

TECHNICAL-DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE > WHAKAWĀ

Deductibility of depreciation and expenses

Decision date | Te Rā o te Whakatau: 11 March 2022

Issue date | Te Rā Tuku: 03 August 2022

TDS 22/15

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Subjects | Ngā kaupapa

Income Tax: Deductions for expenses and depreciation; quantum of losses carried forward; depreciation of pooled assets. Tax Administration Act 1994: Deemed acceptance.

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
TAA	Tax Administration Act 1994
TCO	Tax Counsel Office, Inland Revenue
CNOPA	Notice of Proposed Adjustment issued by the Commissioner
TNOR	Notice of Response issued by the Taxpayer
TSOP	Statement of Position issued by the Taxpayer

Taxation laws | Ngā ture take

All legislative references are to the Income Tax Act (ITA 2007) unless otherwise specified.

Facts | Ngā meka

1. The Taxpayer is a company and owned two properties, Property A and Property B. The Taxpayer was put into liquidation in late 2013 but the liquidators obtained an order terminating the liquidation in mid-2014.
2. Property A was leased by the Taxpayer to various businesses. Property B was purchased as a going concern which had been originally set up as a tourist venture.
3. The Customer and Compliance Services group (**CCS**) issued a Notice of Proposed Adjustment to the Taxpayer (**CNOPA**). The CNOPA contained a range of proposed adjustments. The Taxpayer issued a Notice of Response (**TNOR**). In the TNOR, the

Taxpayer disputed CCS's proposal to disallow deductions for rates and depreciation incurred on Property B. The Taxpayer also claimed an entitlement to deduct certain legal fees.

4. The Taxpayer issued a Statement of Position (**TSOP**). In the TSOP, the Taxpayer purported to dispute an adjustment that they did not dispute in the TNOR; that is, a proposal to reduce depreciation claimed on a pool of assets located at Property A.
5. No agreement between the Taxpayer and CCS was achieved and the matter was referred to the Tax Counsel Office (**TCO**), Inland Revenue for adjudication.

Issues | Ngā take

6. The main issues considered in this dispute were:
 - Whether the Taxpayer was entitled to deduct expenses and depreciation in relation to Property B.
 - Whether the Taxpayer was entitled to deduct legal fees.
 - The quantum of loss balances available to carry forward.
 - Calculation of depreciation losses for pooled assets.
7. There were also preliminary issues on the onus and standard of proof as well as deemed acceptance under s 89H of the Tax Administration Act 1997 (TAA).

Decisions | Ngā whakataurua

8. TCO decided that:
 - The Taxpayer was not entitled to the depreciation and rates deductions they claimed in relation to Property B.
 - The Taxpayer was not entitled to deduct legal fees in any of the years in dispute.
 - The Taxpayer had not shown that the loss carried forward amounts calculated by CCS were incorrect.
 - The Taxpayer was deemed to have accepted CCS's proposal to reduce the depreciation on the pool of assets at Property A but observed that the Taxpayer's arguments were not correct in any event.

Reasons for decisions | Ngā take mō ngā whakatau

Preliminary Issues | Take tōmua

Onus and standard of proof

9. The onus of proof in civil proceedings¹ is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.² The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.³
10. The standard of proof in civil proceedings is the balance of probabilities.⁴ This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer discharged the onus of proof is considered in the other issues.

Deemed acceptance

11. In the CNOA, CCS proposed a series of adjustments that fell into 13 separate categories (the specific adjustments). In the TNOR, the Taxpayer disputed three of these: CCS's proposal to disallow a loss carried forward to the 2013 year and their proposals to disallow rates and depreciation (as they did not meet the requirements of ss DA 1 and EE 6) claimed in relation to Property B. The Taxpayer also disputed CCS's proposal to disallow depreciation deductions claimed in relation to the Pooled Assets located at Property A. However, the Taxpayer disputed this adjustment in the TSOP.
12. After the TNOR was issued CCS accepted the Taxpayer's position concerning the loss carried forward to the 2013 year and the parties resolved another of the specific adjustments by agreement.
13. Accordingly, with the exception of CCS's proposal to disallow expenses and/or depreciation relating to Property B and the Pooled Assets located at Property A, the Taxpayer did not produce any evidence or raise any arguments for the purpose of disputing the specific adjustments that had not been resolved by agreement. As the

¹ Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

² Section 149A(2) of the Tax Administration Act 1994 (TAA).

³ *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

⁴ Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

Taxpayer had not disputed these adjustments, the Taxpayer had not discharged the onus of proving that they were wrong.

