

**ISSUES PAPER**

# **Income Tax – Government payments to businesses (grants and subsidies)**

– A TAX COUNSEL OFFICE DISCUSSION DOCUMENT

Issued: 30 June 2022

**Issues Paper IRRUIP16**

This Issues Paper considers when and how the government grant provisions in the Income Tax Act 2007 may apply to grants and subsidies received by businesses. Where the government grant provisions apply, a grant or subsidy paid by a local or public authority to a business is excluded income and the expense funded by the grant is non-deductible.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

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## About this document

Issues Papers are issued by the Tax Counsel Office where sufficient uncertainty exists about a particular issue and it would be helpful to hear from interested parties before we prepare any public statement.

Issues Papers represent the Commissioner's initial views only on a particular tax issue. They are intended to stimulate discussion and invite comments. They help us gain a better understanding of the issues, including practical concerns taxpayers have.

Inland Revenue officers, taxpayers and practitioners cannot rely on Issues Papers – they are not authoritative statements of the Commissioner's stance on the issues covered. Views presented in an Issues Paper do not change the Commissioner's current position or practices.

If an Issues Paper results in a draft public statement, public consultation will occur in the usual manner.

### LET US KNOW WHAT YOU THINK

We want to know what you think about our initial views presented in this Issues Paper.

We would like to know:

- if you think the initial interpretation of the relevant tax laws is correct
- if you have practical concerns about the interpretation
- if you think the result is correct from a tax policy perspective (that is, whether the tax law needs changing)
- your ideas on how to administer the tax laws.

More specific questions also appear in the body of this Issues Paper.

Email your comments to [Public.Consultation@ird.govt.nz](mailto:Public.Consultation@ird.govt.nz)

Deadline for comment: **11 August 2022**

Quote reference: **IRRUIP16**

## Introduction

1. This Issues Paper discusses how the government grant provisions in ss CX 47 and DF 1 apply to a grant or subsidy paid by a local authority or a public authority to a business. In general terms, a “grant or subsidy” is financial assistance the Crown or a public body provides to promote some activity for the benefit of the community or a section of the community, including, in some cases, businesses.
2. The government grant provisions apply to treat a grant or subsidy paid by a local or public authority to a business as excluded income of the business. To ensure a tax-neutral outcome, the government grant provisions disallow deductions for corresponding expenditure that would otherwise be deductible to the business.
3. In this Issues Paper:
  - all legislative references are to the Income Tax Act 2007 unless otherwise stated
  - reference to a grant or a payment includes a grant, subsidy and grant-related suspensory loan, except where it is necessary to separate the concepts,<sup>1</sup> and
  - reference to a deductible expense includes a reference to a depreciation loss for depreciable property.
4. We have set out examples in this Issues Paper to explain concepts and demonstrate our initial views. The examples are not intended to reflect any existing or previous grants or entities and are illustrative only.

## Overview of the government grant provisions

5. The government grant provisions are in ss CX 47 and DF 1. The government grant provisions were introduced in 1973, and the wording of the provisions has changed over time. Where the provisions apply, a grant or subsidy paid by a local authority or a public authority to a business is treated as excluded income of the business.
6. To ensure a tax-neutral outcome, the government grant provisions apply only where the grant corresponds to expenditure that would otherwise be deductible to a business. Those deductions (or depreciation losses) for the expenditure that corresponds to the grant payment are disallowed. It is important to note that not all grants or subsidies relate to deductible business expenses. For example, grants or subsidies for non-deductible expenditure do not qualify, nor do grants or subsidies

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<sup>1</sup> Grant-related suspensory loans are discussed at [63]–[64].

that are an income top-up (as they do not relate to any expense). The tax treatment of such payments would fall under ordinary principles.

7. Where a government grant is paid to a business for a specific deductible expense and the business derives the grant and spends it in the same income year, the tax treatment is straightforward. The treatment is also straightforward where a grant is paid to reimburse expenditure already incurred. In these cases, the grant payment is excluded income and the expenses funded by the grant are disallowed as deductions. However, uncertainty exists about how and when the government grant provisions apply in other circumstances.
8. This Issues Paper considers how the government grant provisions apply to a grant payment where the terms of the grant do not identify a specific expense or where derivation and expenditure occur in different income years.

## Purpose and scope of this Issues Paper

9. This Issues Paper seeks your comments on the four issues set out at [13].
10. The issues arise from the wording of the government grant provisions. Some of the wording is capable of more than one interpretation. The different interpretations result in significant differences in how the government grant provisions operate and the grants to which they apply.
11. This Issues Paper sets out the different views that can be taken for each issue. It offers tentative conclusions, bearing in mind the legislative wording and policy intent of tax neutrality.
12. This Issues Paper does not address in any detail:
  - when a payment is in the nature of a grant or subsidy
  - whether a payment is made by a local or public authority, and
  - when a person is in business.

## Summary of issues and initial conclusions

13. The issues addressed in this Issues Paper are:
  - which grants are captured by the government grant provisions
  - when a grant is derived
  - when does an expense need to be incurred, and

- when does a grant become excluded income.
14. As noted earlier, when the terms of a grant specify an expense (which is deductible) and the grant is derived and spent in the same income year (or the grant reimburses expenses already incurred), the issues addressed in this Issues Paper do not arise. However, the issues do arise in other situations.
  15. The first issue arises where the terms of a grant do not identify a specific expense. This issue relates to the relationship between the grant payment and a deductible expense. It affects whether the provisions apply to a particular grant or not.
  16. The second issue arises where a grant has conditions attached to it. The issue is whether the grant is derived when it is received or when the conditions are satisfied.
  17. The third and fourth issues relate to timing; that is, if the expense is not incurred in the same year in which the payment is derived, issues arise as to how the provisions apply, both in terms of when the expense needs to be incurred and when the grant is treated as being excluded income.
  18. These issues and our tentative conclusions are summarised at [19]–[40]. More detail about the issues is at [75]–[157].

## **Which grants are captured by the government grant provisions**

19. Section CX 47 applies where a grant payment corresponds to a deductible expense. The first issue, then, is what it means for a payment to correspond to a deductible expense. This issue refers to the relationship between the grant and the relevant expense, which is necessary for the government grant provisions to apply.
20. There are two alternative views about when a grant payment could be said to correspond to a deductible expense for the purposes of s CX 47.
21. The first view is that a grant corresponds to a deductible expense only when the grantor specifies the exact expense that the grant is intended to fund. For example, where the grantor specifies that the grant is to fund a business's new roof. On this interpretation, if there is no specified expense, then the grant provisions do not apply. The tax treatment of such payments fall under ordinary principles.
22. The second view is that a grant corresponds to a deductible expense where the recipient is to use it to fund any deductible expense. For example, where an organisation receives a grant for general operational expenses to use as it sees fit. Under this interpretation, as long as the grant has a relationship (or nexus) with the

business and is for the business to fund expenditure that is deductible, the grant will correspond to the expense.

23. It is debateable which of the two views is correct on the plain language of the provisions. However, we consider that the intended policy outcome of tax neutrality is better achieved under the second view; that is, where the intended use of the payment, as identified by the grantor, is for deductible expenditure generally. This means an exact expense does not need to be specified by the grantor, but the grant must be for deductible expenditure. This conclusion is not free from doubt, and we invite comment on this issue.
24. We also consider the government grant provisions do not apply to grants or subsidies that are not linked in any way by the grantor to a deductible expense. For example, a subsidy paid to compensate a business for lost income does not correspond to any deductible expenditure.
25. The terms and conditions of a grant, or the fund from which the grant is paid, should indicate what the intended use of the grant or subsidy is. We expect businesses to use any grants from a local authority or a public authority in accordance with the terms of the grant.

