trader builder, trading as *Bruce Builders*. He agrees to build the gymnasium at his daughter's school in return for an annual 50% discount on his daughter's school fees for the time she attends the school.

The school will provide the materials, but Bruce will supply the labour (himself and three of his employees). While the gymnasium is being built, the school agrees for Bruce to erect signage on the construction site stating that the gymnasium is being built by *Bruce Builders*. After it is completed, a prominent plaque will be displayed on the front of the gymnasium stating that it was constructed by *Bruce Builders*. Does the prohibition for expenditure of a private or domestic nature apply to the expenditure Bruce incurs on staff wages in relation to the construction?

The expenditure on the wages was not incurred by Bruce in deriving gross income since he derives no income from building the gymnasium (limb (a) of section BD 2(1)). It is arguable, too, that they were not necessarily incurred in the course of carrying on Bruce's business for the purpose of deriving his gross income since, arguably, he did not need to construct the gymnasium (limb (b) of section BD 2(1)). Even if it were considered that limb (b) of section BD 2(1) applied (because his business was promoted during the construction and after the construction was completed), one purpose of incurring the expenditure was to gain the 50% discount on his daughter's school fees, i.e. the advantage sought was of a private nature. On the facts presented, it is not considered that this private advantage was just incidental to any business promotion contemplated by Bruce in entering into the arrangement with the school. Therefore, as a minimum, it would be necessary to apportion the expenditure between that which was of a private nature (not deductible), and that which was deductible (if any). In this regard, the burden of proof is on Bruce to show what part of the expenditure was deductible.

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**Example 7**

Jenny is in business as a scuba-diving instructor. She enjoys horse riding and watching horse riding competitions. She decides to organise a gymkhana with prizes being given for the winning rider. She arranges for a billboard to be erected at the site of the competition with her business name etc. on it. She expends a total of $2,000 in arranging the competition. Is her expenditure deductible?

In this case, Jenny's scuba-diving instructing business bears no relationship to horse riding. The attendees are not a natural audience for the scuba-diving promotion so as to reasonably form a potential market. This, considered with the fact of Jenny's private enjoyment of horse riding, strengthens the conclusion that there is no identifiable nexus between the expenditure and her business. While there is some business exposure in the form of a billboard, it is considered that the expenditure on the competition was likely to have been incurred for private enjoyment with any business promotion being incidental to that private enjoyment purpose. On this basis, and in the absence of further evidence as to Jenny's purpose in incurring the expenditure, it is considered that no deduction would be allowed for expenditure on the competition.

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**Example 8**

A firm, AAA Accounting, has entered into an agreement with the national opera company whereby the firm will cover the cost to the opera company of financing the orchestra that accompanies the operas. In return, the opera

company will prominently display the words "proudly sponsored by AAA Accounting" on the buildings where the operas are performed and on all programs sold, as well as in all advertisements for the operas. AAA Accounting's purpose in entering into the agreement was to provide exposure to influential members of the audience, as confirmed in its marketing plan. A survey, which it had commissioned, showed that a significant proportion of opera attendees were individuals from whom the firm sought business, being people who were of high net worth or who were influential in the corporate and government sectors. On the basis of the survey, it considered that the exposure obtained from sponsoring the opera company would attract these people as clients. In the opera company's annual report, the managing director referred to the agreement with AAA Accounting and noted that two of the three partners in the firm had personally had a long association with opera in the past, being "opera lovers" themselves. Is the expenditure under the agreement deductible to AAA Accounting?

In this case, although AAA Accounting is not in a business related to opera, it does obtain business exposure through the agreement. As well, the agreement is part of the firm's marketing strategy as indicated in the firm's marketing plan. While the private enjoyment of opera by two of the three partners in the firm may indicate that the expenditure was incurred for private purposes, it is considered that the reasoning given in the marketing plan shows that the expenditure was incurred for business purposes and any private enjoyment will be incidental to the business purpose of incurring the expenditure.

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**Accrual expenditure**

As noted earlier, section EF 1 may apply to limit the deduction in any income year to that portion of the expenditure which relates to the current income year. Where the expenditure relates to the purchase of goods, the current year deduction is effectively restricted to goods used in that year in deriving gross income. Where the expenditure relates to a payment for services, the current year deduction is effectively restricted to the amount incurred on services performed in that year. Where the expenditure relates to a chose in action, the deduction is deferred for the portion relating to the unexpired part of the period that the chose is enforceable.

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**Example 9**

John owns and operates a restaurant. He enters into a sponsorship agreement with the local brass band whereby he agrees to pay $9,000 up-front towards the band's running costs for the next three years in return for the name of his restaurant to be displayed prominently on the drums. What effect, if any, does section EF 1 have on the deductibility of the $9,000?

