Vol 22 No 8 September 2010

TAX INFORMATION *Bulletin*

CONTENTS

1 In summary

2 Binding rulings

Product ruling BR Prd 10/03: Bank of New Zealand

7 Interpretation statements

IS 10/05: Depreciation – estimated useful life and lease terms

IS 10/06: Deductibility of business relocation costs

38 Legal decisions – case notes

A gain "in kind" offsets the loss incurred

Security for costs ordered

Inland Revenue
Te Tari Taake

ISSN 0114–7161 (Print)
ISSN 1177–620X (Online)

YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe to receive regular email updates when we publish new draft items for comment.

IN SUMMARY

Binding rulings

Product ruling BR Prd 10/03: Bank of New Zealand 2

This product ruling applies to the TotalMoney product offered by Bank of New Zealand to its customers.

Interpretation statements

IS 10/05: Depreciation – estimated useful life and lease terms 7

This interpretation statement addresses whether a lease term is a relevant factor in determining an item's estimated useful life for the purposes of setting a special depreciation rate.

IS 10/06: Deductibility of business relocation costs 20

This interpretation statement considers the deductibility of business relocation costs incurred to carry out an overall business relocation under the general rules of deductibility in the Income Tax Act 2007.

Legal decisions – case notes

A gain "in kind" offsets the loss incurred 38

When a partner left a partnership he was required to forfeit 50% of shares otherwise forfeited by way of settlement of an employment dispute. He claimed a deduction under the FIF rules for the value of shares forfeited, which the Commissioner disallowed. The Court held that under the FIF rules, the partner derived a gain "in kind", which offset the loss he incurred through the forfeiture of the other shares.

Security for costs ordered 39

The High Court upheld the Commissioner's security for costs application on the basis that the plaintiff was impecunious and that the Commissioner had a strong case.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings: A guide to binding rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin*, Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at **www.ird.govt.nz**

PRODUCT RULING BR PRD 10/03

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the person who applied for the Ruling

Bank of New Zealand (BNZ) has applied for this Ruling.

Taxation Laws

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

This Ruling applies in respect of:

(a) sections BG 1, CC 7, EW 15, EW 31, GA 1, RE 1 to RE 6, RE 10, RF 2, RF 3 and RF 4;

(b) sections 86F and 86I of the Stamp and Cheque Duties Act 1971 (SCDA); and

(c) the definition of "disposition of property" in section 2 of the Estate and Gift Duties Act 1968 (EGDA).

The Arrangement to which this Ruling applies

The Arrangement is a product (TotalMoney) that BNZ offers to its customers. These customers may be only individuals, companies, or trusts.

TotalMoney involves the creation of new types of accounts that must be in a group of accounts, and the facility to elect to group any number of these new types of accounts into one or more groups for the purpose of either "pooling" or "offsetting" the account balances.

"Pooling" involves the aggregation of account credit balances for the purpose of determining the interest rate that will apply to the calculation and crediting of interest to each account balance. "Offsetting" involves the aggregation of account balances for the purpose of calculating the amount of interest debited to a lending facility account balance.

The Arrangement is set out in the documents listed below, copies of which were received by the Taxpayer Rulings Unit, Inland Revenue, on 12 February 2010:

- Terms and Conditions for your Bank of New Zealand TotalMoney Account for Personal Customers;
- Terms and Conditions for your Bank of New Zealand TotalMoney Account for Companies and Trusts;
- Bank of New Zealand Facility Master Agreement; and
- Letter of Advice – TotalMoney Home Loan.

Additional changes will be made to the documents listed in the first two bullet points above to enable business customers to use TotalMoney in the manner described below. For example, the reference to TotalMoney not being available for business purposes in clause 5 of each of these documents will be removed.

Further details of the Arrangement are set out in paragraphs 1 to 28 below.

1. TotalMoney is a package of accounts and loans that BNZ offers to its customers. These customers may be only individuals, companies, or trusts.
2. Customers in general have a range of accounts with BNZ, including transaction accounts, savings accounts, and various loan accounts. Loan accounts may be only table, non-table, tailored, principal and interest, interest only, fixed or floating home loan accounts, or business loan accounts.
3. Interest under a TotalMoney loan account cannot be capitalised, for example, by virtue of a "mortgage holiday". TotalMoney allows customers to group or aggregate these accounts for the purposes of either "pooling" or "offsetting" the account balances.

Primary features of TotalMoney

4. The primary features of TotalMoney are the "pooling" and "offsetting" features. These features operate in the manner described below.

Pooling

(a) The pooling aspect of TotalMoney can operate when there are several transaction accounts with credit balances. Interest on these credit balance

accounts is calculated and paid having regard to the cumulative credit balance of all transaction accounts in the group that are nominated for the pooling feature. Interest-bearing accounts usually attract interest in accordance with interest rate brackets that apply to the balance of each relevant individual account.

(b) The cumulative credit balance is calculated purely for BNZ to ascertain the relevant interest rate tier applicable to the relevant accounts. The separate funds are not actually transferred to one account before the interest is calculated. BNZ calculates interest by reference to the applicable interest rate tier that applies to the accumulated balance.

Offsetting

(a) With the offset feature of TotalMoney, interest on a lending facility or facilities within the group is calculated and paid by the customer on the difference between the lending facility balances and the credit balances of transaction accounts in the group that are nominated for the offset feature. Under the terms and conditions agreed between BNZ and its customers for TotalMoney, BNZ pays no interest on the credit balances that are "offset" against the lending facility.

(b) The "offsetting" is only for the purpose of calculating the balance of the lending facility or facilities on which interest is payable, or, where the credit balances nominated for the "offset" feature exceed the balance of the lending facility, the balance of the credit balances on which interest is receivable. There is no actual transfer of funds, no set-off or "netting" of funds together in an account, and no transfer of any interest in or entitlement to funds.

5. Every transaction account in a TotalMoney group must be selected to either "pool" or "offset". That is, customers can choose whether some or all of their transaction accounts with credit balances are "pooled" (in which case BNZ will pay interest to those accounts) or "offset" against the product lending facility. By default all accounts will be set to the "offset" feature unless changed to "pooled" (by the customer or BNZ on the customer's instructions) except where the customer has no loan account (in which case the customer's TotalMoney accounts will automatically "pool").

6. TotalMoney does not provide a facility for existing accounts. TotalMoney involves the creation of a new type of account. To participate in TotalMoney, a customer must open specific TotalMoney accounts that are particular to the TotalMoney product. Customers may convert an existing non-TotalMoney transaction or savings account that they have with BNZ to a new TotalMoney account. However, the customer must agree that the existing terms and conditions that apply to those accounts cease to apply, and are replaced by the TotalMoney Terms and Conditions.

7. In relation to the new TotalMoney accounts, the customer can select and change between that account participating in either the "offset" or the "pooling" features at any time and for any period.

Pooling – further detail

8. BNZ has a contractual obligation to pay interest to each transaction account with a credit balance participating in the pooling feature, based on the applicable interest rate tier that applies based on the total cumulative balance of all accounts being "pooled". In accordance with its usual business practice, BNZ makes a separate determination in relation to withholding tax on each interest payment made to each account.

9. The benefit of the "pooling" feature for customers is that they can earn more interest by combining smaller balances and reaching higher interest-rate tiers and still maintain their money in separate accounts for separate purposes. The customer may consider this an advantageous way to manage their money.

10. Account owners have full deposit and withdrawal access to their transaction accounts. Overdraft facilities may be available in relation to these accounts. However, any overdraft balance is ignored for "pooling" purposes. BNZ charges debit interest on the overdrawn balance of any account. The overdrawn balance does not reduce the "pooled" balance of the accounts with credit balances when BNZ is calculating interest in relation to those accounts.

Offsetting – further detail

11. Where one loan account is in the group, the interest payable on the loan account is calculated by reference to the balance of the loan account less the credit balances of accounts set to the "offset" feature. This will be the case as a matter of law (in terms of TotalMoney documentation) and as a matter of practice (in terms of BNZ's computer system). There is no actual set-off, netting, or transfer of funds, or transfer of any interest in or entitlement to funds. "Offsetting" occurs before debit or credit interest is calculated.

12. For example, in the case of a loan account that would otherwise be the same as a standard variable rate table home loan facility over 20 years with a "minimum

payment", there will be no provision for the amount of interest saved under "offsetting" to reduce the "minimum payment". The effect of "offsetting" is the same as a decrease in the floating interest rate and a decision not to reduce the amount of the "minimum payment". In either case, the term of the loan is reduced because the principal portion of the payment is effectively increased. In the case of a non-table loan, interest payments will be reduced by "offsetting", principal repayments will not change, and the loan term will not reduce.

13. Where there is more than one loan account in the group, the default position is that the loan accounts in the group are given a default priority; namely, the oldest loan account in the group will receive the highest priority. However, the customer may elect two or more of those loan accounts to be prioritised for "offsetting" purposes. The loan account with the highest priority will receive the benefit of "offsetting" first, and it is only where the credit balances of transaction accounts set to offset exceed the balance of that highest priority loan account that the next highest priority loan account balance is offset, and so on.

14. If the total credit balances of the transaction accounts set to "offset" are greater than the total debit balance of the loan accounts, credit interest will be applied to the difference and paid on a prorated basis to the credit balance accounts in accordance with the balance of those accounts (essentially in line with the "pooling" feature of TotalMoney).

15. BNZ calculates interest daily. If, during a month, BNZ has both an entitlement to receive interest (that is, the balance of participating loan accounts exceeds the balance of all transaction accounts set to the offset feature) and, at another point in the month, BNZ has an obligation to pay interest (that is, the balance of transaction accounts set to offset exceeds the balance of the relevant loan accounts), then the two interest payments are made and are not set-off.

16. The "offsetting" feature of TotalMoney essentially offers the same benefits to customers as offered by a revolving credit loan (such as BNZ's "Rapid Repay" product) in terms of lower interest costs and a shorter time to repay the loan. However, this feature overcomes a primary perceived disadvantage of a revolving credit loan, because it allows customers to retain separate account balances (which customers may prefer when managing their finances).

17. Where a customer has a TotalMoney loan account, this account must be grouped with at least one other TotalMoney transaction account.

18. There is no arrangement between the customers who have grouped their accounts which provides for the loan account owner(s) to make a payment(s) to the transaction account owner(s) in consideration for the transaction account owner(s) electing the "offset" feature of TotalMoney.

Terms and Conditions for the TotalMoney loan products

19. Each of BNZ's home loans is explained in a collection of documents. These documents include primarily a Facility Master Agreement (which is a standard form master document that contains generic provisions that apply to all BNZ home loan facilities), and a Letter of Advice (which contains particular and specific provisions in relation to the home loan facility being made available to the customer). The Letter of Advice is produced from a computer system that contains a master list of possible provisions that can apply to BNZ's home loans. Under this system, the provisions applicable to a particular home loan are selected, collated, and produced in a document.

20. The TotalMoney product home loans are also documented in a Facility Master Agreement and Letter of Advice. Customers may also enter into another Letter of Advice if they want to be able to redraw amounts that they have repaid under a fixed home loan at a later stage. The Facility Master Agreement is the standard document that applies to all BNZ home loans. The Letter of Advice contains only small differences compared with the Letter of Advice for other loans, primarily relating to branding (that is, the name BNZ has given to this particular form of home loan) and the interest calculation in relation to the variable rate components of the home loan (to account for the "offset" feature of TotalMoney).