## **When a grant is derived**

26. The second issue is about when a grant is derived by a business. The time of derivation determines which income year a grant is allocated to. This is especially relevant for conditional grants, where a grant recipient may have to repay a grant if associated conditions are not met.
27. An argument could be made that s CX 47 alters the time that a grant is derived because it applies when a payment is made. We consider that the government grant provisions do not alter the ordinary principles of derivation and that a grant will be derived when it has been earned (for example, depending on the terms of the grant, when a recipient has satisfied any conditions).

## **When an expense needs to be incurred**

28. The third issue concerns the timing of the expenditure and whether the expense needs to be incurred before or after the grant is paid to come within the provisions.
29. We consider the government grant provisions could apply regardless of the timing of the expense; that is, the expense could be incurred before or after the payment of the grant.

30. Under former versions of the legislation, a view could have been taken that the expense had to be incurred before the payment was made. This would have the effect that the government grant provisions operate on only a reimbursement basis. This would result in different tax treatment for grants based on the timing of the derivation of the grant relative to the corresponding expenditure.
31. In our view, the current wording of the legislation allows for the corresponding expense to be incurred before or after the grant payment is derived. However, this view raises an issue about how to treat unspent grants and grants that have been partially spent at year end.

### **When a grant becomes excluded income**

32. The fourth issue is also one of timing and concerns when the grant payment is treated as being excluded income. This issue concerns how the provisions apply where the recipient has not spent all the grant funding before the end of the income year; for example, where a business received a grant for a new roof in May 2021, but only spent the grant in August 2022.
33. There are two alternative views about when the grant payment is treated as excluded income when a grant or part of a grant has not been spent in an income year.
34. The first view is that a grant will correspond to an expense when the expense has been incurred. The result of this view is that the grant becomes excluded income when it is spent because it corresponds to a deductible expense. Under this view, to the extent that a grant has not been spent before the end of the income year, it will not be excluded income as the grant does not correspond to a deductible expense. This view allows for a grant payment to be apportioned between taxable and excluded income depending on the amount of the grant spent.
35. The implication of this view is that a business may need to return the grant as taxable income in the income year it was derived if, under ordinary principles, the payment would be treated as income. In the following year (when the grant is spent), the business would need to go back and amend that assessment to treat the grant as excluded income. Where a grant is spent over several years, a business may need to amend the earlier assessment several times to change the grant amount incrementally from being taxable income to being excluded income. This would require the business to request an amendment to its earlier assessment under s 113 of the Tax



Administration Act 1994.<sup>2</sup> Accordingly, this view results in compliance and administrative difficulties.

36. However, we note that this will also be the case where a business derives a grant that reimburses expenditure already incurred and for which a business has already claimed deductions. The business will have to request an amendment to its earlier returns to deny those deductions. The need to re-open assessments is consistent with the legislative history of the government grant provisions that have always contained a specific provision allowing the Commissioner to amend earlier assessments at any time. (Although, since 2004, this has applied to only deductions, not the grant payment.) This arguably lends some support to the first view.
37. The second view is that as long as the grant is for a deductible expense, this is sufficient for it to correspond to such an expense. Under this view, the grant becomes excluded income when it is derived (under ordinary derivation principles). Once derived, the whole amount is excluded income, regardless of when it is ultimately spent. The recipient needs to keep records to show what expenses the grant was ultimately used for to demonstrate that the grant did in fact correspond to deductible expenditure. Those deductions are denied.
38. Again, it is debateable which of the two views is correct on the plain language of the provisions. Our tentative view is that a grant becomes excluded income on derivation, provided it is intended to be used on deductible expenditure. The recipient needs to show what the grant was spent on and that deductions for the corresponding expense were denied.
39. The second view is arguably supported by the absence of any apportionment wording in s CX 47, which refers only to “the payment”. Under the plain language of the provision, where the provision applies, the whole payment is treated as excluded income. If the payment becomes excluded income only when spent, then issues arise where a grant is spent progressively over income years. This tentative conclusion is not free from doubt, and we invite comment on this issue.

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<sup>2</sup> The Commissioner would consider such requests under [Standard Practice Statement: Requests to amend assessments](#) (SPS 20/03).

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## Initial conclusions – how the government grant provisions apply

40. In summary, while not free from doubt, we consider the government grant provisions work as intended and achieve tax neutrality when the following approach is adopted:
- Where the grant payment is provided for deductible expenses (whether for specific expenses or more generally), the whole payment is excluded income when derived (even if it is not spent in that income year).
  - Where the grant is a top-up of income or is for non-deductible and non-depreciable expenditure, then the government grant provisions do not apply and ordinary principles apply.
  - Ordinary derivation principles apply for determining when a payment is derived.
  - A deduction for the corresponding expense is disallowed when it is incurred, to the extent that it is funded by the grant. The recipient needs to keep records of these corresponding expenses.
  - A business does not need to request an amendment to earlier assessments under s 113 of the Tax Administration Act 1994 in the following years when a grant is spent. (Although a business will still need to amend earlier assessments to reverse out deductions already claimed where a grant reimburses past expenditure.)
  - The government grant provisions apply to all government grants provided for meeting deductible expenditure and/or acquiring depreciable property, ensuring clear and consistent tax treatment for such grants.

## Background

41. Before considering the issues identified at [13], this Issues Paper sets out:
- the legislative history of the provisions
  - our previous view set out in exposure draft *PS1686 Income Tax Treatment of Grants and Subsidies* (1996), and
  - the preliminary requirements of the government grant provisions (including what payments are excluded from the provisions, the requirement for a grant recipient to be carrying on a business, and when a payment is in the nature of a grant or subsidy).

## Legislative history

42. The original government grant provisions were introduced in 1973 to cater for a regional development assistance programme that included industrial research and development grants. The grants were based on the increase in qualifying wages over expenditure in a base period.<sup>3</sup> The grants were paid to reimburse expenditure already incurred.
43. Until 2004, the only changes made to the government grant provisions were to exclude specific new grants and subsidies and to reflect broad changes in terminology and concepts arising from the introduction of the core provisions in part B of the Act.
44. In 2004, the structure of the government grant provisions was amended with the income and deduction provisions being separated into different parts of the Act. The provision that overrode the time bar, allowing assessments to be amended at any time, remained part of the deduction provisions and was not replicated in the income provisions. The result of this was that earlier assessments could be amended, at any time, to reverse out deductions already claimed, but only within the four-year time bar period to change taxable income to excluded income. Minor changes were also made to the wording of the provisions with the introduction of the Income Tax Act 2007.
45. The current provisions are ss CX 47 and DF 1. Section CX 47 makes a government grant excluded income. Section DF 1 prevents an expense that has been funded by a government grant from being deductible. The relevant parts of the two sections for the purposes of this Issues Paper are as follows:

### Section CX 47 Government grants to businesses

*When this section applies*

- (1) This section applies when—
  - (a) a local authority or a public authority makes a payment to a person for a business that the person carries on; and
  - (b) the payment—
    - (i) is in the nature of a grant or subsidy to the person; or
    - (ii) is a grant-related suspensory loan to the person; and
  - (c) the payment is not in the nature of an advance or loan other than a grant-related suspensory loan; and

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<sup>3</sup> "[Tax incentives](#)", *Public Information Bulletin* no 71 (December 1972).