In order to determine whether or not section EF 1 applies, it is necessary to determine if there is any "unexpired portion" at the end of the income year. In this regard, limb (d) of section EF 1(5) applies. This is because the expenditure results in John acquiring the chose in action consisting of the right to have his name displayed on the drums. Therefore, the unexpired portion of the expenditure at the end of the income year will be the portion of the $9,000

that relates to the unexpired part of the three-year period in relation to which the choses are enforceable. If a full 12 months under the agreement falls within the first income year, the unexpired portion will be $6,000 relating to the two years remaining under the agreement.

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**Example 10**
PQR Ltd pays a local trust $3 million toward the cost of construction of a swimming complex in return for naming rights for a 10 year period. PQR pays the $3 million in one lump sum in the current income year.

Here, business exposure is obtained by the expenditure in the form of the company's name appearing on the complex and therefore PQR is allowed a deduction for $3 million when it incurs the expenditure.

In this regard, it is considered that any enduring advantage from the expenditure, namely business exposure for a 10 year period, is of the same nature as advertising i.e. of a revenue nature. The fact that the expenditure is made in a lump sum does not change its revenue character, as it merely relieves the company from making revenue payments for the 10 year period (*Anglo-Persian* at page 262). Hence, it is not considered that the capital prohibition applies in this case.

However, the right to this exposure, which lasts for 10 years, is a chose in action and, therefore, section EF 1 applies to require that the unexpired portion of the expenditure be included in PQR's gross income at the end of the current income year. The amount of the unexpired portion is determined under limb (d) of section EF 1(5), this being the amount of the expenditure which relates to the unexpired part of the period in relation to which the chose is enforceable. In the absence of any other relevant facts, the unexpired portion at any point in time will be determined by calculating the proportion of the 10 year period remaining and multiplying it by $3 million. For example, if at the end of the current income year, 9½ years remains of the 10 year period, then the unexpired portion will be $2,850,000. This will be included in PQR's gross income, but will be allowed as a deduction in the next income year. At the end of that year, the unexpired period will be 8½ years and so $2,550,000 must be included in PQR's gross income in that income year. And so on until the 10 year period is expired.

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**Depreciation**

If the expenditure was incurred in relation to depreciable property (as defined in section OB 1), a deduction will be allowed for depreciation as determined under section EG 2. The amount of the deduction is dependent upon whether the depreciable property is wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income.

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**Example 11**
Paul owns and operates a plant nursery. He purchases a van on which he displays his business name prominently. He makes the van available to the

local garden society on weekends, but retains ownership of it and uses the van for business purposes during the week. Is Paul allowed a deduction for the cost of the van? If not, would he be allowed a deduction for the depreciation of the van?

The cost of the van is not deductible by virtue of the capital prohibition. However, a deduction for depreciation may be allowed. In this case, the question which arises is whether or not Paul would be allowed a deduction for the full amount of depreciation on the van calculated pursuant to limb (a) of section EG 2(1) or whether limb (d) of section EG 2(1) would apply. In this regard, it could be thought that when the van was being used by the garden society members, it would not be used or available for use by Paul for business purposes and that, therefore, limb (d) of section EG 2(1) would apply to limit the deduction otherwise available. However, because Paul's business name is prominently displayed on the van, this provides business exposure. As well, the garden society members are a potential market for his plant nursery business. Hence, it is considered that the van is being used for business purposes, even when it is being used by the garden society members, and that, therefore, limb (d) of section EG 2(1) does not apply to limit the deduction available for depreciation.

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**Example 12**
John is a shareholder-employee of ABC Ltd, a marine products supplier. His hobby is to race yachts. ABC purchases a yacht which John races in various yachting competitions. The company's name and logo is painted on the hull of the boat.

Here, a physical asset is acquired by the business and therefore no deduction is allowed by reason of the capital prohibition in section BD 2(2). However, because the company's name is displayed on the yacht, and ABC's business of supplying marine products would be potentially promoted in a yachting competition, a deduction for depreciation will be allowed under section EG 2. The fact that John enjoys yachting does not preclude a depreciation deduction being allowed.

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**Monetary remuneration**

There may be occasions where an employer sponsors an employee to take part in some event such as by paying his or her entry fees. At first glance, this might appear to be another instance of sponsorship expenditure, the deductibility of which would need to be tested in the ways considered so far in this statement. However, where expenditure is on account of an employee, then it will be deductible under limb (b) of section BD 2 by virtue of being monetary remuneration of that employee (the definition of "monetary remuneration" in section OB 1 includes within it any expenditure on account of an employee). Although there may be an element of "sponsoring" the employee, in that the payment on his or her behalf is over and above what would ordinarily be paid, the expenditure will be deductible for the same reasons that his or her ordinary salary is deductible.

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**Example 13**
XYZ Ltd pays the entrance fee of one of its employees (Anne) who is going to compete in the local triathlon competition. Anne agrees to display the firm's name prominently on her T-shirt, bicycle and swimming togs.

Here, Anne is the one who enters the race and therefore the payment of the entrance fee is expenditure on account of Anne. Hence, the amount paid is monetary remuneration of an employee and as such is deductible under limb (b) of section BD 2(1).

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