21. Table loans provide for regular payments and a set date when they will be paid off. Most payments early in the loan term comprise interest, while most of the payments later in the term comprise repayments of the principal. Non-table loans have two separate repayments, one of interest and one of principal. Customers repay the same amount of principal each time and interest is charged separately.

22. The documentation for a TotalMoney standard variable rate table home loan facility over 20 years will largely be the same as that for current BNZ home loan facilities that are standard variable rate table home loans over 20 years. The only differences are; branding (the name on the Letter of Advice), the interest calculation (which provides for the effect of the "offset"), and, in relation to table loans, the provision stating that where the loan has the benefit of the "offset" to reduce the

interest cost, the "minimum payment" specified for the loan will not decrease because of any interest savings but instead the loan term will reduce. In relation to this latter point, under a non-table loan, any interest saving (whether arising as a result of a reduction in the applicable interest rate for the loan because of a general decrease in interest rates, or because of the offset feature), would result in either a reduction of the interest repayment of the loan or a reduction in the loan term (if the original repayment amount is maintained despite the interest saving). In relation to a TotalMoney product home loan that is a table home loan, a reduction is allowed only in the loan term.

Groups

23. TotalMoney is based on a group of participating accounts. Groups can be composed of one of the following categories only:
    (a) *Natural persons:*
        (i) The accounts of an individual, or the individual and joint accounts of married, de facto, and civil union couples, and any of their children may be combined as part of one group.
        (ii) For example, the various accounts of one natural person, Jane, or, the various accounts (individual or joint) of Jane and her husband John and their child Joe. The group is not limited to residents of New Zealand.
    (b) *One company or one trust:*
        (i) Multiple accounts of one company (including a qualifying company or loss attributing qualifying company) or one trust may be combined as part of a group. Only one entity can be in a group at any time.
        (ii) Accounts of different entities (including the entity and any related individual) cannot be pooled or offset. Business rules will be implemented to specify those companies and trusts entitled to use TotalMoney.
24. A customer may be a resident or non-resident of New Zealand for tax purposes. However, where a group of accounts consists of accounts owned by more than one legal person, BNZ will obtain representations from the owners of those accounts that the owners do not have multiple residency status. That is, where more than one legal person is participating in a group of accounts, either all persons must be residents of New Zealand for tax purposes or all persons must be non-residents of New Zealand for tax purposes.

Business purposes

25. When TotalMoney was established, customers were contractually prohibited from using TotalMoney for business purposes. BNZ is removing the prohibition on the business use of TotalMoney. BNZ intends to extend the availability of TotalMoney to business customers to give them the same tools for managing their financial affairs as it gives to personal customers.
26. In the period following the introduction of TotalMoney, BNZ's staff noted that operating multiple accounts enables a business customer to set aside funds for specific purposes (for example, GST, provisional tax, payroll and other costs), while obtaining the benefits of pooling and offsetting. The greater visibility that customers have of their funds when they are not held in one overall transactional account is expected to bring cash management benefits to some customers. Essentially, the benefits that TotalMoney brings to retail customers are equally valid for business customers. BNZ considers that making TotalMoney available to those customers will provide BNZ with a competitive advantage in an important market segment.
27. Under the terms and conditions applicable to TotalMoney, customers will be able to use TotalMoney accounts for business purposes, which means that, in future, customers will be able to group business and non-business product accounts. This will mean that a sole trader, for example, will be able to group their business and non-business accounts.

BNZ's objectives

28. BNZ's objectives in providing TotalMoney are to:
    (a) increase its market share, particularly in relation to home loans and transaction-type accounts;
    (b) increase the proportion of its home loans that are charged variable interest rates;
    (c) increase customer satisfaction and customer retention; and
    (d) improve its brand awareness and be seen as a market leader.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following condition:

(a) All interest rates related to the TotalMoney product are arm's length market interest rates.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the condition stated above, the Taxation Laws apply to the Arrangement as follows.

Gift duty

In relation to a group where the participating accounts are owned by different legal persons, where a credit balance account owned by one person is offset against the loan account balance of another person, with the effect that the interest liability of that other person is less, there is no "disposition of property" for the purposes of section 2 of the EGDA and gift duty cannot apply.

Financial arrangements rules

When a credit balance of a transaction account and a debit balance of a loan account are "offset", there is no amount of consideration paid or payable by virtue of that "offset" for the purposes of the calculation of income and expenditure under sections EW 15 and EW 31 of the "financial arrangements rules" (as defined in section EW 1(2)).

Resident Withholding Tax ("RWT"), Non-Resident Withholding Tax ("NRWT") and Approved Issuer Levy ("AIL")

Under the "pooling" feature of TotalMoney:

- "RWT" (as defined in section YA 1) and "NRWT" (as defined in section YA 1) must be deducted by BNZ from the interest credited to the participating transaction accounts in a group, in accordance with the RWT rules (as defined in sections RE 1(1) and YA 1) and the NRWT rules (as defined in sections RF 1(1) and YA 1);
- in relation to an account that is a "registered security" (as defined in section 86F of the SCDA), "approved issuer levy" (as defined in section 86F of the SCDA) may be paid by an "approved issuer" (as defined in section 86F of the SCDA) in relation to the interest credited to that account pursuant to section 86I of the SCDA.

Under the "offsetting" feature of TotalMoney:

- There is no payment of or entitlement to "interest" (as defined in section YA 1) in relation to the credit balances of participating transaction accounts in a group, and no obligation to deduct RWT or NRWT or pay AIL, except to the extent that the combined credit balance of those accounts exceeds the combined debit balance of the lending facility accounts.
- To the extent that interest is credited to participating transaction accounts in a group:
  - "RWT" (as defined in section YA 1) and "NRWT" (as defined in section YA 1) must be deducted by BNZ from the interest credited to the participating transaction accounts in a group, in accordance with the RWT rules (as defined in sections RE 1(1) and YA 1) and the NRWT rules (as defined in sections RF 1(1) and YA 1);
  - in relation to an account that is a "registered security" (as defined in section 86F of the SCDA), "approved issuer levy" (as defined in section 86F of the SCDA) may be paid by an "approved issuer" (as defined in section 86F of the SCDA) in relation to the interest credited to that account pursuant to sections 86F and 86I of the SCDA.

Section CC 7

No income arises under section CC 7 for BNZ or its customers in relation to the Arrangement.

Tax avoidance

Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2010 and ending on 31 March 2014.

This Ruling is signed by me on the 30th day of June 2010.

Howard Davis
Director (Taxpayer Rulings)

INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 10/05: DEPRECIATION – ESTIMATED USEFUL LIFE AND LEASE TERMS

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

Summary

1. This Interpretation Statement addresses whether a lease term is a relevant factor in determining an item's estimated useful life ("EUL") for the purposes of setting a special depreciation rate.
2. The issue arises where the item to be depreciated by the taxpayer is owned by the taxpayer (or deemed to be owned by the taxpayer for the purposes of being entitled to depreciate the item), but is located in something leased where the taxpayer is the lessee. However, section EE 35(2) provides that special rates cannot be set for buildings, so the issue does not arise for those items that are part of a building.
3. The issue also arises where the item to be depreciated by the taxpayer is the item that is being leased and the taxpayer is either the lessee (in the case of a finance lease as defined in the ITA 2007) or the lessor (in the case of an operating lease).
4. In the above situations, the issue is whether taxpayers may get a special depreciation rate that is based on an EUL that is equal to the length of the lease.
5. It is concluded that the term of a lease is not a relevant factor in determining a special rate for an item of depreciable property under section 91AAG(2) of the Tax Administration Act 1994 ("TAA").
6. A special rate is determined by considering all factors that are relevant to the EUL, as defined in the ITA 2007. Section EE 63(1) defines EUL as the period over which an item of depreciable property might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account the passage of time, likely wear and tear, exhaustion, and obsolescence, and an assumption of normal and reasonable maintenance.
7. It is considered that "passage of time, likely wear and tear, exhaustion, and obsolescence" involves the consideration of deterioration, exhaustion, and external factors that cause the item to no longer be of use to any business. Therefore, an individual taxpayer's decision to abandon or demolish the item at the end of a lease term is irrelevant when determining the EUL of an item. This interpretation of EUL is supported by the provisions in the ITA 2007 that relate to loss on disposal and finance leases.

Legislation

8. The following are the relevant sections from the ITA 2007.
9. Section EE 2 defines "own" for the purposes of owning depreciable property:

> **EE 2 Nature of ownership of item**
>
> *Kinds of ownership*
>
> (1) **Own**, for the ownership of depreciable property,—
>
> (a) means legal or equitable ownership; and
>
> (b) includes ownership of the kinds described in sections EE 3 to EE 5.
>
> *Shared ownership*
>
> (2) When more than 1 person owns an item of depreciable property, own means the interest that the person has in the item.

10. Sections EE 4 and EE 5 describe when a lessee is deemed to own a fixture or an improvement that is located on land that they are leasing:

> **EE 4 Ownership of lessee's improvements: lessee**
>
> *When this section applies*
>
> (1) This section applies when—
>
> (a) a lessee of land incurs expenditure during the period during which the land is leased to the lessee in erecting a fixture on the land or making an improvement to the land; and
>
> (b) the lessor owns the fixture or improvement.

Ownership of fixture or improvement

(2) The following apply to the ownership of the fixture or improvement:

(a) in the period during which the land is leased to the lessee,—

(i) the lessee is treated as owning the fixture or improvement; and

(ii) the lessor is treated as not owning the fixture or improvement; and

(iii) a person to whom the lessor disposes of the land during the period is treated as not owning the fixture or improvement; and

(b) after the period during which the land is leased to the lessee,—

(i) the lessor is treated as not owning the fixture or improvement, unless the lessor incurs a cost relating to it at the end of the period; and

(ii) a person to whom the lessor disposes of the land during the period is treated as not owning the fixture or improvement.

EE 5 Ownership of lessee's improvements: other person

When this section applies: first case

(1) This section applies when—

(a) a lessee of land incurs expenditure during the term of the lease in erecting a fixture on the land or making an improvement to the land; and

(b) the lessee has been allowed a deduction for an amount of depreciation loss for the fixture or improvement; and

(c) the lessee disposes of their interest in the lease to another person; and

(d) the other person pays the lessee for the fixture or improvement.

When this section applies: second case

(2) This section also applies when—

(a) a lessee of land has been allowed a deduction for an amount of depreciation loss for a fixture on the land, or an improvement to the land, that a previous lessee erected or made; and

(b) the lessee disposes of their interest in the lease to another person; and

(c) the other person pays the lessee for the fixture or improvement.

Other person treated as owner

(3) The other person is treated as owning the fixture or improvement from the time at which they pay the lessee for it.

11. Section EE 35 provides that a special rate is set under section 91AAG to 91AAJ of the TAA:

EE 35 Special rate or provisional rate

Rate set for item of depreciable property

(1) A special rate or a provisional rate is set for an item of depreciable property under sections 91AAG to 91AAJ of the Tax Administration Act 1994.

No special rate for excluded depreciable property, special excluded depreciable property, or building

(2) A special rate may not be set for an item of excluded depreciable property, an item of special excluded depreciable property, or a building.

...

12. Section EE 44 provides for when the loss on disposal provision (section EE 48(2)) applies.

EE 44 Application of sections EE 48 to EE 52

When sections apply

(1) Sections EE 48 to EE 52 apply when a person derives consideration from the disposal of an item or from an event involving an item, if—

(a) the consideration is consideration of a kind described in section EE 45; and

(b) either—

(i) the item is an item of a kind described in section EE 46; or

(ii) the event is an event of a kind described in section EE 47.