- (d) the payment corresponds to—
  - (i) expenditure that they incur and for which they would be allowed a deduction in the absence of section DF 1 (Government grants to businesses);
  - (ii) expenditure that they incur in acquiring, constructing, installing, or extending an asset for which they would have an amount of depreciation loss in the absence of section DF 1.

*Excluded income*

- (2) The payment is excluded income of the person.

...

**Section DF 1 Government grants to businesses**

*When this section applies*

- (1) This section applies when—
  - (a) a local authority or a public authority makes a payment to a person for a business that the person carries on; and
  - (b) the payment—
    - (i) is in the nature of a grant or subsidy to the person; or
    - (ii) is a grant-related suspensory loan to the person; and
  - (c) the payment is not in the nature of an advance or loan other than a grant-related suspensory loan; and

...

*When subsection (2) applies*

- (1B) Subsection (2) applies when, in the absence of this section, the person would be allowed a deduction for expenditure by the person to which the payment by the local or public authority corresponds.

*No deduction (with exception)*

- (2) The person is denied, to the extent of the amount of the payment, the deduction that they would have been allowed in the absence of this section.

*When subsection (4) applies*

- (3) Subsection (4) applies when—
- (a) expenditure by the person in the acquisition, construction, installation, or extension of an item of depreciable property is expenditure to which the payment by the local or public authority corresponds; and
  - (b) in the absence of this section, the person would be allowed a deduction for an amount of depreciation loss for the item of depreciable property.

*Amount of depreciation loss*

- (4) For the purpose of quantifying the amount of depreciation loss, the amount of the expenditure is reduced by the amount of the payment.

*Amendment of assessment*

- (5) Despite the time bar, the Commissioner may amend an assessment at any time in order to give effect to this section.

- (6) ...

*Link with subpart DA*

- (7) This section overrides the general permission.

## Exposure draft PS1686 Income Tax Treatment of Grants and Subsidies (1996)

46. In July 1996, Inland Revenue issued *PS1686 Income Tax Treatment of Grants and Subsidies*. *PS1686* set out the Commissioner's view at the time on the tax treatment of government grants and subsidies under the Income Tax Act 1994 as follows:

- If a grant was used for the specific purpose for which it was provided, then the government grant provisions would treat the grant as excluded income and the related expense as non-deductible.
- An expense could be incurred before or after the grant was received. If the expenditure was incurred before a grant was received and deductions were claimed, then Inland Revenue could amend assessments beyond the time bar to disallow the deductions.
- The grant would become excluded income only when the related expense was incurred. Until then, the payment would be subject to ordinary principles. If the payment was revenue in nature, then it would be taxable income.

- Any unspent grant funds would also be subject to ordinary principles, so could be taxable income.
  - If a grant was not used for the purpose for which it was provided or was not provided to fund a specific expense, then the grant would be taxable income (if revenue in nature) and the usual deductibility or depreciation provisions would apply to the expense.
47. Since *PS1686*, the Income Tax Act has been re-written twice and legislative changes have been made to the government grants provisions.

## Preliminary requirements of the government grant provisions

48. This section sets out the preliminary requirements of the provisions that must be met in addition to the issues considered in this paper. These other requirements are included briefly for completeness.
49. The government grant provisions apply where the:
- payment is from a local or public authority
  - payment is to a person for a business that the person carries on
  - payment is in the nature of a grant or subsidy or is a grant-related suspensory loan, and
  - corresponding expense is, in the absence of s DF 1, ordinarily deductible.

### Payment from a local or public authority

50. The provisions apply where a local authority or public authority makes a payment to a person.
51. A “local authority” means a local authority as defined in the Local Government Act 2002 and includes regional councils and territorial authorities, which are also defined in the Local Government Act 2002. Section YA 1 also specifies entities that are local authorities.
52. A “public authority” means every department or instrument of the Executive Government of New Zealand and includes bodies set out in the definition in s YA 1.

53. Payments specifically excluded from the government grants provisions are:
- loans under the Small Business Cashflow Scheme
  - loans under the Research and Development (R&D) Loan Scheme
  - R&D Growth Grants that meet certain conditions and that the recipient has elected, under s CX 47(4), to treat as taxable income (see further [“Consequential R&D amendments”](#), *Tax Information Bulletin* Vol 23, No 1 (February 2011): 84)
  - an R&D tax loss credit granted under subpart MX (see further [“New legislation – Taxation \(Annual Rates for 2015–16, Research and Development, and Remedial Matters\) Act 2016”](#), *Tax Information Bulletin* Vol 28, No 3 (September 2016)), and
  - an R&D tax incentive transition support payment (see further [“Amending the exclusion of expenditure related to a government grant”](#), *Tax Information Bulletin* Vol 33, No 6 (July 2021)).
54. A local or public authority must make a payment to a person. The ordinary meaning of the phrase “make a payment” is to bring about the act of being paid or the process of being paid (*Concise Oxford English Dictionary* (12th ed rev, Oxford University Press, New York, 2011)). An amount will have been paid to a business when it has been distributed to it, credited to an account for it, or dealt with in its interest or on its behalf (s YA 1, definition of “pay”).

## **Payment made to a person for a business that the person carries on**

55. The payment must be to a person for a business that a person carries on. It is a question of fact whether a person is carrying on a business. A “business” is defined broadly in s YA 1 as including “any profession, trade, or undertaking carried on for profit”.
56. The leading case on what constitutes a business is *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). In *Grieve*, the Court of Appeal held that whether a taxpayer is in business involves a two-fold inquiry as to:
- the nature of the activities carried on, and
  - the intention of the taxpayer in engaging in those activities.

57. Richardson J identified six factors relevant to determining whether a taxpayer is carrying on a business. These factors are the:
- nature of the activity
  - period over which the activity is engaged in
  - scale of operations and volume of transactions
  - commitment of time, money and effort
  - pattern of activity, and
  - financial results.
58. Therefore, whether a business exists is a question of fact in each case. However, a business must be in existence and the grant must be provided to the person *for* the business for the government grant provisions to apply. For more information on the factors identified in *Grieve*, see [IS 21/04](#) *Income tax and GST – deductions for businesses disrupted by the Covid-19 pandemic*.

## **Payment is in the nature of a grant or subsidy or a grant-related suspensory loan**

59. The government grant provisions apply when a local or public authority makes a payment to a business and the payment is in the nature of a grant or subsidy or a grant-related suspensory loan. The government grant provisions do not define what a payment in the nature of a grant or subsidy is but there is relevant case law.
60. A payment is in the nature of a grant or subsidy when the payment is:
- a gift, in the sense that the grantor has no legal or other obligation to make it
  - special assistance
  - a payment to promote or encourage an industry or enterprise
  - made out of public funds
  - beneficial to the public interest.



61. In deciding whether a payment is in the nature of a “grant or subsidy”, it is the character or quality of what is paid and of the consideration given that are crucial, not its receipt in the hands of the payee.<sup>4</sup>
62. For further information on the nature of a grant or subsidy see:
- Interpretation Statement “[Treaty of Waitangi settlements – GST treatment](#)”, *Tax Information Bulletin* Vol 14, No 9 (September 2002): 50, and
  - Question We’ve Been Asked [GST Treatment of Funding Provided to Treaty of Waitangi Claimants by the Crown through the Office of Treaty Settlements](#) (2006).

