



Deductibility of payment to settle legal proceedings

Decision date | Rā o te Whakatau: 2 February 2023

Issue date | Rā Tuku: 4 May 2023

TDS 23/06

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Subjects | Kaupapa

Deduction from assessable income; payment for settlement of legal proceedings

Abbreviations | Whakapotonga

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
ITA 2007	Income Tax Act 2007
CNOR	Commissioner Notice of Response
TCO	Tax Counsel Office, Inland Revenue
TNOPA	Taxpayer Notice of Proposed Adjustment

Taxation laws | Ture tāke

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

Facts | Meka

1. The Taxpayer is involved in a number of businesses that primarily relate to property development including being involved as a director of numerous companies.
2. They are also involved as an employee of one company. Their salary as an employee was their only source of income returned for the 2018, 2019 and 2020 tax years, and main source of income for the 2021 tax year (and 2022 tax year up to 18 August 2021).
3. One of the businesses that the Taxpayer was involved with was put into liquidation and legal proceedings were initiated by the Liquidators against the business, the Taxpayer (as a Director) and other parties.
4. The proceedings were settled out of court with an agreement between the Liquidators and the Taxpayer (and the other parties), requiring the Taxpayer to pay to the Liquidators a significant sum referred to as the Settlement Amount.

5. The Taxpayer proposed an adjustment to their 2020 income tax return to include a deduction for the Settlement Amount in a Taxpayer's Notice of Proposed Adjustment (**TNOPA**) on the basis that:
 - they paid the amount to protect their reputation within the property development industry; and
 - their reputation was an essential part of his income-earning activities.
6. Customer & Compliance Services, Inland Revenue (**CCS**) rejected the proposed adjustment in the TNOPA in a Commissioner's Notice of Response (**CNOR**). In the CNOR, CCS said that no proof of payment of the Settlement Amount had been provided and the Settlement Amount did not have the necessary nexus to the Taxpayer's income to be deductible.
7. The Taxpayer maintained the position taken in their TNOPA in a Taxpayer's Statement of Position and a Commissioner's Statement of Position was issued to the Taxpayer in which CCS maintained the position taken in the CNOR, rejecting the Taxpayer's position that the Settlement Amount is deductible.
8. This dispute was referred to the Tax Counsel Office, Inland Revenue (**TCO**) for review

Issues | Take

9. The main issues considered in this dispute were:
 - Had the Taxpayer incurred the Settlement Amount?
 - Does the Settlement Amount have the necessary nexus with the Taxpayer's assessable income to be deductible under the general permission under s DA 1 and if so, does the private limitation under s DA 2(2), the capital limitation under s DA 2(1) and/or the employment limitation under s DA 2(4) apply to prohibit any deduction?

Decisions | Whakatau

10. TCO decided that:
 - The Taxpayer had incurred the Settlement Amount. The Taxpayer was under a legal obligation to pay the amount, and became definitively committed to the expenditure, upon execution of the Settlement Agreement.
 - The Settlement Amount was not deductible to the Taxpayer and the Settlement Amount was not sufficiently linked to satisfy the nexus test, so deductibility was

denied under the private and capital limitations. Even if the Settlement Amount was sufficiently linked to the Taxpayer's employee income to be deductible, the employment limitation would have prevented deductibility.

Reasons for decisions | Pūnga o ngā whakataurua

Issue 1 | Take tuatahi: Deductibility of the Settlement Amount

11. Section DA 1 contains the general rule allowing deductions for expenditure or loss. The general rule is called the general permission.
12. There are two alternative grounds under which a deduction is allowed (sometimes referred to as the first and second limbs of s DA 1). A deduction is allowed for expenditure or loss incurred by a person:
 - in deriving their assessable income, or
 - in the course of carrying on a business for the purpose of deriving their assessable income.
13. The alternative grounds are not cumulative. Expenditure or loss will be deductible under s DA 1 if only one of the alternative grounds is met.
14. For an amount of expenditure to be incurred by a person, the person must have either paid or become definitively committed to the amount. To be definitively committed to the amount:
 - the amount must constitute an existing obligation;
 - the amount must be more than merely impending, threatened or expected; and
 - theoretical contingencies can be disregarded.
15. Section DA 2 provides the general limitations. Each of these overrides the general permission and denies a deduction for an amount of expenditure or loss to the extent that it is:
 - of a capital nature (Capital limitation)
 - of a private or domestic nature (Private limitation)
 - incurred in deriving income from employment (Employment limitation)
16. TCO derived the following principles in respect to the deductibility of expenses incurred by a person (including to protect their reputation):