...

13. Section EE 46 describes the items to which the loss on disposal provision applies.

EE 46 Items for purposes of section EE 44

Items to which sections EE 48 to EE 52 apply

(1) For the purposes of section EE 44, an item of property to which sections EE 48 to EE 52 apply is an item of depreciable property that a person owns, including —

(a) an item for which the person has been allowed a deduction for an amount of depreciation loss they have had under section EE 33; and

(b) an item to which section CZ 11 (Recovery of deductions for software acquired before 1 April 1993) applies.

...

14. Section EE 47 describes the events to which the loss on disposal provision applies:

EE 47 Events for purposes of section EE 44

Events to which sections EE 48 to EE 52 apply

(1) For the purposes of section EE 44, this section describes the events to which sections EE 48 to EE 52 apply.

Change of use or location of use

(2) The first event is the change of use, or change of location of use, of an item of property, as a result of which a person is denied a deduction for an amount of depreciation loss for the item for the next income year. The event is treated as occurring on the first day of the next income year.

Loss or theft

(3) The second event is the loss or theft of an item of property, if the item is not recovered in the income year in which the loss or theft occurs.

Irreparable damage

(4) The third event is the irreparable damage of an item of property.

…

Cessation of ownership under section EE 4 or EE 5

(8) The seventh event is the cessation of ownership of a fixture or improvement—

(a) that a lessee is treated as having under section EE 4(2); or

(b) that a person is treated as having under section EE 5(3).

Cessation of rights in intangible property

(9) The eighth event is an occurrence that has the effect that the owner of an item of intangible property is no longer able, and will never be able, to exercise the rights that constitute or are part of the item.

Item leaving New Zealand permanently

(10) The ninth event is described in section EZ 21(2) (Sections EE 45 and EE 47: permanent removal: allowance before 1 April 1995).

15. Section EE 48(2) provides for loss on disposal:

EE 48 Effect of disposal or event

…

Amount of depreciation loss

(2) For the purposes of section EE 44, if the consideration is less than the item's adjusted tax value on the date on which the disposal or the event occurs, the person has an amount of depreciation loss, for the income year in which the disposal or the event occurs, that is the amount by which the consideration is less than the item's adjusted tax value on that date.

…

16. Section EE 63 sets out the definition of estimated useful life:

EE 63 Meaning of estimated useful life

Meaning for item of depreciable property, except for copyright in sound recording

(1) **Estimated useful life**, for an item of depreciable property, other than a copyright in a sound recording, means the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account—

(a) the passage of time, likely wear and tear, exhaustion, and obsolescence; and

(b) an assumption of normal and reasonable maintenance.

…

17. Section FA 6 provides that for a finance lease the lease is treated as a sale of the leased item:

FA 6 Recharacterisation of amounts derived under finance leases

When a personal property lease asset is leased under a finance lease, the lease is treated as a sale of the lease asset by the lessor to the lessee on the date on which the term of the lease starts, and—

…

(c) subpart EE (Depreciation), the financial arrangements rules, and the other provisions of this Act apply to the arrangement as recharacterised.

18. Section FA 8 provides that for a finance lease the lessee is the owner of the property for depreciation purposes:

FA 8 Deductibility of expenditure under finance lease

Lessee treated as owner

(1) The lessee under a finance lease is treated as the owner of the personal property lease asset for the purposes of subpart EE (Depreciation).

Lessor not treated as owner

(2) The lessor under a finance lease is not treated as the owner of the personal property lease asset for the purposes of subpart EE.

19. The definition of finance lease is set out in section YA 1:

YA 1 Definitions

finance lease means a lease of a personal property lease asset entered into by a person on or after 20 May 1999 that—

…

(b) when the person enters the lease or from a later time, involves a term of the lease that is more than 75% of the asset's estimated useful life as defined in section EE 63 (Meaning of estimated useful life):

…

20. Section 91AAG of the TAA provides for the setting of special rates:

91AAG Determination on special rates and provisional rates

(1) A person may apply, in writing, to the Commissioner for the issue of a determination allowing them to use for an item, for a specified income year or years,—

(a) a special rate higher or lower than the economic rate set in a determination under section 91AAF; or

…

(2) When determining whether or not to grant an application for a special rate or a provisional rate, the level of any such rate, and the income year or years to which it applies, the Commissioner may have regard to any factors that are relevant in determining the item's estimated useful life, including an estimate based on a depreciation method or on a valuer's

report, or a rate of depreciation that the person uses for the item for financial reporting purposes.

(3) The Commissioner may issue a determination setting a special rate using—

(a) the formula in section EE 27 of the Income Tax Act 2007; or

(b) the formula in section EE 28 of that Act; or

(c) the formula in section EE 30 of that Act; or

(cb) the formula in section EZ 23 of that Act; or

(d) the straight-line method other than under paragraph (b).

…

Analysis

21. At issue is whether taxpayers may get a special depreciation rate that is based on an EUL that is equal to the length of a lease. This analysis sets out the situations in which the issue tends to arise. The analysis then looks at the process by which the Commissioner determines a special rate, and concludes that the process includes determining an item's EUL. It is concluded that factors that the Commissioner takes into account when determining a special rate are those that are relevant to determining the item's EUL. The definition of EUL is then analysed to determine whether a lease term is a factor the Commissioner should take into account when determining a special rate. It is concluded that the definition of EUL does not allow a lease term to be a factor the Commissioner is to take into account when determining a special rate. This interpretation of EUL is supported by the legislative provisions relating to loss on disposal and finance leases.

Situations where the lease term issue arises

22. The issue of whether the Commissioner may set a special depreciation rate for an item of depreciable property based on an EUL equal to the length of a lease to which the item is subject to, tends to arise in either of two situations:

- The item to be depreciated by the taxpayer is owned by the taxpayer (or deemed to be owned by the taxpayer for the purposes of being entitled to depreciate the item) and is located in something leased where the taxpayer is the lessee.

- The item to be depreciated by the taxpayer is the item that is being leased where the taxpayer is either the lessee (in the case of a finance lease as defined in the ITA 2007) or the lessor (in the case of an operating lease).

23. The above two situations exist because of the operation of the provisions in the ITA 2007 that relate to who is entitled to depreciate items of property. Section EE 1(2) provides that in order to claim depreciation, a person must own the item of depreciable property. "Own", for the purposes of ownership of depreciable property is defined in sections EE 2 to EE 5. Section EE 2(1) provides that "own" means legal or equitable ownership. Section EE 2(2) provides that "own" includes ownership of the kind described in sections EE 4 and EE 5.

24. The first situation exists where a person legally owns an item that is located in something leased, or, under section EE 4 or section EE 5, is deemed to own an item that is located on leased land (being a fixture or an improvement that is not considered part of a building).

25. The second situation exists where the item is the leased item. Such situations typically would involve personal property leases where only the lessee is allowed a depreciation deduction on the item. The definition of "finance lease" in section YA 1 includes leases of items of personal property, if the term of the lease of the item is more than 75 percent of the EUL for that item. Where the lease must be treated as a finance lease, section FA 6 deems that a sale of the property has occurred at the date that the lease term starts, and section FA 8(1) deems the lessee as the owner of the property for the purposes of being allowed a depreciation deduction for the property under subpart EE.

How a special rate is determined

26. Section EE 35(1) provides that a special rate or provisional rate is set under sections 91AAG to 91AAJ of the TAA.

EE 35 Special rate or provisional rate

Rate set for item of depreciable property

(1) A special rate or a provisional rate is set for an item of depreciable property under sections 91AAG to 91AAJ of the Tax Administration Act 1994.

…

27. Section 91AAG(1)(a) of the TAA provides that a person may apply to the Commissioner to set a special depreciation rate that is higher or lower than the economic rate for the item, for the person to use for depreciating the item.

91AAG Determination on special rates and provisional rates

(1) A person may apply, in writing, to the Commissioner for the issue of a determination allowing them to use for an item, for a specified income year or years,—

(a) a special rate higher or lower than the economic rate set in a determination under section 91AAF; or

…

Section 91AAG(2) of the Tax Administration Act 1994

28. Section 91AAG(2) of the TAA provides that when determining a special rate, the Commissioner may have regard to any factors that are relevant in determining the item's EUL, including an estimate based on a depreciation method or valuer's report, or a rate of depreciation that the person uses for the item for financial reporting purposes.

    91AAG Determination on special rates and provisional rates

    …

    (2) When determining whether or not to grant an application for a special rate or a provisional rate, the level of any such rate, and the income year or years to which it applies, the Commissioner may have regard to any factors that are relevant in determining the item's estimated useful life, including an estimate based on a depreciation method or on a valuer's report, or a rate of depreciation that the person uses for the item for financial reporting purposes.

    …

29. Having regard to section 91AAG(2), the EUL is the key component in determining a special rate. It is considered that the financial reporting treatment or "any [other] factors" are to be taken into regard in determining the EUL, rather than as separate considerations in determining a special rate.

30. The background to section 91AAG(2) of the TAA indicates that this interpretation is correct. The predecessor to section 91AAG(2) was section EG 10(2) of the Income Tax Act 1994. Section EG 10(2) provided that, in determining a special rate, the Commissioner must have regard to the basic economic rate formula set out in section EG 4(3) of the Income Tax Act 1994, and the rate of depreciation used by the taxpayer for financial reporting. The formula set out in section EG 4(3) included the EUL as a necessary factor in the equation.

31. As a result of the enactment of the Income Tax Act 2004, section 91AAG(2) of the TAA replaced section EG 10(2) of the Income Tax Act 1994. Section 91AAG(2) was virtually the same as section EG 10(2) until the section was amended in 2005 by the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005. Inland Revenue's Policy Advice Division discussed section 91AAG(2) in its commentary on the Taxation (Base Maintenance and Miscellaneous Provisions) Bill, which resulted in the 2005 amendment to that provision (Policy Advice Division, *Taxation (Base Maintenance and Miscellaneous Provisions) Bill* (Inland Revenue Department, Wellington, 2004) (at page 19)):

    At present, the basis on which the Commissioner will issue special tax depreciation rates requires taxpayers to identify, for example, the actual economic life of depreciable property with a high degree of certainty. This has led to concerns that this basis is too rigid. That is, if actual economic life cannot be clearly ascertained, a special tax depreciation rate will generally not be allowed.

    The changes will allow the Commissioner greater flexibility in considering special tax depreciation rate applications if he is reasonably satisfied that, in the circumstances, the actual economic life of depreciable property differs significantly to the estimate of economic life used to prescribe the general tax depreciation rate (estimated useful life). This would include taking into account assessments of economic life based on valuers' reports and other available best estimates (for example, from different depreciation methods). However, the current legislation guiding the Commissioner on the factors that he may have regard to in this area is unclear. The changes are intended to clarify this.

    At present, in section [91AAG(2)] of the Tax Administration Act 1994, the Commissioner is required to have regard to the formula in section EE 25(4) of the Income Tax Act 2004 and the rate of depreciation (if any) that the person uses for financial reporting purposes. How this provision is meant to be interpreted is unclear because financial reporting depreciation rates can differ significantly from tax depreciation rates, simply because of the differences in the underlying formula used or even the method - for example, diminishing value versus straight-line. In such cases **the more important piece of information is likely to be the estimate of useful life and how this is calculated. To that effect, section [91AAG(2)] is being amended to explicitly allow the Commissioner to have regard to any factors that are relevant in determining estimated useful life.** This will include, as noted above, estimates from independent valuers.