14. Section 89H(1) of the TAA also applies in this dispute. Section 89H(1) deems the Taxpayer to have accepted any of the specific adjustments that the Taxpayer has not rejected in the TNOR. This means that the Taxpayer is deemed to have accepted all of the specific adjustments in the CNOA except the adjustments resolved by agreement between the parties and CCS's proposal to disallow rates and depreciation on Property B.

Issue 1 | Take tuatahi: Deductions of rates and depreciation

15. To establish that a deduction for expenditure or loss, including a depreciation loss, is allowable under the general permission in s DA 1 a taxpayer must show that:
 - they have incurred⁵ the expenditure or loss; and
 - the expenditure has a sufficient nexus or relationship with the gaining or producing of the taxpayer's assessable income or with the carrying on of a business for that purpose.⁶
16. This inquiry involves the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the taxpayer's income earning process.
17. Whether or not an expenditure or loss meets the requirements of the general permission is a question of fact and degree.
18. In each case, the true character of the particular expenditure or loss must be determined.
19. Whether a business exists involves a twofold inquiry into:⁷
 - the nature of the activities carried on.
 - the intention of the taxpayer in engaging in those activities.

⁵ *A M Bisley & Co Ltd & Ors v CIR* (1985) 7 NZTC 5,082. Affirmed by the Privy Council in *CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351 (PC) at 12,353.

⁶ *CIR v Banks* [1978] 2 NZLR 472 (CA), *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 (CA); (1978) 3 NZTC 61,271.

⁷ *Grieve v CIR* (1984) 6 NZTC 61,682 (CA), at 61,691, and see also *Calkin v CIR* (1984) 6 NZTC 61,781 (CA)

20. Factors relevant to the inquiry include:
- the period over which the activities are engaged in;
 - the scale of operations and the volume of transactions;
 - the commitment of time, money, and effort;
 - the pattern of activity;
 - the financial results.
21. A person will have a depreciation loss if they own an item of depreciable property for which a loss is calculated under ss EE 9 to EE 11.
22. An item of tangible property will be depreciable property if the following requirements are met:
- the item is property;
 - the item is one that, in normal circumstances, might reasonably be expected to decline in value;
 - the item is used or available for use in deriving assessable income or in carrying on a business for the purpose of deriving assessable income;
 - the item is not described in the list in s EE 7 [What is not depreciable property?].
23. Pursuant to s EE 9(1), a person who owns an item of depreciable property calculates the depreciation loss for the property by applying either the straight line method or the diminishing value method. A person who owns depreciable property that is “poolable property” as that term is defined in s EE 66, may elect to use the pool method.
24. Sections EE 14 to s EE 19 apply for the purpose of calculating a depreciation loss that a person has if they use the diminishing value method or the straight line method (s EE 9(1)). Section EE 14(1) provides that a person’s depreciation loss is the lesser of the amounts in ss EE 15 and EE 16.
25. The Taxpayer did not produce any evidence that a business or other type of income earning operation was carried on from Property B during the years in dispute. There was no evidence of income derived from the property, there was no evidence of any business operations carried on from or in relation to the property, and there was no evidence which would otherwise suggest that the property was employed in an income earning operation. Further, one of the Taxpayer’s shareholders and

directors made statements to CCS and to the liquidator of the Taxpayer that the business carried on from the property had ceased. There were similar statements in a valuation of the property prepared by a real estate agent.

26. These circumstances showed that during the years in dispute, Property B was not used in gaining or producing the Taxpayer's income. Consequently, the Taxpayer has not proved that the rates incurred on Property B had any connection with the Taxpayer's income or with a business carried on by the Taxpayer. As such, the Taxpayer had not established an entitlement to deduct the rates under the general permission in s DA 1.
27. The assets in respect of which the Taxpayer claimed depreciation deductions consist of the buildings and the chattels at Property B. The Taxpayer had not shown that a business was carried on from Property B or that Property B was in any other way used to derive income during the years in dispute. Further, the buildings and the chattels were inoperative and they were not a part of any underlying income earning operation in which they could have been deployed. Consequently, the assets were not used or available for use in deriving income or in carrying on a business for the purpose of deriving income. This means the assets were not items of "depreciable property". Consequently, the Taxpayer was not entitled to the depreciation deductions they claimed in relation to the assets.
28. CCS calculated the depreciation losses that the Taxpayer would be entitled to deduct if it was found that the buildings and chattels were depreciable property. The Taxpayer did not dispute CCS's methodology or the correctness of CCS's calculations. Therefore, the Taxpayer had not proved that CCS's alternative assessments were wrong. As such, the amounts calculated by CCS apply for assessment purposes if the dispute progresses and it is found that the assets are depreciable property.