### **Payment that is a grant-related suspensory loan**

63. Government payments to businesses do not include payments in the nature of an advance or a loan, other than a grant-related suspensory loan. An “advance” is when money is handed over to someone before it is due. A “loan” is an amount of money or a credit that a person lends or gives, whether or not that lending or giving is secured or evidenced in writing.
64. Therefore, a loan will be a grant-related suspensory loan if it is made by a public authority (and is not designated as a specified suspensory loan by a public authority), and it:
- includes the term that the liability of the borrower may be wholly or partly remitted, or
  - was granted by the Rural Banking and Finance Corporation of New Zealand (now ANZ Bank) as a West Coast drainage or irrigation suspensory loan (s YA 1).

### **Corresponding expense, in the absence of s DF 1, is ordinarily deductible**

65. When a local or public authority makes a payment to a business and the payment is in the nature of a grant or subsidy or is a grant-related suspensory loan, the corresponding expense must be, in the absence of s DF 1, ordinarily deductible.

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<sup>4</sup> See *Placer Development Ltd v Commonwealth of Australia* (1969) 121 CLR 353, *First Provincial Building Society v FC of T* (1995) 95 ATC 4,145, *GTE Sylvania v R* [1974] CTC 751, *Reckitt & Coleman v FCT* 74 ATC 4,185, *Director General of Social Welfare v S & D De Morgan* (1996) 17 NZTC 12,636 and *Kena Kena Properties Ltd v A-G* (2002) 20 NZTC 17,433.

66. Expenditure incurred in carrying on a business for the purpose of deriving income is deductible under s DA 1, provided that none of the general limitations in s DA 2 apply.
67. Some business expenses, however, are not deductible as they are not incurred for the purpose of deriving income, for example, payments to satisfy tax obligations or the payment of dividends to shareholders.
68. The capital limitation prevents expenditure of a capital nature being deductible under the general permission. However, s DA 4 permits a deduction for a depreciation loss for capital expenditure on depreciable property.
69. Other limitations in s DA 2, such as the private limitation, also prevent a deduction for an expense being claimed.
70. The government grant provisions will not apply to payments that fund expenses that are not deductible under ordinary principles.

## Summary

71. The preliminary requirements of the government grant provisions that must be met before considering the specific issues addressed in this paper are:
  - there is a payment from a local or public authority
  - the payment is to a person for a business that the person carries on
  - the payment is in the nature of a grant or subsidy or is a grant-related suspensory loan, and
  - the corresponding expense is, in the absence of s DF 1, ordinarily deductible.
72. For some businesses, the tax treatment of a government grant is reasonably straightforward. This is where a grant is paid for specific deductible expenses and the payment is derived and the expenses are incurred in the same income year or where the grant reimburses expenditure already incurred. In those cases, the payment is excluded income and the expenses that are funded by the grant are not deductible. For other businesses that receive a generally expressed grant or derive the payment in a different income year to when they incur corresponding expenses, the issues addressed in the following parts of this Issues Paper may arise.
73. The four issues discussed in this paper and on which we specifically seek comment are:
  - issue 1 – which grants are captured by the government grant provisions (see from [75])
  - issue 2 – when a grant is derived (see from [108])

- issue 3 – when does an expense need to be incurred (see from [114]), and
- issue 4 – when does a grant become excluded income (see from [126]).

74. Although these issues are considered separately in this Issues Paper, they are not separate issues. As is shown below, how particular parts of the government grant provisions are interpreted has an impact on how the other parts of the provisions apply.

## Issue 1 – Which grants are captured by the government grant provisions

75. This first issue addresses which grants fall within the government grant provisions. The provisions require that the grant payment corresponds to expenditure that the business incurs and for which it would be allowed a deduction (in the absence of s DF 1). If a payment corresponds to such an expense, the payment is excluded income and the corresponding expense is non-deductible. The first issue, therefore, considers when a grant payment could be said to correspond to a deductible expense.

76. Section CX 47(1)(d)(i) states:

(1) This section applies when—

...

(d) the payment corresponds to—

(i) expenditure that they incur and for which they would be allowed a deduction in the absence of section DF 1 (Government grants to businesses):

77. Section DF 1(1B) and (3)(a) states:

*When subsection (2) applies*

(1B) Subsection (2) applies when, in the absence of this section, the person would be allowed a deduction for expenditure by the person to which the payment by the local or public authority corresponds.

...

*When subsection (4) applies*

(3) Subsection (4) applies when—

(a) expenditure by the person in the acquisition, construction, installation, or extension of an item of depreciable property is expenditure to which the payment by the local or public authority corresponds; and

78. The provisions require that a local or public authority makes a payment to a person for a business that the person carries on and the:
- grant corresponds to the expenditure that a person incurs (s CX 47(1)(d)), and
  - expense or depreciation loss corresponds to the grant (s DF 1(1B) and (3)(a)).

## Meaning of the word “corresponds”

79. The word “corresponds” was introduced into the government grant provisions in 2010. Earlier provisions used the phrase “in relation to” or “in respect of” when describing the required relationship (or nexus) between the grant payment and the expense.
80. The word “corresponds” is not defined in the Act. The *Concise Oxford English Dictionary* defines “correspond” as having a close similarity, matching, agreeing almost exactly, or being analogous or equivalent.
81. In *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1,092, the ordinary meaning of the word “correspond” was considered in the context of whether parts of two international tax treaties corresponded to each other. The Federal Court (at [562]) referred to the ordinary meaning of corresponds as “be similar or analogous, to be equivalent in function”.
82. The ordinary meaning of the word “corresponds” must be considered in the context of the government grant provisions and the purpose of those provisions (s 10 of the Legislation Act 2019). The word “corresponds” is used in ss CX 47 and DF 1. The following paragraphs consider the meaning of the word in each section.

## Use of “corresponds” in s CX 47

83. The ordinary meaning of the word “corresponds” set out above indicates a similarity, matching or equivalence between two things.
84. In the context of s CX 47, this means there needs to be a similarity, matching or equivalence between the payment of a grant and a deductible expense. This is referred to in this Issues Paper as the necessary relationship (or nexus) between the grant and the deductible expense. Issues exist about whether the scope of the relationship between the grant and the expense is a narrow or wide one.
85. For instance, if the required relationship between a grant and an expense is a narrow one (that is, the grant matches or almost exactly matches the expense), this could require that a grant must specify exactly what expense it is for. In that case, issues arise about whether the provisions can be satisfied for many grant payments that may

be of a more general nature. That is, a narrow nexus between the expense and the grant (requiring the grant to specify an exact expense) limits the scope of the government grant provisions. As an example, if a business received a grant to help fund its general operational expenditure, an interpretation adopting a narrow nexus would mean this grant does not correspond to deductible expenditure.

86. A wider nexus that allows the grant to have a close similarity to the expenditure is also available on the ordinary meaning of “corresponds” and presents fewer difficulties in determining whether the provisions apply to individual grants. For instance, a grant provided for general operational expenses would correspond to a business expense (which is ordinarily deductible) such as paying staff wages and vehicle maintenance costs.
87. A wider nexus is available under the ordinary meaning of “corresponds” and ensures a more consistent tax treatment across government grants as more grants would be subject to the same tax treatment. Example 1 illustrates this.

#### **Example 1: Wide nexus between a grant and an expense**

A business receives a grant that is provided to fund general operational expenses. The grant does not specify which particular expenses are to be funded by the grant.

The grant is used to pay wages, electricity and insurance expenses. As these are general business expenses and are, in the absence of s DF 1, usually deductible, the government grant provisions apply.