    [Emphasis added]

32. The above commentary shows that the changes to section 91AAG(2) of the TAA appear to have been intended to clarify that the EUL of an item to which a special rate is sought should be determined on an assessment of a broad range of factors that provide a reasonable level of certainty, although it does not have to be an absolute certainty. Therefore, the section expresses that the relevant factors may include estimates.

33. The above commentary also emphasises that special rates are determined if the economic life of the particular item is expected to be different from the economic life estimated for the general economic depreciation rate applicable to items of the kind to which a special rate is sought. EUL is equated with

economic life and is considered an important piece of information in considering a special rate. Therefore, the changes to section 91AAG(2) of the TAA also appear to have been intended to clarify that the EUL is the key component that must be considered when determining a special rate. This supports the view that the financial reporting treatment, estimates from valuers, and other factors are to be taken into regard if they are relevant to determining the item's EUL, rather than as separate considerations in determining a special rate.

Section 91AAG(3) of the Tax Administration Act 1994

34. Section 91AAG(3) of the TAA sets out the methods the Commissioner may use to determine a special depreciation rate. It is considered that section 91AAG(3) is consistent with the view that the Commissioner must include the item's EUL as the key component in determining any special rate.

35. Section 91AAG(3) of the TAA provides that the Commissioner may set a special depreciation rate using a statutorily set formula or an alternative straight-line method. This ability to issue a special rate based on a straight-line method other than in accordance with the statutory formula was introduced as part of the amendments in the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005.

36. Before the 2005 amendments, section 91AAG(3) of the TAA provided that the Commissioner could issue a special depreciation rate after having regard to the factors in section 91AAG(2) of the TAA. Before the 2005 amendments, the factors in section 91AAG(2) were the economic rate formula set out in section EE 25(4) of the Income Tax Act 2004 and the rate of depreciation used for financial reporting purposes.

37. The reason for the 2005 amendments to section 91AAG(3) of the TAA was discussed in the Inland Revenue's Policy Advice Division 2004 commentary on the Taxation (Base Maintenance and Miscellaneous Provisions) Bill (at page 20):

> Another concern is whether, under section [91AAG(3)], the Commissioner can prescribe a special tax depreciation rate that is not determined using the legislated diminishing value formula (the formula in EE 25(4)). This has implications when, for example, a taxpayer requests a straight-line rate to be calculated without reference to the diminishing value formula. Changes are therefore proposed to section [91AAG(3)] to allow the Commissioner to prescribe special tax depreciation rates using a straight-line method from the outset, instead of setting a diminishing value rate and then prescribing a straight-line equivalent.

38. Section 91AAG(3)(d) of the TAA provides for the alternative straight-line method, and section 91AAG(3)(a) to (cb) of the TAA provides for a statutory formula provided in section EE 27, section EE 28, section EE 30, or section EZ 23, which the Commissioner may use to determine a special rate:

> **91AAG Determination on special rates and provisional rates**
>
> …
>
> (3) The Commissioner may issue a determination setting a special rate using—
>
> (a) the formula in section EE 27 of the Income Tax Act 2007; or
>
> (b) the formula in section EE 28 of that Act; or
>
> (c) the formula in section EE 30 of that Act; or
>
> (cb)the formula in section EZ 23 of that Act; or
>
> (d) the straight-line method other than under paragraph (b).
>
> …

39. Each formula contained in sections EE 27, EE 28, EE 30, and EZ 23 includes the EUL as a component. Therefore, a statutory formula, which includes the EUL, must be used to determine a special rate unless an alternative straight-line method is chosen. The straight-line method is defined in section EE 67 as:

> the method of calculating an amount of depreciation loss for an item of depreciable property by subtracting, in each income year, a constant percentage of the item's cost, to its owner, from the item's adjusted tax value

40. Whether the EUL must be used to determine a rate for an alternative straight-line method is unclear from the above definition of the straight-line method, and is not discussed in the above commentary on the amendment. However, as discussed above, section 91AAG(2) of the TAA appears to clarify that the EUL is the overriding factor that must be considered when determining a special rate. This effectively suggests that even though the EUL is not expressed as a requirement of calculating an amount of depreciation loss under the straight-line method defined in section EE 67, in order to set a special rate the Commissioner must consider factors that are relevant in determining an item's EUL. This implies that the Commissioner must include the item's EUL as a component in determining any special rate.

41. Therefore, it is considered the correct interpretation is that in order to set a special rate, whether using a statutory formula or an alternative straight-line method, the Commissioner must consider factors that are relevant in determining the item's EUL and must include the item's EUL as a component in determining the special rate. This means the definition of EUL needs to be examined to determine whether a particular factor, such as a lease term, is relevant to determining the EUL required for setting special rates.

Estimated useful life defined

42. Section EE 63(1) sets out the definition of EUL for an item of depreciable property, other than a copyright in a sound recording. This is the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account the passage of time, likely wear and tear, exhaustion, and obsolescence, and an assumption of normal and reasonable maintenance.

    EE 63 Meaning of estimated useful life

    Meaning for item of depreciable property, except for copyright in sound recording

    (1) **Estimated useful life,** for an item of depreciable property, other than a copyright in a sound recording, means the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account—

    (a) the passage of time, likely wear and tear, exhaustion, and obsolescence; and

    (b) an assumption of normal and reasonable maintenance.

43. The definition of EUL was introduced into section 107A of the Income Tax Act 1976 by section 2(1) of the Income Tax Amendment Act 1993 as part of the then new depreciation regime. The definition introduced into the Income Tax Act 1976 is substantially the same as the definition in the ITA 2007. The definition introduced into the Income Tax Act 1976 states:

    "Estimated useful life" means, in respect of any depreciable property, the period over which such property might reasonably be expected to be useful in gaining or producing assessable income or in carrying on a business in New Zealand, having regard to such factors as likely wear and tear, the passage of time, exhaustion, and obsolescence and based upon an assumption of normal and reasonable maintenance:

44. The Consultative Committee on the Taxation of Income from Capital ("Valabh Committee") in a letter to the Government dated 14 November 1991 on the Committee's recommendations for the new depreciation regime (introduced by the Income Tax Amendment Act 1993), states that it is necessary to identify objective criteria for determining useful life (Consultative Committee on the Taxation of Income from Capital, *Final Report of the Consultative Committee on the Taxation of Income from Capital* (Consultative Committee, Wellington, 1992, Appendix A, point 6 "Definition of useful life")):

    [The] definition [of EUL in the draft legislation] reflects our view that the useful life of an asset for depreciation purposes is not the life for which an asset could technically be used, but the life for which it is or will be useful in the income earning process. It is necessary to identify relevant objective criteria for determining useful life such as physical deterioration, technical obsolescence, obsolescence due to market factors and the average length of time for which an asset is held for income-earning or business purposes.

    However it is necessary to note that it is the useful life of the asset which is the important criteria for determining depreciation rates, not necessarily the length of time for which it will be used by any particular taxpayer. This means that where an asset will be disposed of to another taxpayer for use by that taxpayer, the useful life of the asset needs to be calculated having regard to the entire period for which the asset will be used, not just the period for which the asset is first used by a taxpayer.

    [Emphasis added]

45. Earlier in the Valabh Committee's letter (under point 4 "Schedular Versus Taxpayer-initiated Rate Setting"), the Committee recommended that individual taxpayers should be entitled to apply for a rate specific to their circumstances, although the same statutory criteria for determining useful life should be applied for setting all rates:

    We continue to hold the view that the Commissioner should set a schedule of tax depreciation rates, and that taxpayers should be able to apply for higher rates where appropriate.

    Whether rates are calculated at the Commissioner's initiative or as a consequence of a taxpayer's request the same statutory criteria (ie determination of useful life and estimated residual value) should be applied. However, although the same criteria for determining useful life and estimated residual value would be used it does not follow that the rate determined should be the same. Tax depreciation rates set by the Commissioner have to apply for all assets of a class and to all taxpayers who own such assets. Many taxpayers will lack the resources to determine accurately the tax depreciation rates applying to their assets. This means that there will inevitably be some inaccuracies in the rates set by the Commissioner when applied to individual taxpayers. We would expect that rates set as a consequence of application by taxpayers and using information in respect of their own circumstances would be considerably more accurate than those set by the Commissioner which need to have general application.

    [Emphasis added]

46. It appears that the Valabh Committee envisaged a depreciation regime that would allow taxpayers to obtain special rates that are based on the useful life of the item in the specific conditions that the item is being used in the taxpayer's business. However, the useful life of an item is determined by an assessment of the item's

usefulness, in the specific conditions, to any business rather than its usefulness to a particular taxpayer. The Valabh Committee envisaged objective criteria for determining an item's useful life.

Criteria for determining an item's estimated useful life

47. In the Valabh Committee's letter to the Government dated 14 November 1991, the Committee envisaged objective criteria for determining an item's useful life, such as "physical deterioration, technical obsolescence, obsolescence due to market factors and the average length of time for which an asset is held for income-earning or business purposes". Criteria of "likely wear and tear, the passage of time, exhaustion, and obsolescence" were written into the definition of EUL from its introduction in 1993. These criteria are now provided in the definition of EUL in the ITA 2007, which provides that the Commissioner is to take them into account when determining the EUL of an item.
48. It is interesting to note as a preliminary observation that the term "the passage of time" seems rather vague in respect of its meaning in relation to considering EUL. It appears that the Valabh Committee's reference to "the average length of time for which an asset is held for income-earning or business purposes" may have been the basis for the term "passage of time". However, even if that is so, it is considered that it does not add any meaning to the term in the context of what should be considered in determining an EUL. This is because the phrase "average length of time for which an asset is held for income-earning or business purposes" appears to be another way of describing EUL, which the criteria are supposed to establish. That is, that phrase describes the outcome, but does not assist with determining what is required to be considered in determining an EUL.
49. The criteria of "likely wear and tear, the passage of time, exhaustion, and obsolescence" have remained in the definition of EUL, except that in the Income Tax Act 2004 the order was changed to "the passage of time, likely wear and tear, exhaustion, and obsolescence", and has remained in this order in the ITA 2007. There is no obvious reason for this change in order, and there appears to be no published background commentary on this. The meanings of these terms are discussed below, with "likely wear and tear", "exhaustion", and "obsolescence" discussed briefly before "passage of time".

Likely wear and tear

50. "Wear and tear" is defined in *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis New Zealand, Wellington, 2005) as the "deterioration or waste of any substance by the ordinary use of it". Therefore, the period over which an item is likely to become fully deteriorated is relevant in determining an EUL.

Exhaustion

51. The *Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006) defines "exhaustion" as "the action or state of exhausting something or of being exhausted", and defines "exhaust" as "tire out completely" and "use up (resources or reserves) completely". It is considered that exhaustion in the definition of EUL means the using up of the item itself or the using up of things such as resources to cause an item to become useless. Therefore, exhaustion will be a consideration in determining an EUL for an item where after a period of time an item can no longer be used due to the item being functionally used up or deterioration of resources used by the item, or some external factor such as resources no longer available. To this degree, exhaustion has similarities with obsolescence in the definition of EUL.