- The expenses must have a sufficient nexus with the derivation of the person's assessable income or a business carried on for the purpose of deriving the person's assessable income (*Banks*¹, *Buckley & Young*²);
- Whether an expenditure has the necessary nexus is a matter of degree and so a question of fact (*Banks*, *Buckley & Young*) based on a pragmatic approach and common sense and business realities (*Europa Oil*³, *Cox*⁴, *P v CIR*⁵);
- The heart of the inquiry into nexus is the identification of the relationship between the advantage gained or sought to be gained and the income earning process. This in turn requires determining the true character of the payment (*Buckley & Young*);
- The true character of a payment depends on what the expenditure is calculated to effect from a practical and business point of view (*Hallstroms*⁶, *McElwee*⁷, *P v CIR*);
- A sufficient nexus can exist between expenditure and a person and the carrying on of a business for the purposes of generating that person's assessable income even though the personal interests of those employed or otherwise involved in the business are also advanced (*Magna Alloys & Research*⁸);
- A hazard of a person conducting business through a company is that business expenditure incurred by the person will likely relate to the company's income earning process and not that of the person (*McElwee*, *Case S5*, *Case T9*);
- Expenditure need not produce income in the year of deduction (*Ward*, *Cox*); and
- It is not necessary to be able to trace through to an identifiable item or amount of income (*Cox*).
- Expenses to protect reputation will have a sufficient nexus to a person's income earning process if that income earning process is essential to, or dependent to a

¹ *CIR v Banks* [1978] 2 NZLR 472; (1978) 3 NZTC

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

³ *Europa (No Oil (NZ) Ltd 2) v C of IR* (1974) 1 NZTC 61,169 (Court of Appeal)

⁴ *Cox v CIR* (1992) 14 NZTC 9,164 (HC).

⁵ *P v CIR (No 2)* (1998) 18 NZTC 13,647 (HC).

⁶ *Hallstroms Pty Ltd v FCT* (1946) 8 ATD 190 (HCA).

⁷ *McElwee v CIR* (1997) 18 NZTC 13,288 (HC).

⁸ *Magna Alloys & Research Pty Ltd v FCT* (1980) ATC 4,542 (FCAFC).

substantial degree on, the reputation of the person (*Case M121*⁹, *Case N4*¹⁰, *P v CIR*);

- A person's reputation is not a capital item or private or domestic in nature if a person's reputation is an essential ingredient for the person to be able to earn income (*Case N4, Cox*);
- Legal proceedings can relate to actions not within the scope or course of the person's income earning process (*Case M121*);
- In assessing the value of a person's reputation, evidence of regular income from self-employment, the person's professional activities and experience along with evidence of any detriment they have or would have suffered is required in assessing the nexus between the expenditure incurred and the income earning process that is being protected (*Case M121, Case N4, P v CIR, Cox, Case T9*¹¹);
- A person who only derives employment income will be unable to deduct payments to protect their business reputation (*Case M121, Case T9, Case U29*¹², s DA 2(4) (employment limitation)).

17. TCO concluded that the Taxpayer had incurred the Settlement Amount. Although the Taxpayer had not provided evidence to show that they had paid the amount, the Taxpayer was under a legal obligation to pay the Settlement Amount, and became definitively committed to the expenditure, upon execution of the Settlement Agreement.

18. However, the Settlement Amount was not deductible to the Taxpayer for the following reasons:

- The Taxpayer was not a self-employed professional director and did not derive any income from their activities as a director.
- The Settlement Amount had not been incurred by the Taxpayer in the course of gaining or producing income, or to preserve their ability to continue to earn income, as a director.
- While there was some connection between the Settlement Amount and the Taxpayer's income earning activities, the connection was not strong enough, or sufficient, to achieve deductibility of the Settlement Amount.

⁹ *Case M121* (1990) 12 NZTC 2,773 (TRA).

¹⁰ *Case N4* (1991) 13 NZTC 3,030 (TRA).

¹¹ *Case T9* (1997) 18 NZTC 8,049 (TRA).

¹² *Case U29* (2000) 19 NZTC 9,273 (TRA)

- The Taxpayer's salary had been derived by them for their services to their employer from funds gained by the employer through its own income earning process.
 - Any dividend paid to the Taxpayer was related to the Taxpayer's shareholding in the relevant company rather than to the payment of the Settlement Amount.
 - The expenditure in question related directly to the income earning process of the companies through which the Taxpayer operated, but not, in any direct sense, to the Taxpayer's assessable income.
19. That the expenditure in question was not sufficiently linked to the Taxpayer's income earning process to be deductible was also determinative of the collateral issues of whether the expenditure was not deductible under the private and/or capital limitations. The expenditure did not satisfy the nexus test. It was of a private or domestic nature, and capital in nature, and was not deductible under the private and capital limitations.
20. Even if the Settlement Amount was sufficiently linked to the Taxpayer's employee income to be deductible, the employment limitation prevented deductibility. Under the employment limitation, a person is not allowed a deduction for expenditure to the extent to which it is incurred in deriving income from employment.