In contrast, under a narrow nexus, as the grant does not specify the exact expenses that the grant is intended to fund, it would not be subject to the government grant provisions.

#### **Previous view on this issue**

88. The view taken in *PS1686* was that the required relationship was a narrow one. That is, for the government grant provisions to apply to a payment, the payment had to be made in respect of a specific expense.
89. This view was based on the phrase “in respect of”, which was used in the legislation at the time to describe the connection between the grant and the expense. Case law on the meaning of the phrase “in respect of” indicates a relatively wide connection or link

between two subjects.<sup>5</sup> However, case law also indicates that the nature of the connection or link may be restricted, depending on the context in which it is used.<sup>6</sup>

90. *PS1686* considered the context of the government grant provisions restricted the connection between the making of a grant and a certain class of expenditure. It considered that the connection was used as the principal means of determining the tax consequences of a grant. On that basis, the connection between a grant and a taxpayer's expenditure had to be sufficiently direct to show how the grantor intended the grant to be applied in the business. Given that a grant is made in one direction, from grantor to grantee, *PS1686* considered that the connection was to be deduced from the intentions of the grantor.
91. The view set out in *PS1686* required taxpayers to trace grant funds to a specific expense and to show that the funds were spent in accordance with the purpose of the grantor. Where businesses could not demonstrate this, *PS1686* considered that the grant would not be subject to the government grant provisions.
92. The language of the government grant provisions has been amended since *PS1686*. As set out above, the provisions now require that the grant "corresponds" to expenditure that a recipient business incurs and for which the business would be allowed a deduction in the absence of s DF 1. As noted at [80], the ordinary meaning of the phrase "correspond to" means "should agree, be similar or analogous, to be equivalent in function". Therefore, the word "corresponds" has a wide ordinary meaning.

### **Our initial view on this issue**

93. The government grant provisions do not appear to constrain the ordinary meaning of the word "corresponds" to the narrow nexus discussed above. There is no legislative requirement that a grant payment must be for a specific expense. The ordinary meaning of "corresponds" is wide enough to enable a wider view to be taken; that is, that the grant payment is similar to or equivalent in function to what it is spent on. That means, in our view, where a grant is paid for a business's general operating expenditure, that payment will be similar, analogous to or equivalent to any type of general operating expenditure that the organisation uses it for (as long as the expense is deductible). The same principle applies where a grant is paid to fund unspecified capital expenses— as long as the item the grant funds is depreciable property and within the terms of the grant, the grant and the expense will correspond.

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<sup>5</sup> *Shell NZ Ltd v CIR* (1994) 16 NZTC 11,303; *Hochstrasser (Inspector of Taxes) v Mayes* [1959] 3 All ER 817 (HL) and *Trustees, Executors & Agency Co Ltd v Reilly* [1941] VLR 110.

<sup>6</sup> *State Government Insurance Office v Rees* (1979) 144 CLR 549.

94. We consider the requirement that a grant corresponds to an expense could be read widely as the provisions do not further explain how or when a grant will correspond to an expense or otherwise restrict the ordinary meaning of the word “corresponds”.
95. Accordingly, we consider that a grant will correspond to an expense when it is intended to offset deductible expenditure or depreciable property generally or specifically and the recipient business incurs that expenditure.
96. The terms or conditions of a grant or the parameters of the fund that provided the grant will generally indicate whether a grant was provided for deductible expenditure.
97. A business needs to keep records to show what the grant was spent on and what deductible expenses were denied because they were funded by the grant.
98. On this view, the grant terms do not have to specify the exact expense that the grant relates to. Example 2 illustrates a grant payment for a specific expense, and Example 3 illustrates a grant for a general expense, both of which fall within the broader interpretation of the government grant provisions. Example 4 illustrates the use of excess grant funds if our initial views are correct.

### **Example 2: Payment for a specific expense**

In April 2021, the Kanapu local authority introduces a fund to help retain part-time hospital staff. Any initiatives that help to retain such staff are eligible for a grant.

The Kanapu Centre provides childcare for staff who work at Kanapu Hospital. It wishes to extend its opening hours to provide childcare to staff working until 10pm.

In July 2021, the centre applies to the local authority’s fund for a \$50,000 grant, stating that it wants the money to help employ additional childcare staff. Better childcare facilities would help retain hospital staff.

In August 2021, the centre receives a grant from the fund and, in September 2021, successfully employs additional childcare staff.

Because the centre intended to use the grant money to employ staff and the local authority provided the grant for that purpose, the grant and the expense correspond to each other. Therefore, assuming the whole grant is spent, the \$50,000 payment is not taxable and \$50,000 of the costs associated with employing the additional staff is not deductible. Therefore, the total amount of staff wage costs, which would ordinarily be deductible, must be reduced by \$50,000.

### Example 3: Payment for general expenditure

Trainmewell is a vocational training organisation providing training courses nationally. As a result of increasing demand, Trainmewell decides to build a purpose-built facility in Kettering to offer residential training courses.

In November 2021, when the facility is complete and open, Kettering Regional Council offers Trainmewell \$40,000 towards the operating expenditure of the facility. Trainmewell accepts the offer.

Trainmewell incurs operating expenditure of \$300,000 during the year, including expenditure on employees, teaching materials, travel, electricity and insurance.

The payment is subject to the government grant provisions because the grant was provided for general operating expenditure even though the regional council did not specify exactly what the payment was to be used for.

Trainmewell will need to be able to demonstrate that operating expenditure of \$40,000 has not been deducted in its tax return.

### Example 4: Use of excess grant funds

In mid-March 2022, the Kanapu Centre (from Example 2) realises it has \$3,000 left from the \$50,000 grant payment it received from the Kanapu local authority for employing staff. As all the staff costs for the year have been met, the Kanapu Centre obtains the consent of the local authority to use the leftover funds to add additional play equipment to the playground.

Although the local authority provided \$50,000 specifically for staffing, only \$47,000 was needed to meet staff costs. As the centre has used the surplus \$3,000 on capital items for which a depreciation loss is deductible and the local authority has agreed to the use of the excess funds, the government grant provisions apply to both the \$47,000 of staff costs and the \$3,000 capital expenditure. Therefore, the whole \$50,000 is excluded income and any deductions for staff costs and depreciation loss on the playground equipment are denied.

99. However, the government grant provisions do not apply where the grant is:
- not for any expenditure but is a top-up of income, for example, where a subsidy is paid to replace lost income or to supplement income, or
  - for any non-deductible and non-depreciable expenditure.



100. This is because the grant does not satisfy the requirements of the provisions as the payment is not intended to be spent on deductible expenditure, so does not match, does not agree with, or is not similar or analogous to deductible expenditure. Example 5 illustrates a grant payment that does not correspond to deductible expenditure.

### Example 5: Payment that is not for a deductible expense

In October 2021, a significant cyclone crosses the upper North Island, leaving farmland flooded and many crops destroyed.

In November 2021, the Government announces a subsidy for affected farmers to top up their income to make up for some of the income lost from the destroyed crops.

The North Valley farm receives a subsidy of \$15,000 and later decides to use that money to buy new seedlings (a deductible expense).

Because the subsidy is provided to top up the farm's income and not for a deductible expense, the subsidy is not subject to the government grant provisions. Therefore, the subsidy is taxable, being of an income nature under ordinary principles, and the deductibility of the seedling expenditure is determined under the ordinary deductibility rules.