Obsolescence

52. The *Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006) defines "obsolescent" as "becoming obsolete" with "obsolescence" included as a derivative word, and defines "obsolete" as "no longer produced or used; out of date".
53. There are no New Zealand cases on the meaning of "obsolescence" in the context of the current depreciation provisions. However, the ordinary meaning of obsolescence has been considered in various cases (see: *Para Handkerchief & Textiles (1964) Ltd v CIR* (1992) 14 NZTC 9,125; *Anaconda Co v Property Tax Department of the State of New Mexico* App 94 NM 202; 608 P2d 514 (1979); *Real Estate-Land Title & Trust Co v United States*, 309 US 13 (1940); and *SS White Dental Manufacturing Co v United States* 38 F Supp 301; 93 Ct CL 469 (1941)). These cases tend to show that the meaning of obsolescence in the context of the definition of EUL is as follows:
    - Obsolescence is the process whereby an item loses its economic usefulness through causes other than physical deterioration. It is a progressive reduction in the item's ability to function in the business of the taxpayer, such that it will become useless, before the end of its "normal" useful life.
    - Obsolescence is where the uselessness arises from external forces that are generally outside the taxpayer's control.
    - Obsolescence may exist where an item becomes outmoded by virtue of improved alternatives that

make the item uneconomic or uncompetitive such that it must be replaced. However, obsolescence does not equate to something simply being suboptimal, or there simply being "better" or more modern alternatives. A substantial diminution in utility will be necessary, which (in the case of depreciable property used in business) would be likely to progressively contribute to the decline in business (due to the loss of the underlying item's utility).

- Obsolescence is not established by the abandonment or demolition of the item, or a decision to do so. The presence and impact of obsolescence must be determined having regard to the status of the item before its abandonment or demolition.

54. Therefore, obsolescence will be an objective consideration in determining an EUL for an item where after a period of time external factors have caused the item to become useless to any business, disregarding any decision by a particular taxpayer to abandon or demolish the item.

Passage of time

55. The term "passage of time" seems vague. It is not defined as a term in any of the dictionaries referred to above. However, given the ordinary meaning of "passage" is "the action or process of moving" (*Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006)), it is possible to infer that "passage of time" means simply movement through time. This however provides little guidance on how "passage of time" is to be taken into consideration when determining an EUL. It merely indicates that the elapse of time is a consideration, which is already obvious from the nature of EUL, being inherently something that is a unit of time (a "life").

56. The statutory interpretation concept of *noscitur a sociis* provides that groups or lists of words should be read together and will take meaning from each other. Given the vagueness of the term "passage of time" in relation to how it relates to considering EUL, *noscitur a sociis* appears to be an appropriate concept to apply in the interpretation of the phrase "passage of time". Under this concept, the words "likely wear and tear", "exhaustion", and "obsolescence" would add some meaning to "passage of time". As outlined above, "likely wear and tear" brings into consideration the deterioration normally expected of items during their use. "Exhaustion" brings into consideration deterioration of resources used by the item and external factors such as resources no longer available, which cause the item to no longer be of use. "Obsolescence" brings into consideration external factors that cause the item to become useless to any business, disregarding any decision by a particular taxpayer to abandon or demolish the item. Therefore, "passage of time" will take on a meaning that is consistent with the considerations of deterioration of the item and resources used by the item, and external factors, which cause the item to no longer be of use to any business.

57. The above conclusion indicates that it is not the mere passage of time that can be taken into account when determining an EUL. This means any argument that the EUL should be equal to a lease term based on the fact that time has elapsed, would not withstand the interpretation of "passage of time" based on the *noscitur a sociis* concept. That is, something more than the passing of time to the end of the lease must occur for the EUL to be equal to the length of the lease. Something more would have to be the occurrence of deterioration or some external factor that causes the item to no longer be of use to any business. This interpretation is consistent with the objective criteria the Valabh Committee envisaged for determining an item's useful life. That is, the EUL of an item is determined by an assessment of the usefulness of the item being used in particular conditions, rather than necessarily the item's usefulness to a particular taxpayer.

58. An argument may be that if "passage of time" is to be interpreted with the same meaning as "likely wear and tear", "exhaustion", or "obsolescence", it would be unnecessary to include it in the list of criteria. The answer would appear to be that "likely wear and tear", "exhaustion", and "obsolescence" were not meant to be exhaustive, and instead were indicators of the kind of things to be taken into account. Such things would be of a kind that would cause the item to become no longer useful to any business. This interpretation follows closely the most descriptive part of the definition of EUL being; "the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income".

59. It is also noted that there may be cases where items of property depreciate in value even when they are not used. In such cases, it may be considered that the passage of time would have some bearing on the item's EUL. However, it is considered that it is the deterioration over time caused by the lack of use of

an item (for example, a car left idle) or the possible obsolescence of an item (for example, machinery unique to a particular situation) that would be relevant to determining the EUL.

60. The above interpretation that "passage of time" takes its meaning from the other terms in the list is also supported by consideration of the purpose of the 1993 amendments to the depreciation provisions. The February 1993 officials' report to the Finance and Expenditure Committee on Taxation Reform Bill (No 6) stated that one intention of the 1993 amendments was to establish legislative criteria for setting depreciation rates and require the Commissioner to follow the criteria. Therefore, it seems that the definition of EUL was phrased so to secure the kind of deduction for taxpayers that already had been established under the earlier provisions (although previously subject to the Commissioner's discretion).

61. Before the 1993 amendments, the depreciation provisions (sections 74 and 108) in the Income Tax Act 1976 provided the Commissioner with a discretion to allow a deduction for depreciation of an item where the depreciation was caused by "fair wear and tear or by the fact of the asset becoming obsolete or useless" and the "depreciation cannot be made good by repair". Therefore, it seems the definition of EUL introduced by the 1993 amendments included some of the terms from the old depreciation provisions, as well as "exhaustion" and "passage of time". This tends to indicate that, to secure the same kind of deduction as established under the pre-1993 provisions, the term "passage of time" would take its meaning from the other terms in the list, which were seemingly provided for in the pre 1993 provisions.

62. Therefore, the above analysis of the terms "passage of time", "likely wear and tear", "exhaustion", and "obsolescence" tends to indicate that considerations of an item's EUL are not open to the mere passing of time, and instead are restricted to considerations of deterioration, exhaustion, and external factors that cause an item to no longer be of use to any business.

Interpretation of estimated useful life supported by other provisions

Loss on disposal

63. A loss on disposal may be claimed under section EE 48(2).

> **EE 48 Effect of disposal or event**
>
> …
>
> *Amount of depreciation loss*
>
> (2) For the purposes of section EE 44, if the consideration is less than the item's adjusted tax value on the date on which the disposal or the event occurs, the person has an amount of depreciation loss, for the income year in which the disposal or the event occurs, that is the amount by which the consideration is less than the item's adjusted tax value on that date.
>
> …

64. Section EE 44(1) provides for when the above loss on disposal provision, section EE 48(2), applies. Section EE 44(1) provides for cases where there has been a "disposal of an item" that is "of a kind described in section EE 46" or where there has been an "event involving an item" where the event is "of a kind described in section EE 47".

> **EE 44 Application of sections EE 48 to EE 52**
>
> *When sections apply*
>
> (1) Sections EE 48 to EE 52 apply when a person derives consideration from the disposal of an item or from an event involving an item, if—
>
> (a) the consideration is consideration of a kind described in section EE 45; and
>
> (b) either—
>
> (i) the item is an item of a kind described in section EE 46; or
>
> (ii) the event is an event of a kind described in section EE 47.
>
> …

65. The term "disposal" for depreciation purposes takes its meaning from paragraph (f) of the definition of "dispose" in section YA 1, which provides that the word "dispose" "for depreciable property, includes destroy, withdraw, or let lapse". This definition is not exhaustive, so the term "disposal" for depreciation purposes also takes on its ordinary meaning. The *Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006) defines "disposal" as "the action or process of disposing" and "the sale of assets", and "dispose" as "get rid of". Therefore, it is considered that the term "disposal" for depreciation purposes is wide enough to cover the abandonment of property after a lease.

66. Items described in section EE 46(1) are generally items of depreciable property that a person owns.

> **EE 46 Items for purposes of section EE 44**
>
> *Items to which sections EE 48 to EE 52 apply*
>
> (1) For the purposes of section EE 44, an item of property to which sections EE 48 to EE 52 apply is an item of depreciable property that a person owns …

67. As seen, the word "own" is defined for depreciation purposes in sections EE 2 to EE 5. Section EE 2 provides that "own" means legal or equitable ownership, and includes ownership described in sections EE 3 to EE 5. Therefore, a taxpayer who legally owns an item that is

being used in a lease situation (such as an item located in something leased, or machinery hired out) can apply the loss on disposal provision to that item on any disposal that may occur as a result of the termination of the lease. Also, as discussed above, a person can "own" an item for depreciation purposes under sections EE 4 to EE 5 in specific leasing situations involving deemed lessee ownership of fixtures or improvements, as well as finance lease situations under section FA 8. Therefore, the loss on disposal provision may be applied to the disposal of depreciable property as a result of the termination of a lease.

68. Therefore, section EE 48 specifically provides for an allowable deduction for loss on disposal where disposal is determined by the taxpayer's decision to abandon or otherwise dispose of an item, and can include specific circumstances to the taxpayer such as lease arrangements. This indicates that depreciation deductions in general (that is, without this specific loss on disposal provision) are meant to apply to the expected total useful life of an item to any business, without shortening the expected total useful life of the item due to a taxpayer's decision to dispose of the item in the future (for example, at the end of a lease term). Therefore, it is considered this indicates EUL is the estimated usefulness of the item to **any** business, which is consistent with the interpretation of EUL discussed above.

Finance leases

69. The definition of "finance lease" in section YA 1 includes leases of items of personal property, if the term of the lease of the item is more than 75 percent of the EUL for that item. Therefore, it is expressly envisaged in the legislation that the EULs of items will not necessarily coincide with lease terms. Although this inclusion in the definition of finance lease is not determinative, it is consistent with the view that lease terms do not determine EULs.

70. It appears the drafters of the definition of "finance lease" also held this view. The definition of finance lease has included this requirement (where the term of the lease is more that 75 percent of the EUL) since the Taxation (Accruals and Other Remedial Matters) Act 1999 introduced it into the Income Tax Act 1994. The definition of "specified lease", which "finance lease" replaced, did not contain this provision. In the 1999 officials' report to the Finance and Expenditure Committee on submissions on the Taxation (Accruals and Other Remedial Matters) Bill, the above EUL requirement provided in the definition of "finance lease" was briefly discussed (at page 34):

> We also recommend that "estimated useful life" be linked to the estimated useful life as determined by the Commissioner when setting depreciation rates. Otherwise taxpayers could inappropriately determine their own "estimated useful life" for leased assets under the finance lease rules.

71. The above statement, which says it would be inappropriate for taxpayers to determine their own EUL for a leased asset under the finance lease rules, also tends to indicate that EULs are not determined by lease terms. This is also consistent with the above view that an individual taxpayer's decision to abandon or demolish the item is an irrelevant consideration when determining an EUL.

Lease terms and factors relevant to determining an estimated useful life

72. The EUL is defined in section EE 63(1) as the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account the passage of time, likely wear and tear, exhaustion, and obsolescence, and an assumption of normal and reasonable maintenance.

73. The consideration of "likely wear and tear" indicates that the period over which an item is likely to become fully deteriorated is relevant in determining an EUL. It is considered that the term of a lease does not, by itself, indicate that an item will be fully deteriorated by the end of the lease. The item may still be in reasonable condition for another business to be able to use the item after the particular business has ended the lease.