Issue 2 | Take tuarua: Deduction of legal fees

29. In the TNOR the Taxpayer argued that they were entitled to deduct legal fees that relate to a tenancy matter. An account statement and bank payment advice form provided by the Taxpayer were evidence of legal fee obligations incurred by the Taxpayer. All of the dates on the documents occur in the income year immediately post those in dispute. Therefore, the documents were consistent with CCS's position that the debt obligations the documents relate to were incurred in the income year after the periods in this dispute. The Taxpayer did not argue that this was incorrect or provided evidence that would indicate the legal fees were incurred

in any other year. As such, the Taxpayer had not shown that CCS's position (to deny deduction in the years in dispute) was wrong.

30. Section BD 4 requires a person to allocate a deduction for expenditure to the income year in which the expenditure was incurred. In the context of the general permission, the word "incurred" has been held by the courts to mean a taxpayer must have paid for or become "definitively committed" to an item of expenditure and that the expenditure must constitute an existing obligation which arose in the income year in question.
31. Therefore, if the Taxpayer considers that the legal fees meet the requirements for deductibility, the Taxpayer should claim them in the correct income tax return.

Issue 3 | Take tuatoru: Loss balances

32. Section IA 2(1) provides that a person's "tax loss" for a tax year, is calculated by adding together the amounts described in ss IA 2(2) to (4). The amounts in ss IA 2(2) and IA 2(3) are: (i) any "net loss" that the person has under s BC 4; and (ii), any loss balance the person has carried forward under s IA 3(4), but only to the extent that it is not subtracted from the person's net income under s IA 4(1)(a).
33. The Taxpayer argued that they had loss balances available to be carried forward at amounts higher than that allowed by CCS. These amounts were the loss balances that the Taxpayer claimed in their 2014 and 2015 income tax returns. As such, they did not take account of the adjustments that CCS proposed. This approach was incorrect. Calculating a person's tax loss for a tax year requires that the person's net income or net loss for the year be taken into account. Further, in calculating the Taxpayer's net loss and net income figures in the 2013-2015 income years it was necessary to take account of the adjustments that CCS was proposing in those years. This is because the adjustments had either been accepted by the Taxpayer, or to the extent that they had been disputed, the Taxpayer did not prove that the adjustments were wrong.
34. As the Taxpayer had not taken account of the adjustments, the amounts they contended were their loss balances available to be carried forward will be incorrect if and when new assessments that take account of CCS's proposed adjustments are made. The adjustments that CCS proposed produced consequential changes to the Taxpayer's net income, net loss, tax loss and loss balance figures, as applicable, in each of the years in dispute. TCO considered the amounts calculated by CCS to be correct.

Issue 4 | Take tuawhā: Depreciation losses – pooled assets

35. The pool method for calculating the amount of a depreciation loss is contained in s EE 21. In relation to Property A, the Taxpayer claimed deductions for depreciation losses incurred in relation to pooled assets. In the CNOPA, CCS proposed to reduce the deductions on the ground that the Taxpayer had applied an incorrect cost base when calculating the deductions. The Taxpayer did not reject these adjustments in the TNOR. Consequently, s 89H deems the Taxpayer to have accepted the adjustments and the Taxpayer cannot now challenge them.
36. Despite the inability to further dispute or challenge this matter, the Taxpayer purported to dispute the adjustments in the TSOP. As the Taxpayer was deemed to have accepted the adjustments, those arguments could not succeed.
37. However, TCO made some brief observations on the issue. They remarked that the adjusted tax value of a pool of assets is found by aggregating the cost of each item in the pool and subtracting all depreciation deductions that have previously been allowed. The courts have held in general terms, the “cost” of something is the amount that must be given up to obtain it.⁸ Similarly, in a depreciation context the courts have held that the cost of a depreciable asset is the entire amount that has been laid out to acquire the asset.⁹ “Cost” is not limited to expenditure in money and determining the cost of something can involve viewing transactions in their commercial reality.¹⁰
38. The cost was the amount that the Taxpayer gave up or laid out in order to acquire the pool of assets at Property A. To ascertain this, CCS referred to the terms of a deed the Taxpayer entered into to acquire the assets. TCO confirmed that CCS’s calculations were correct even though as noted above there was deemed acceptance by the Taxpayer on this issue.

⁸ *Kettle River Sawmills Ltd v MNR* (1993) 64 NR 241 at 249.

⁹ *BP Refinery (Kwinana) Ltd v FCT* 8 AITR 113.

¹⁰ *Tasman Forestry Limited v CIR* (1999) 19 NZTC 15,147 (CA).