101. Accordingly, we consider that a wider nexus between the grant payment and the corresponding expense is available on the legislative wording and the ordinary meaning of "correspond". This view is also consistent with the policy intent and would result in more grants being subject to the government grant provisions and treated consistently. It would present fewer difficulties for taxpayers in determining whether the provisions apply to individual grants.
102. However, having more grants subject to the government grant provisions could potentially increase compliance costs for businesses where grants are provided for general deductible expenditure. Businesses would need to show which expenses "correspond" to a grant payment and which deductions have not been claimed.

### Use of "corresponds" in s DF 1

103. As well as connecting the non-deductible expense to the non-taxable grant for the purposes of s CX 47, the word "corresponds" in s DF 1 is also used to limit the amount of the deduction that needs to be denied.

104. Section DF 1(2), which applies to deny the deduction, states:

*No deduction (with exception)*

- (2) The person is denied, to the extent of the amount of the payment, the deduction that they would have been allowed in the absence of this section.

105. Section DF 1(2) denies the deduction “to the extent of the amount of” the grant payment. The section limits the amount of the deduction denied to the amount of the grant. Therefore, deductions are available for any amount of expenditure that exceeds the amount of the grant.

106. This ensures that where expenses exceed the amount of grant funding, that additional expense is still deductible, so the receipt of the grant remains tax neutral. Example 6 illustrates this point.

### **Example 6: Deduction denied corresponds to the excluded income**

A business receives a grant of \$30,000 to fund the wages of an apprentice. The business pays the apprentice \$39,000 and reduces the deduction it takes for its wage bill for the year by \$30,000. It treats the \$30,000 grant as excluded income. The remaining \$9,000 of wages is still deductible.

107. We consider that the arguably better view is that the word “corresponds” in s CX 47 links the grant to any deductible expenditure that a business incurs rather than to a particular expense. In s DF 1, we consider the word is used to limit the amount of the deduction denied to the amount of the grant. Adopting this meaning of the word “corresponds” in the government grant provisions better supports the intended policy outcome of government grants being tax neutral.

## **Issue 2 – When a grant is derived**

108. The second issue relates to when a grant has been derived. Once an amount is derived, it will be income in that income year unless a provision in any of parts C and E to I of the Act provides for allocation on another basis (s BD 3). It could be argued that the use of the word “payment” in s CX 47 means a grant is derived when the payment is received.

109. This issue relates to when a grant may need to be included in a tax return and is particularly relevant where grants have conditions attached to them that, if unsatisfied, require repayment of the grant to the grantor.

110. The government grant provisions apply when there has been a “payment” of a grant and the payment satisfies the requirements of s CX 47(1)(a)–(d). The section refers to a “payment” that is made by a local or public authority and specifies that the payment is excluded income of the person. The section does not specify when the excluded income is to be allocated. Accordingly, we consider that the wording is not specific enough to alter the time of derivation under ordinary principles. There are no other relevant provisions in part C or parts E to I that apply to alter the time of derivation for government grants under s BD 3. Therefore, the time of derivation is determined by case law (s BD 3(3)). General principles from the case law on derivation are as follows:
- In relation to the derivation of income generally, the appropriate method for recognising income is the method that gives “a substantially correct reflex of the taxpayer’s true income”: *CT (SA) v Executor Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 (*Carden’s Case*) at 154.
  - In *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 14 CLR 314 the High Court of Australia held that amounts paid for services in advance of the services being supplied did not constitute income derived until they were earned by the provision of the services for which the payment was made.
  - In *Case N30* (1991) 13 NZTC 3,266 the Taxation Review Authority held that pre-payments would be recognised as income at the time it became apparent that the recipient was no longer required to provide the services for which payment was made.
  - In *CIR v Molloy* (1990) 12 NZTC 7,146, the High Court held that commissions advanced to an insurance agent did not have the quality of income earned and derived by the agent at the time they were received. This was because the commissions were not earned unless the insurance policy remained in force for two years.
111. Two general principles can be drawn from the above case law on the derivation of income:
- A receipt of a payment is not derived by a taxpayer until it is earned by the taxpayer providing the quid pro quo (for example, the services) for which it is paid.
  - The contingency that all or some part of the receipt might have to be repaid if the quid pro quo is not provided is relevant for determining whether the receipt has been derived.
112. For more information on when income is derived, see [IS 16/06](#) *Income tax – timing – when is income from professional services derived?*

113. The above principles are relevant to establishing the point at which a business derives income. These principles apply to all types of income, including government grants. For example, if a grant has conditions attached, then depending on the condition, derivation generally occurs when the terms are satisfied such that the business can unconditionally keep the funds. Similarly, if the terms of a grant require that the funds be spent within a specified timeframe, it is likely that derivation occurs when the grant is spent. It is when the grant is spent that the business has met the conditions of the grant and has earned the income. In this situation, any unspent grant money at the end of the specified term would be returned and, hence, has never been derived. Example 7 illustrates when a conditional grant is derived under ordinary principles.

#### **Example 7: Derivation of a conditional grant**

In January 2022, the government announced an apprenticeship scheme to encourage refugees to train as electricians and plumbers. The scheme will pay a \$5,000 grant to businesses who employ a refugee as an apprentice and retain the apprentice for at least six months. The grant is paid to the business in increments every fortnight. At the end of the six-month period, if the business has retained the apprentice, the business will have earned the grant and the income will be derived. If the business has not retained the apprentice, the business will have to repay the full grant and will not have earned any part of the grant.

### **Issue 3 – When does an expense need to be incurred to come within the government grant provisions**

114. The government grant provisions were originally enacted to cater for grants that were paid on a reimbursement basis after expenditure had been incurred. Grants would, therefore, always correspond to the expense (as that expense had already been incurred). However, grants can be paid to fund future expenditure as well as reimburse expenses. This raises questions about whether any timing requirements exist in the provisions.

115. This issue is relevant for two reasons:

- If the government grant provisions apply only to reimburse expenditure already incurred, then grants that are paid “up-front” will be excluded from the government grant provisions and their tax treatment will be subject to ordinary principles.
- If there is no restriction on when an expense needs to be incurred, a question arises as to when a grant becomes excluded income.

116. The requirement to incur an expense in order to claim a deduction is set out in the general permission in s DA 1. Under the general permission, a business can claim a deduction to the extent to which it is incurred by the business carrying on its business for the purpose of deriving its assessable and/or excluded income. However, s DF 1(5) states that s DF 1 overrides the general permission. This means that s DF 1, not s DA 1, determines whether a deduction is allowed.

117. However, s DF 1 does not require an expense to be “incurred”. The section refers only to the person being allowed a deduction for an expense:

*When subsection (2) applies*

- (1B) Subsection (2) applies when, in the absence of this section, the person would be allowed a deduction for expenditure by the person to which the payment by the local or public authority corresponds.

*No deduction (with exception)*

- (2) The person is denied, to the extent of the amount of the payment, the deduction that they would have been allowed in the absence of this section.

118. Earlier versions of the government grant provisions referred to expenditure “incurred” by a taxpayer or to “expenditure that they incur”. This included the original wording of s DF 1. However, any reference to the incurrance of an expense was removed from s DF 1 in 2010. The current wording of s DF 1 does not use the word “incur”, so the section, arguably, does not link the denial of a deduction to the incurrance of an expense.