74. The consideration of "exhaustion" indicates that exhaustion will exist for an item after a period of time where an item can no longer be used due to the item being functionally used up or deterioration of resources used by the item, or some external influence such as resources being used up. It is considered that the term of a lease does not, by itself, indicate that an item will be exhausted by the end of the lease. Other businesses may be able to use the item after the particular business has ended the lease.

75. The consideration of "obsolescence" indicates that obsolescence will exist for an item after a period of time where external factors have caused the item to become useless to any business, disregarding any decision by a particular taxpayer to abandon or demolish the item. There may be situations where the taxpayer will use an item only during the term of a lease. However, it is considered that the term of the lease does not, by itself, indicate that something is obsolete by the end of the lease. As indicated above,

the mere abandonment or demolition of an item does not constitute obsolescence. Other businesses may be able to use the item (but for the demolition), or wish to use the item, after the particular business has ended the lease. It is acknowledged that some items may be specifically designed for a particular situation and have no use beyond that situation, to which a lease term may coincide. In such cases, it is the termination of the situation that causes the item to be obsolete, rather than the coincidental end of the lease term.

76. The consideration of "passage of time" does not mean the mere passage of time will determine an EUL. It is considered that an EUL should not be determined to be equal to a lease term based merely on the fact that time has elapsed. It is considered that something more than the passing of time to the end of the lease must occur for the EUL to be equal to the length of the lease. Something more would have to be the occurrence of deterioration, exhaustion, or some external factor that causes the item to no longer be of use to any business.

77. Therefore, the analysis of the terms "passage of time", "likely wear and tear", "exhaustion", and "obsolescence" indicates that lease terms are not consistent with any of the considerations that are to be taken into account in determining the EUL. This means that under section 91AAG(2), a lease term is not a relevant factor the Commissioner may have regard to when determining the EUL required for setting a special rate.

Financial reporting

78. It is noted that section 91AAG(2) provides that the rate of depreciation that the person uses for the item for financial reporting purposes may be included as a relevant factor the Commissioner may have regard to when determining the EUL for the item. However, it is considered that the rate used for financial reporting purposes will not always be a relevant factor for determining an EUL.

79. New Zealand International Accounting Standard 16, Property, Plant and Equipment, states (at paragraph 50) that the "depreciable amount of an asset shall be allocated on a systematic basis over its useful life", and, of particular relevance, that legal or similar limits on the use of an asset, such as related leases, are factors in determining the useful life of an asset (at paragraph 56). Therefore, it appears that for financial reporting purposes lease terms are considered relevant to determining the "useful life" over which an item is to be depreciated, which conflicts with the above conclusion in relation to EUL.

80. New Zealand International Accounting Standard 16 states (at paragraph 57) that the "useful life of an asset is defined in terms of the asset's expected utility to the entity" and that the "useful life of the asset may be shorter than its economic life". In contrast, and discussed above, EUL is equated to an estimate of economic life and considered in terms of usefulness of the item to any entity, rather than usefulness to one particular entity. This is the case for any tax depreciation rate including special rates. Therefore, in the context of a lease situation, the "useful life" on which the rate of depreciation for financial reporting is based, will not necessarily be relevant to determining the EUL for the tax depreciation rate. A "useful life" based on the term of a lease would not be consistent with the interpretation of the definition of EUL considered to be the correct interpretation.

81. Therefore, although section 91AAG(2) of the TAA provides that an estimate based on a depreciation method or on a valuer's report, or a rate of depreciation for financial reporting purposes may be relevant factors in considering an EUL for a special rate, such factors would be relevant only if they are consistent with the view of EUL being the estimated economic life or usefulness of the item to any business.

Conclusion

82. It is concluded that the EUL is a necessary component in determining a special rate, and factors relevant to determining the EUL are the relevant factors the Commissioner may take into account when determining a special rate. The EUL is considered to be the estimated useful life of an item to any business, where an individual taxpayer's decision to abandon or demolish an item is irrelevant. It is concluded that the definition of EUL does not allow lease terms to be relevant factors for the Commissioner to take into account when determining a special rate, because they are not consistent with the criteria for considering EUL. Therefore, the Commissioner cannot issue a special rate that is based on an EUL that has been determined by the length of a lease to which the item is subject.

83. There may be cases where the EUL coincides with the lease term. However, in such cases the EUL will not have been determined by the length of a lease. In all cases the EUL will be determined by reference to the applicable criteria, being "passage of time", "likely wear and tear", "exhaustion", and "obsolescence". It is considered that these criteria are restricted to considerations of deterioration, exhaustion, and external factors that cause an item to no longer be of use to any business.

Examples

84. The following examples illustrate situations in which the issue arises as to whether taxpayers may get a special depreciation rate based on an EUL that is equal to the length of the lease.

Example 1

85. The taxpayer is a lessee of an office and has purchased non-load-bearing partitions for the office. (This example assumes that the partitions are not part of the building. If they are part of the building then a special rate cannot be set for them as section EE 35(2) provides that a special rate cannot be set for buildings.) The taxpayer seeks an EUL for a special rate for the partitions equal to the length of the lease of the office, which is 10 years. The general economic depreciation rate for non-load-bearing partitions is based on an EUL of 20 years.

86. The Commissioner will not set a special rate for the partitions based on an EUL that is determined by the length of the lease. At the end of the lease, although the taxpayer may no longer use the partitions, the partitions would not necessarily be useless (but for any demolition at the end of the lease).

87. It is acknowledged that there may be factors that could cause the partitions to no longer be of use to any business after 10 years as a result of deterioration or external factors. However, a lease term is not such a factor, so is not considered a relevant factor in determining the EUL of the partitions.

Example 2

88. The taxpayer is a lessee of a mobile crane and seeks an EUL for a special rate for the mobile crane equal to the term of the lease, which is five years. (The lessee will be entitled to depreciation deductions on the crane if the lease is a "finance lease" as defined in the ITA 2007.) The general economic depreciation rate for mobile cranes is based on an EUL of 15.5 years.

89. The Commissioner will not set a special rate for the mobile crane based on an EUL that is determined by the length of the lease. At the end of the lease, although the taxpayer would no longer use the crane, the crane would not necessarily be useless.

90. It is acknowledged that there may be factors that could cause the crane to no longer be of use to any business after five years as a result of deterioration or external factors. However, a lease term is not such a factor, so is not considered a relevant factor in determining its EUL.

IS 10/06: DEDUCTIBILITY OF BUSINESS RELOCATION COSTS

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

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

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

Scope of this statement

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

5. In this Interpretation Statement the Commissioner addresses the deductibility of business relocation expenditure incurred to physically move a business. That is, the costs associated with physically relocating business records, trading stock, employees, and items of depreciable property from the business' existing location to its new location. In the Commissioner's view the types of costs typically incurred to physically move a business (and those costs covered by this Interpretation Statement and referred to as "business relocation costs") are:

   - packaging and packing/unpacking costs;
   - freight costs;
   - temporary storage costs;
   - additional insurance premiums on cover acquired specifically for the move;
   - hire charges for the use of containers, forklifts and similar machinery to effect the relocation; and
   - expenditure on labour, in the form of salary or wages, or payments to contractors to effect the dismantling, relocation and re-assembly of property.

6. This Interpretation Statement does not consider the deductibility of any costs associated with vacating the old premises or preparing the new premises. In the Commissioner's view these costs although also incurred on the relocation of a business can be different in nature to the business relocation costs set out above. The deductibility of these other costs may be determined by applying specific provisions of the Act or if necessary, by applying the capital/revenue tests. Under either scenario, the outcome (that is, whether the costs are deductible) may be different from the outcome provided for business relocation costs under this Interpretation Statement.

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

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

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

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

11. Where employees are relocated as part of a business relocation, the relocation costs covered by this

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

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

Summary

12. A business is entitled to claim a deduction for business relocation expenditure if the costs are deductible under the general permission in section DA 1(1), and if those costs are not excluded from deductibility by the capital limitation in section DA 2(1).
13. For convenience this statement considers the deductibility of business relocation expenditure collectively, rather than as a series of apportioned amounts based on the type of underlying business property being relocated. In the Commissioner's view, the business relocation costs covered by this statement will all be incurred for the same principal reason, on the occurrence of the same event, and therefore all fall to be treated in the same way for tax purposes.

General permission

14. To qualify for a deduction under the general permission in section DA 1(1), the principal reason for relocating the business to a new location must bear a sufficient relationship and nexus to the carrying on of the business for the purpose of deriving assessable income.
15. The Commissioner expects most business relocations to satisfy the general permission. However, some business relocations may fail to have the necessary nexus and in those circumstances the relocation costs will not be deductible. Satisfying the general permission will be a question of fact in each case.

Deductible business relocation expenditure

16. On balance, the Commissioner concludes that business relocation expenditure will be deductible where the principal purpose of the relocation is to maintain and preserve the existing structure of the business. The Commissioner does not consider that a move to new, and possibly larger, premises is necessarily expansionary (and therefore capital expenditure). Where the principal purpose of a relocation is merely to enable a business to carry on operating in much the same way as it did before the move, and not to extend or enlarge the structure of the business, then the capital limitation will not prevent a deduction. This will be the case even if the new premises are larger or if there is a possibility that the business may make profitability gains over time as a result of the relocation. The Commissioner does not consider that business relocations that are made to take account of the organic growth or decline of a business are made for the purpose of extending or enlarging the structure of the business.

Capital limitation

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

Depreciation

18. If the capital limitation in section DA 2(1) denies a deduction for business relocation costs, those costs cannot be added to the cost base of an item of depreciable property, unless the relocation results in an alteration, extension, or repair of the item that increases the capital value of the item. This means that unless the relocation costs result in an "improvement" to the item of depreciable property being relocated (as defined in section EE 67) no depreciation loss will be available under subpart EE in respect of those relocation costs.

Analysis

General permission

19. The approach for determining whether business relocation expenditure is deductible is first to consider the general permission provision in section DA 1.

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

Nexus with income

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

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

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

Example where a sufficient nexus has been established

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

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

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

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

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

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

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

Example where nexus test may not be established

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

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

for the relocation must relate to the carrying on of the business.

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

Capital limitation

31. Having concluded that prima facie a deduction is available under the general permission (section DA 1(1)), the next step is to determine whether the capital limitation in section DA 2(1) applies to deny a deduction for the business relocation costs.
32. On the face of it, business relocation expenditure may appear to be capital in nature; given that it relates to the premises of a business, which arguably form part of the business structure, and the fact most businesses do not move premises on a regular basis. However, balanced against this is the fact that a business relocation is often triggered by the occurrence of an ordinary commercial event such as the expiry of a lease, the natural growth of a business as it prospers, or the contraction of a business during tougher economic times. Relocations occurring as a result of such occurrences do not necessarily result in a business expanding or enlarging its business structure or gaining any advantages of enduring benefit over and above mere efficiency or profitability gains achieved through continued trading over time.
33. Therefore, to decide whether the capital limitation applies to deny a deduction for business relocation expenditure it is necessary to consider the various tests the courts have formulated for determining whether expenditure is capital or revenue in nature. Before applying those tests, it is necessary to clarify the approach to be taken when applying those tests in the context of business relocation expenditure.