119. However, s CX 47 does refer to the incurrance of an expense. Paragraphs (a)–(d) of s CX 47(1) set out the elements to be satisfied for the section to apply. If all the elements are satisfied, the grant is excluded income. Section CX 47(1)(d)(i) states:

- (d) the payment corresponds to—
- (i) expenditure that they incur and for which they would be allowed a deduction in the absence of section DF 1 (Government grants to businesses):

120. Case law has established the general rule that an expense is incurred, even though it has not been paid once the taxpayer is definitively committed to it (*FC of T v James Flood Pty Ltd* (1953) 88 CLR 492). For more information on when an expense is incurred, see [IS 3533](#) *Meaning of "Incurred": The Privy Council decision in the Mitsubishi case*. The question for the government grant provisions is whether the expense needs to be incurred before the grant is derived.
121. The use of the word "incurred" in earlier versions of the provisions reflected the reimbursement model under which the industrial research and development grants were paid (discussed at [42]). This may be why the provisions referred to the requirement to incur expenditure in the past tense.
122. The current s CX 47 uses words that are present tense – "that they incur" or "incurs". The section also refers to deductions in the future tense – "for which they would be allowed a deduction". The use of the present and future tense could support the view that there is no timing requirement for the incurrance of the expense in relation to the derivation of the grant; that is, the grant payment corresponds to an expense that a business incurs or will incur, whenever that time is.
123. Case law indicates that little weight should be given to tenses used in legislation.<sup>7</sup> We also note that, in recent years, there has been a move towards the use of the present tense in drafting legislation for plain language reasons.<sup>8</sup>
124. Therefore, the tenses used in the government grant provisions may not be particularly persuasive in determining the correct interpretation of the provision. However, the tense changes are, in our view, a relevant factor and could indicate the approach to be taken to determine when an expense needs to be incurred.
125. On balance, we consider that the wording of s CX 47 does not restrict the incurrance of an expense to any particular time. The wording of the section is broad enough to allow expenses to be incurred before or after a grant is derived. This is also the view taken in *PS1686*. However, this raises the question of when a grant payment becomes excluded income, discussed next.

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<sup>7</sup> *Public Trustee v McKay (Minister of Health)* [1969] NZLR 995 (CA) and *R v Lewis* [1975] 2 NZLR 490.

<sup>8</sup> See, for example, [Principles of clear drafting | Parliamentary Counsel Office \(pco.govt.nz\)](#).

## Issue 4 – When does a grant become excluded income

126. If the view is adopted that s CX 47 applies to grant payments that correspond to expenditure yet to be incurred, this raises an issue about when the section applies to treat the grant payment as excluded income.
127. This issue arises where a grant is derived in an income year but has not been spent in that same year. In some situations, grants may be spent shortly after receiving the payment or, if a grant is subject to conditions, it may be derived at a later time, such as when the grant is spent, and so these timing issues do not arise. There is also no issue where grants are provided to reimburse expenditure already incurred.
128. Based on the wording of earlier versions of the government grant provisions, *PS1686* considered that a grant became excluded income when the corresponding expenditure was incurred.
129. Under the current provisions, if the requirements of paras (a)–(d) of s CX 47(1) are met, s CX 47(2) states:
- Excluded income*
- (2) The payment is excluded income of the person.
130. Section CX 47 does not specify any timing requirements for when a grant becomes excluded income. As discussed at [108]–[113], we consider a grant is derived at the time determined under ordinary derivation principles. Where conditions are attached that mean the payment or part of the payment might need to be repaid, then this will likely affect the timing of derivation.
131. However, arguably, the time of derivation applies to the timing and allocation of income to an income year but does not necessarily determine when a grant becomes excluded income under s CX 47.
132. The timing issue concerning when a payment becomes excluded income relates back to the meaning of the word “corresponds” as discussed at [79]–[107]. That is, a question is whether the use of “corresponds” means the payment is excluded income only after the expense has been incurred or whether it could be excluded income when derived (as long as the expense will be incurred in the future). This uncertainty stems from the use of the phrase “expenditure that they incur” rather than expenditure that is or has been incurred. There are two alternative views on this issue.

133. The first view is that a grant becomes excluded income only when the corresponding expense has been incurred. Under this view, where a grant is derived in one year but is not spent until a subsequent year, then ordinary principles apply. The grant may need to be included in the recipient's return as taxable income in the year of derivation if it is of an income nature. This is on the basis that the grant payment has not corresponded to deductible expenditure by the end of that income year, so the government grant provisions do not apply at that stage. Under this view, a grant payment can be apportioned (as it is spent) between being included as taxable income or treated as excluded income. A business can request an amendment to its earlier assessments to change the taxable amount to an excluded amount once expenses are incurred in future years. This is the view taken in *PS1686*. This view provides administrative and compliance difficulties and involves considering how ordinary principles apply to the payments (including provisions treating amounts as income and potentially the capital contribution provisions).
134. The second view is that a grant that is provided for deductible expenditure and *will* be spent on that expenditure becomes excluded income on derivation. Under this view, the treatment of the grant is not linked to the time an expense is actually incurred. This is on the basis that the person will incur expenditure in accordance with the grant terms in the future, so the amount could be said to correspond to a deductible expense that the person will incur. This view provides a more straightforward outcome as it does not require assessments to be amended to change income amounts in the future. Once a grant is derived, it is excluded income.
135. Both views arise from the wording of s CX 47(1)(d)(i), which states:
- (d) the payment corresponds to—
    - (i) expenditure that they incur and for which they would be allowed a deduction in the absence of section DF 1 (Government grants to businesses):
136. We consider above that the word "incur" in s CX 47 indicates that the section applies to past or future expenditure. The phrase "for which they would be allowed a deduction" in s CX 47(1)(d)(i)), however, is less clear. The section could mean:
- it is only when a deductible expense is incurred that a grant will correspond to an expense (the first view), or
  - if a deduction for an expense will be incurred at some point in the future, a grant will correspond to an expense (the second view).
137. Therefore, how the phrase is interpreted affects when the requirements of s CX 47(1)(a)–(d) are considered to be satisfied.



138. Section CX 47(1)(d) requires that a grant payment corresponds to an expense that the business incurs. Under the first view, if a business has not yet incurred an expense, then it could be argued that s CX 47(1)(d) has not been met. In that case, a grant derived in an income year before the corresponding expense is incurred may be taxable income. However, when the expense is later incurred, the grant will then become excluded income. An issue with this approach is that if a grant is not spent before the time bar expires, a business will not be able to amend the amount of income previously returned as taxable (because, unlike s DF 1, s CX 47 is subject to the time bar). This will not result in tax neutrality.
139. Under the second view, an expense must be one for which the business “would be allowed a deduction” in the absence of s DF 1. The use of the words “would be allowed” are in the future tense and could indicate that a business is not required to have actually incurred the expenditure. The wording could require only that the expenditure to which the grant corresponds is (or will be) deductible expenditure or depreciable property (until s DF 1 denies the deduction). It follows that as long as the expense the business will spend the grant payment on is deductible or the expense is on depreciable property, then the grant payment will be excluded income when it is derived. Example 8 illustrates the second view.

**Example 8: Grant will correspond to a deductible expense if the expense will be incurred at some point**

In August 2023, a bakery receives a grant of \$1,200 to assist it to purchase a new low-emission hydrogen oven costing \$15,000. The business owner intends to buy the oven in April 2024.

The grant and the expense correspond when the business derives the grant. This is because the expense is one for which the business would be allowed a deduction in the absence of s DF 1. Therefore, the grant will be excluded income on derivation. The bakery will need to retain the receipt for the oven to demonstrate that it corresponds to the grant and reduce the depreciation cost base of the oven by \$1,200.