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

34. In the Commissioner's view, the best approach for determining whether the capital limitation applies to deny a deduction for business relocation costs, is to consider the business relocation costs identified in the Interpretation Statement as costs all incurred for the same reason and on the same occasion, regardless of the type of underlying business property being relocated.
35. The alternative approach is to apply the capital/revenue tests to the apportioned relocation costs associated with each underlying type of property being relocated. In the Commissioner's view such an approach is burdensome from a compliance-perspective, artificial and risks the overall reality of a relocation being overlooked in favour of a narrower application of the tests influenced by the type of property being relocated. This in turn could lead to the unsatisfactory application of the capital/revenue tests.
36. The approach outlined in this Interpretation Statement is consistent with that adopted by the United Kingdom's HM Customs & Revenue. Although it has been suggested that some statements in HM Customs & Revenue's manuals on the deductibility of relocation expenses could be taken as differing from this approach, the Commissioner understands that, notwithstanding those brief statements, HM Customs & Revenue adopts an approach that is consistent with the Commissioner's approach in this statement.
37. In particular, it is understood that in the United Kingdom most relocation costs are allowable on first principles because they are revenue in nature, being the ordinary costs of managing and looking after the business. However, HM Customs & Revenue makes a distinction between ordinary business operations where the relocation is to enable the business to operate in as efficient a manner as possible and a relocation that is part of an expansion programme. Where a relocation is part of an expansion programme, then it is understood that HM Customs & Revenue treats the whole cost as coloured with a capital character (not just the expenditure associated with the plant or machinery). In those circumstances, there is no deduction for the costs on first principles. However, capital allowances may be available in respect of the cost of relocating plant and machinery.
38. In contrast, the Australian courts have taken a narrower approach to relocation costs. The full High Court of Australia in *Lister Blackstone* considered the deductibility of the cost of relocating trading stock separately from the cost of relocating fixed assets. The Australian legislation specifically recognises relocation costs in respect of fixed assets as being a "second element of cost" for depreciation purposes, so supports and requires the apportionment of relocation costs by reference to the type of property being relocated.

That is, the court in *Lister Blackstone* simply followed the approach already contemplated by the Australian legislation.

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

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

General principles

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

> [corresponding] with the distinction between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.

42. Dixon J also identified three matters to be considered (at page 363):
    - a consideration of the character of the advantage sought (and in this its lasting qualities may play a part);
    - the manner in which the advantage is to be used, relied on or enjoyed (and in this and under the previous point recurrence may play its part); and
    - the means adopted to obtain the advantage, that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure further use or enjoyment.

43. The matters referred to in *Sun Newspapers* were adopted by the Privy Council in *BP Australia Ltd v FCT* (1965) 14 ATD 1 and followed in New Zealand in *CIR v L D Nathan & Co Ltd* (1972) NZLR 209, *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271, *CIR v McKenzies NZ Ltd* (1988) 10 NZTC 5,233, *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206, and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981.

44. The courts have extracted various indicia from these cases, and have identified seven tests to assist in determining whether expenditure is capital or revenue in nature:
    - The **need or occasion** that calls for the expenditure: This test focuses on the principal reason or need for incurring the expenditure. In the context of this test the object of the expenditure is ascertained by looking not at the actual thing achieved, but the reason or need for making the expenditure. Clear and accurate application of this test is important, because it will often form the basis for applying the other capital/revenue tests accurately.
    - Whether the expenditure is **recurrent** in nature: This test involves a consideration of whether the expenditure is recurrent or a once and for all payment. If the expenditure is recurrent and made to meet a continuous demand this suggests the payment is part of the cost of ordinary business operations and will be a revenue outlay, whilst capital expenditure is going to be spent once and for all.
    - Whether the source of the payment is from **fixed or circulating capital**: This test focuses on whether the source of the payment was from fixed or circulating capital, rather than whether the payment affects the fixed or circulating capital of the business in question. This test is not as useful as other tests in determining whether expenditure is capital or revenue in nature because of the ease with which a taxpayer can choose between financing an asset from circulating capital and financing it from fixed capital, irrespective of the nature of the asset financed. This test has been questioned judicially: *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17, 017 and *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834.

- Whether the expenditure creates an **identifiable asset**: This test indicates that expenditure will be on capital account where an asset of a capital nature has been acquired by the expenditure, and where money is spent on improving the asset or making it more advantageous.
- Whether the expenditure is a **once and for all** payment producing assets or advantages that are of an **enduring benefit**: Under this test, expenditure will be regarded as capital where it brings into existence an asset or advantage for the enduring benefit of the business. This test combines aspects of the recurrence and identifiable asset tests. This test is one of the more relevant and persuasive tests for deciding whether expenditure is on capital or revenue account.
- Whether the expenditure is on the **business structure** or **business process**: This test focuses on the distinction between expenditure on the business structure set up for the earning of profit, and expenditure on the process by which such an organisation operates to obtain regular returns by means of regular outlay. This test is also one of the more relevant and persuasive tests used to determine whether expenditure is on capital or revenue account.
- What the treatment of the expenditure is according to the **ordinary principles of commercial accounting**: The test of applying ordinary principles of commercial accounting to the expenditure, although of some assistance, is not usually determinative. It needs to be remembered that tax and accounting have different aims, and the treatment for one may differ from the treatment for the other. While this test will often be used to support an approach that the other tests have come to, it is not a sufficiently conclusive test by itself to determine the issue of whether the expenditure is on capital or revenue account.

Qualifications when considering and applying the capital/revenue tests

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

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

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

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

48. Other more recent New Zealand cases have taken a consistent approach to the cases discussed above. In *Poverty Bay Electric Power Board v CIR* (1998) 18 NZTC 13,779, Ellis J endorsed the approach of the courts in *BP Australia*, *Sun Newspapers*, and *McKenzies*. On appeal (*Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC

INTERPRETATION STATEMENTS

15,001) the Court of Appeal referred to the approach of *BP Australia*, *Hallstroms*, and *British Insulated and Helsby*. In addition, the Court of Appeal in *Birkdale* endorsed the approach of the Privy Council in *Wattie* and *BP Australia*.

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

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

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

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

Applying the capital/revenue tests

Need or occasion test

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

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

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

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

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

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

56. Lord Reid said (at page 68):

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

57. To illustrate the difference between a wide view and a narrow view of the need or occasion for incurring business relocation expenditure, the Commissioner considers that the following descriptions of possible scenarios are examples of taking a wide view:

- The business moved to larger premises to facilitate a planned expansion of the business into a new field of trading.
- The business relocated so it could continue trading following the expiry of its lease.
- The business relocated to a better location to improve its profitability.
- The business relocated to cheaper premises as part of plan to reduce overheads to enable the business to continue trading in challenging economic times.

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

59. Therefore, in the Commissioner's view, applying the need or occasion test when determining the deductibility of business relocation expenditure, helps

clearly identify the principal reason for incurring the expenditure. When applying the test it is better to take a wide view of the circumstances giving rise to the relocation. In each case, the principal reason or need for the relocation will be a question of fact.

Recurrence test

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

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

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

63. Dixon J believed that the payment was made for organising the staff and was part of a necessary expenditure of conducting the business. It was not made for acquiring new plant or for any permanent improvement in the material or immaterial assets of the business.

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

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

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

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

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

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

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

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

Fixed or circulating capital test

71. In recent years the fixed or circulating capital test has not played an important part in determining whether expenditure is on capital or revenue account. This is

because of the difficulties the courts have in applying the test consistently. As a result, some differences have evolved in how the test is defined, which in turn makes it even more difficult to apply (ie, whether the test is a use of funds test or a source of funds test). The use of funds test determines whether the expenditure relates to the fixed or circulating capital of the business; the source of funds test determines whether the payment is made from fixed or circulating capital.

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

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

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

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

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

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

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

Identifiable asset test

77. The identifiable asset test requires that there be an acquisition of a capital asset, a disposition of an onerous asset, or a modification to an existing asset to improve it or make it more advantageous for a payment to be capital in nature. If there is no resulting identifiable asset, the payment is more likely to be of a revenue nature.

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

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

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

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

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

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

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

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

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

Enduring benefit test

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

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

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

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

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

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

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

    In *Anglo-Persian Oil Co Ltd v Dale* the payment was made in order to free the company from a long term agency agreement which had become onerous to the company. It was held to be deductible. **Applying Lord Cave's test the payment in question did not bring any asset into existence and could not properly be said to have brought into existence an advantage for the benefit of the company's trade within the meaning of that expression as used by Lord Cave.** Two points about the decision should be noticed. The first is that the distinction between fixed and circulating capital reflected in the *Staveley Coal and Iron Co Ltd* case was expressly recognised, and the agency agreement in question was held not to be a fixed capital asset of the company. The second is that Rowlatt J at p 262 explained Lord Cave's phrase "for the enduring benefit of a trade" as meaning:

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

    On appeal in that case Romer LJ emphasised (at p 146) that the advantage need not be of a positive character: "The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in *Mallett v Staveley Coal & Iron Co*".

    [Emphasis added]

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

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

    In the present case the fixed capital was left untouched. No tangible asset was created by the expenditure which could appear in its balance sheet. No new trading sphere was acquired …

    Therefore, although an advantage was obtained by the expenditure in question, and although that advantage conferred enduring benefit upon the company, I am of the opinion that the special circumstances of this case lead to the conclusion that the advantage was not a capital asset …

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

    Of course they obtained an advantage: companies do not spend money either on capital or income account unless they expect to obtain an advantage. And money spent on income account, for example on durable repairs, may often yield an enduring advantage. In a case of this kind what matters is the nature of the advantage for which the money was spent. This money was spent to remove antiquated restrictions which were preventing profits from being earned. It created no new asset. It did not even open new fields of trading which had previously been closed to the company. Its true purpose was to facilitate trading …

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

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

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

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

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

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

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

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

Business structure or business process test

98. The business structure or business process test, in the Commissioner's view, considers the effect the expenditure has on the existing structure of the business or the reason for incurring the expenditure. The cases have variously described the effect as strengthening, maintaining, preserving, extending, or enlarging the business structure. Where the effect of the expenditure is to maintain or preserve the business structure, the cases have found the expenditure is more revenue in nature. Where the effect of the expenditure is to strengthen, enlarge, or improve the business structure, the cases suggest the expenditure is more capital in nature.

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

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

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

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

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

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

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

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

103. These cases demonstrate the approach the courts have taken to distinguishing expenditure that relates to the business structure from expenditure that relates to the

business process. The courts look at the effect of the expenditure and consider whether the result affects the business structure or the business process.

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

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

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

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

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

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

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

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

Ordinary principles of commercial accounting test

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

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

Balancing the capital/revenue tests

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

113. The indica can be summarised as follows:

- It is important to determine the need or occasion for the relocation. The test should not be applied too narrowly, so that the true reality of the situation is not overlooked. Where there is more than one reason for incurring the relocation expenditure, the principal reason for the relocation needs to be identified. This will be a question of fact.
- Relocation expenditure must first satisfy the general permission before the capital/revenue tests are applied. To qualify for a deduction under the general permission, the cost of relocating the

business must bear a sufficient relationship to the carrying on of the business. This is irrespective of whether the business expands or contracts as a result of the relocation.