140. Other parts of the government grant provisions lend support to the second view that a grant payment is excluded income on derivation.
141. First, as explained at [105], s DF 1(2) denies a deduction “to the extent of the amount of” the grant. This wording allows for apportionment. It operates to restrict the amount of the deduction denied to the amount of the grant received. That is, it still

allows deductions for any expenditure over and above the amount of the grant funding.

142. However, different language is used in s CX 47. Section CX 47(2) states:

*Excluded income*

(2) The payment is excluded income of the person.

143. Unlike s DF 1, s CX 47(2) does not allow apportionment or otherwise restrict the amount of excluded income "to the extent that" expenditure has been incurred. The use of the words "the payment is excluded income" could suggest that the payment is to be treated as one amount, as nothing in s CX 47 specifically contemplates apportionment of "the payment". Generally, where a section anticipates apportionment, it uses phrases such as "to the extent that", as with s DF 1, which are absent from s CX 47.

144. Accordingly, if a business spends a grant payment progressively, rather than in one sum, the legislation does not appear to allow the business to treat part of the payment as excluded income and another part (the unspent amount) as taxable income. This could be taken to mean that a grant payment must be treated as a single amount: if s CX 47 applies, then the payment is excluded income either on derivation or when it is fully spent.

145. We consider that the more sensible interpretation of s CX 47 is that a grant payment is excluded income on derivation. The alternative would be to treat a grant payment as taxable until it is all spent (which could be after several years).

146. If the payment is treated as excluded income by a business on derivation, then deductions will be denied when the relevant expenses are incurred. The business will not have to amend any earlier assessments (unless the grant on derivation reimburses for expenditure already incurred and deducted in an earlier year).

147. However, if the payment is not treated as excluded income until it is spent, issues arise where the grant is not wholly spent in one income year. That is, a grant spent over time could be treated as taxable income until the whole amount is spent (given the lack of any apportioning wording in the provision). This could be in a later income year, so a business could need to pay tax on the grant payment in the year of derivation and seek an amendment to its return when expenditure is incurred and the terms of s CX 47 are satisfied (which could also be over more than one income year).

148. Second, s CX 47 is subject to a time bar. If a grant is not spent before the time bar expires, a business cannot amend the amount of income previously returned as taxable to become excluded income. If a business does not spend a grant within the time bar period, the grant remains as taxable income and tax neutrality is not achieved.

149. Before the Income Tax Act 2004, the tax treatment of government grants was contained in one legislative provision. With the introduction of the Income Tax Act 2004, the income provision was separated from the deduction provision with the section overriding the time bar remaining in s DF 1.
150. Section DF 1(5) states:
- Amendment of assessment*
- (5) Despite the time bar, the Commissioner may amend an assessment at any time in order to give effect to this section.
151. Section DF 1, therefore, overrides the time bar to ensure deductions that correspond to a government grant are denied. If a business claims deductions for expenditure that a grant later reimburses, the assessment can be amended at any time to reverse out the deductions claimed.
152. The above points may reflect the original reimbursement model of the original provisions. Under that model, there was no need to amend an amount of grant income because the relevant grants would be paid only once the expense had been incurred, so grants would always be income on derivation. Subsequent legislative provisions, however, have not been amended. Therefore, the current provisions may indicate that an amount of income is intended to be excluded income on derivation as long as the corresponding expense would be for expenditure that is either deductible or depreciable in the absence of s DF 1. On this approach, tax neutrality for the grant and the expense may not be achieved in the same income year if there is a delay in spending the grant but would be achieved over time as the payment is spent.
153. Neither view changes the timing of when a deduction would have been available. The first view requires businesses to amend earlier assessments where the payment of a grant and incurring of corresponding expenditure do not occur in the same income year. The second view recognises that, if the relevant expenditure would be deductible, the grant will be excluded income when it is derived. The second view eliminates any issues about unspent funds and re-opening assessments but increases the possibility that businesses may forget to deny the corresponding deductions if the expenditure occurs in a later income year or otherwise incur larger compliance costs in doing so.
154. Accordingly, we consider that while there are potential arguments for both views and either view could be taken on the wording of the legislation, we consider the second view is, on balance, the stronger view.
155. Example 9 and Example 10 illustrate how the second view would work.

**Example 9: Grant is derived earlier than the expense is incurred**

Following the successful extension of its opening hours to 10pm, the Kanapu Centre (from Example 2) decides to become a 24-hour childcare centre for Kanapu Hospital staff working nightshifts.

In February 2022, the centre applies to the Kanapu local authority for further funding and receives an additional \$40,000 in March 2022. The grant is unconditional.

In April 2022, the centre employs additional staff and opens 24 hours a day. The whole \$40,000 is spent on additional staff costs and is fully spent by 31 March 2023.

Because the centre derived the \$40,000 in March 2022, the amount is excluded income in the centre's 2021/22 tax return. With the whole amount being spent in the following income year, the centre will reduce its employee-related costs by \$40,000 in its tax return for the following year (2022/23).

**Example 10: Expense is incurred earlier than the grant is derived**

Trainmewell's residential training facility (from Example 3) is a success, and Kettering Regional Council is pleased at the impact on the local economy from the large number of students attending the facility. Therefore, the regional council decides to reimburse Trainmewell for the operating costs of its minibus for 2021/22. The council pays \$2,500 to Trainmewell in May 2022.

Because Trainmewell did not derive the grant until 2022/23, it will have deducted the operating costs in its 2021/22 tax return. When it receives the payment in May 2022, the payment will be excluded income and Trainmewell will need to request an amendment to its tax return for 2021/22 to reduce its operating costs by \$2,500.

## Conclusion

156. Depending on the interpretation adopted regarding the above four issues, the government grant provisions can give rise to different tax treatments. On balance, we consider, tentatively, that the government grant provisions work as intended and achieve tax neutrality when the following approach is adopted:

- Where the grant payment is provided for deductible expenses (whether for specific expenses or more generally), the whole payment is excluded income when derived (even if it is not spent in that income year).

- Where the grant is a top-up of income or is for non-deductible and non-depreciable expenditure, then the government grant provisions do not apply and ordinary principles apply.
- Ordinary derivation principles apply for determining when a payment is derived.
- A deduction for the corresponding expense is disallowed when it is incurred, to the extent that it is funded by the grant. The recipient needs to keep records of these corresponding expenses.
- A business does not need to request an amendment to earlier assessments under s 113 of the Tax Administration Act 1994 in the following years when a grant is spent. (Although a business will still need to amend earlier assessments to reverse out deductions already claimed where a grant reimburses past expenditure.)
- The government grant provisions apply to all government grants provided for meeting deductible expenditure and/or acquiring depreciable property, ensuring clear and consistent tax treatment for such grants.

157. We consider that adopting this approach reflects the legislation, simplifies the tax treatment of government grants for taxpayers and reduces compliance issues.

## Closing comments

158. This Issues Paper represents the Tax Counsel Office's initial views on the operation of the government grant provisions. The purpose of this Issues Paper is to stimulate discussion and invite comments from interested parties.

159. As mentioned at the outset of this paper, any conclusions in this paper are the Commissioner's initial views. To assist with our further consideration of these issues, we invite submissions from interested parties. Submissions may relate to legal interpretation, practical aspects, or issues or considerations not dealt with in this paper.

160. We invite your comments on the following questions:

- Do you agree with our interpretation and our initial views set out above?
- Do you think the results of our interpretation are correct from a tax policy perspective?
- Do you have practical concerns about the interpretation taken, such as compliance costs or administrative difficulties?

*Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.*

*In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.*

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