- In some circumstances, relocations may be a recurrent incidence of carrying on business, and in those circumstances, support for treating relocation costs as deductible will be stronger. Where business relocations are not a recurrent incidence of carrying on business, and the relocation costs are more in the nature of once and for all expenditure, then that is indicative of the costs having more of a capital nature.
- The fixed or circulating capital test is difficult to apply. Accordingly, little weight should be given to this test.
- Usually, no new or modified asset will be "seen" or "identified" as a result of relocation expenditure being incurred.
- If a relocation is principally for the purpose of maintaining or preserving an existing business, it is unlikely any advantage obtained will be of sufficiently enduring benefit for the costs to be treated as capital expenditure. On the other hand, if a business relocation is made as part of a plan to extend or enlarge the structure of the business, any resulting advantage is more likely to be of enduring benefit to the business.
- In some circumstances a business relocation will have an effect on the structure of a business. Where the relocation forms part of a planned enlargement or extension of the business then the costs will be capital in nature. A move to larger premises or a move to take account of a natural increase in the size of the business are not necessarily indicative of an enlargement of the structure of the business.
- The accounting treatment of relocation costs supports their being revenue in nature.

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

- The cost of relocating a business must have sufficient nexus to the carrying on of the business to satisfy the general permission in section DA 1. Where the reason for relocating is not sufficiently related to the carrying on of the business, the expenditure will not be deductible. Where the nexus test is satisfied (and this will be the result in most cases), the question becomes whether the relocation costs are capital costs excluded from deductibility by the capital limitation.
- Relocation costs will not be capital costs (and so will be deductible) where the principal need or occasion for the business relocation is to maintain and preserve the business, without extending or enlarging the existing structure of the business. The Commissioner does not consider that a move by a business to new, and possibly larger, premises is necessarily expansionary (and therefore capital expenditure). Similarly, the Commissioner does not consider business relocations made to take account of organic growth or contraction within an existing business to be made for the purpose of extending or enlarging the structure of the business.
- The capital limitation will apply to prevent a deduction for relocation costs that satisfy the general permission only if the business relocation forms part of a plan or strategy to:
  - embark on a new field of business or introduce a new product line or service; or
  - change the structure of the business to enable it to operate in an new or different way (for example, a switch from an exclusively home-based business to a single retail store or a business relocation involving major restructuring of the business so that the business is carried on in a significantly different way);

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

Examples

Example 1: Enhanced trading location

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

Example 2: New location offering benefits

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

Example 3: Organic growth within a business

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

Example 4: Recurring relocations

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

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

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

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

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

Example 6: Relocating divisional operations to one centralised site

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

Example 7: Competing reasons for relocating business

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

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

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

Example 9: Relocation on merger

125. Local Trucking Limited has wanted to expand their operations for sometime and has been actively seeking businesses to takeover. The company recently entered into a deal to acquire a competitor company, Fast Fleet Limited. As part of its takeover plan, Local Trucking Limited has agreed to merge its operations with Fast Fleet Limited. This includes the company relocating its operations to Fast Fleet's larger premises as they have more storage space and better loading facilities. As the relocation forms part of an expansion plan the cost of relocating will be capital and not deductible.

Depreciation

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

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

Meaning of "cost"

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

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

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

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

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

132. Accordingly, the Commissioner's view is that under the depreciation rules relocation costs cannot be subsequently added to the cost of an item of depreciable property except where the relocation costs result in an "improvement" to the item. This means no depreciation loss is available for those costs.

Improvements

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

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

Comments on technical submissions received

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

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

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

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

139. However, the Commissioner is not convinced by this argument. He considers the better view in such circumstances, based on the various cases, is that the need or occasion for relocating the existing property is the expansion of the business structure. The costs flow

from the decision to expand the business. If it were not for the business structure expanding, the existing property would not be relocated, and likewise, the existing property needs to be relocated if the business is to expand. As a result, in those circumstances the relocation costs do give rise to an enduring advantage for the business and do have the purpose and effect of expanding or enlarging the business structure even though the costs relate to existing property.

Legislation

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

DA 1 General permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

(2) Subsection (1) is called the **general permission**.

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

DA 2 General limitations

Capital limitation

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

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

EE 16 Amount resulting from standard calculation

Amount

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

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

Definition of items in formula

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

…

Value or cost

(4) **Value or cost** is,—

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

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

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

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

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

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

EE 67 Other definitions

In this Act,—

…

improvement means an alteration, extension, or repair of an item of depreciable property that increases its capital value

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, Privy Council and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

A GAIN "IN KIND" OFFSETS THE LOSS INCURRED

Case	Govind Prasad Saha V CIR
Decision date	23 July 2010
Act(s)	Income Tax Act 1994, FIF rules
Keywords	FIF rules, comparative value method, "in kind and not in money", paid, payment

Summary

Dr Saha was a partner in a large accounting firm. When part of that business was sold, he was allocated a number of shares in the purchaser company. However, if Dr Saha left the employment within five years he would forfeit the right to some of those shares. Dr Saha subsequently left the partnership but was only required to forfeit 50% of those shares, by way of settlement of an employment dispute. Dr Saha claimed a deduction under the FIF rules for the value of the shares he forfeited. The Commissioner disallowed that deduction. Dr Saha appealed to the High Court and the Court of Appeal. Both Courts upheld the decision of the Commissioner. Dr Saha appealed to the Supreme Court, which also dismissed his appeal. The Court held that under the FIF rules, Dr Saha derived a gain "in kind", which offset the loss he incurred through the forfeiture of the other shares.

Impact of decision

The decision confirms the High Court and the Court of Appeal decisions, but on different reasoning. Although there is discussion of the operations of the FIF rules, some of the provisions discussed have been amended or repealed.

Facts

Dr Saha was a partner in Ernst & Young (E&Y). In 2000, E&Y sold a portion of its business to an overseas French company, Cap Gemini SA. The partners were paid by means of an allocation of shares in Cap Gemini. Part of the sale arrangements was that some of the E&Y partners, including Dr Saha, would work for Cap Gemini for five years. If a partner stopped working for Cap Gemini before the five years were up, share forfeiture would occur. This is what happened with Dr Saha and he was later required to return some of the shares he had received.

The share allocation and disposals were subject to the Foreign Investment Fund (FIF) taxation regime. Dr Saha chose to return his FIF income/losses under the comparative value method (section CG 18 of the Income Tax Act 1994) whereby if the value of a person's holding had increased during the course of a tax year, that increase would be treated as income, and if it had decreased it would be treated as a deductible loss.

Dr Saha forfeited 2095 of the 7566 shares he was allocated when he left the employment of Cap Gemini. Dr Saha claimed a deduction of $602,938 being the market value of the 2095 shares he forfeited to Cap Gemini. The Commissioner disallowed that deduction.

Decision

Dr Saha chose the "comparative value" method under section CG 18. In applying the analysis to the formula, the Court noted at paragraph [14] that:

a) because Dr Saha no longer owned the shares at the end of the income year during which they were forfeited their value at the time was nil;

b) Dr Saha derived no gains during the year "with respect to" those shares (his "interest" in a FIF) because their forfeiture resulted in loss to him;

c) the market value of the shares at the end of the preceding income year was $602,938; and

d) no expenditure was incurred during the income year in acquiring the shares.

The formula in section CG 18 is (a + b) – (c + d). The calculation therefore is (nil plus nil) less ($602,938 plus nil). As a result, the Court said that if section CG 18 was the only relevant section, the deduction would have been correctly claimed. But section CG 18 is subject to sections CG 23(5) and CG 14(2).

Under section CG 23(5), if a person disposes of any interest for no consideration the person shall be deemed to have derived from the disposition consideration equal to the market value of the property. The Court concluded that it could not be said that Dr Saha disposed of his interest for no or inadequate consideration, as there was a benefit to him in the value of the shares he was permitted to retain.

For the Commissioner to rely on section CG 14(2), the Court said that the Commissioner must establish that as a consequence of the forfeiture Dr Saha derived a gain "in kind and not in money". If so, the amount of the gain was deemed to be the market value of the gain. The Court held at paragraph [25] that the gain was deemed by section CG 14(2) to be the market value of the shares which were retained.

The result was (at paragraph [26]):

> The effect of section CG 14(2) was that Dr Saha was deemed to have derived a gain of $602,938 from the forfeiture of the shares. That sum therefore became input (b) into the section CG 18 formula. The resultant calculation was (nil plus $602,938) less ($602,938 plus nil), namely nil. It followed that the Commissioner's assessment that Dr Saha was not entitled to claim a deduction of $602,938 was correct, and his appeal must therefore be dismissed.

SECURITY FOR COSTS ORDERED

Case	DT United Kingdom Ltd V CIR
Decision date	9 July 2010 (oral judgment – written decision delivered 19 July 2010)
Act(s)	High Court Rules, Tax Administration Act 1994
Keywords	Security for costs, stay of proceedings

Summary

The High Court upheld the Commissioner's security for costs application on the basis that the plaintiff was impecunious and that the Commissioner had a strong case.

Impact of decision

This decision confirms the position in *Reefdale Investments Ltd v Commissioner of Inland Revenue* (2004) 17 PRNZ 229, that the Commissioner can make an application for security for costs in respect of a tax challenge. As this decision is purely a procedural matter it will have no direct tax implications.

Facts

This case relates to an application by the Commissioner for security for costs and for a stay under rule 5.45 of the High Court Rules.

Digi-Tech (Communications) Ltd ("Digi-Tech") owned intellectual property rights in three products—Freerider, Terminal Adapter and DFS DBUSS.

Digi-Tech sold its intellectual property rights in these products to a number of subsidiaries, including DT United Kingdom Ltd ("DT UK"). DT UK bought the intellectual property rights for $395.1 million by way of paper transaction.

On 25 January 2002, DT UK sold the intellectual property rights to Fifth Investments Ltd, a related company, for $8.1 million by way of a loan from DT UK to Fifth Investments Ltd.

Digi-Tech reported the sale of the intellectual property rights as a capital receipt and therefore not taxable. DT UK bought the intellectual property rights with a purpose to resale, therefore reported the purchase price as expenditure on the revenue account.

The Commissioner sought valuation advice and found that the value of the intellectual property rights was realistically only in the order of $500,000 rather than $395 million. Accordingly, the Commissioner took the position that this transaction amounted to tax avoidance under section BG 1 of the Income Tax Act 1994 and made an adjustment and issued shortfall penalties. The assessments made by the Commissioner are the subject of challenge in these proceedings.

The Commissioner was concerned about the likely impecuniosity of the taxpayer as DT UK had filed nil returns for the 2005 and 2006 income tax years, except for claiming a loss of $389-odd million. Further it did not file tax returns for the March 2007, March 2008 and March 2009 income years and it is not presently trading. DT UK had already properly conceded the point that it would be unable to pay the Commissioner's costs if it was unsuccessful with its tax challenge. Notwithstanding that concession, DT UK opposed the Commissioner's application for security for costs and a stay on the grounds that it had a strong case and in the interest of justice.

Decision

The Court held that "there is no dispute that the threshold has been established … there is good reason to believe that the plaintiff is unable to pay the defendants costs if the plaintiff is unsuccessful in its challenge".

The plaintiff had conceded the point in his affidavit "… that due to its financial position it is unable to pay costs if it is unsuccessful in this proceedings".

The Court, looking at the merits of the case, noted at paragraphs [21] and [31] that in considering the issues

of the substantive proceedings, the Commissioner had a "stronger" and a "better hand". However, the Court also noted that even though the plaintiff's case was weak, it was not frivolous or vexatious and the plaintiff did have an arguable case.

The Court referred to the Court of Appeal case of *McLachlin v MEL Network Ltd* (2002) 16 PRNZ 747 and *Reefdale* as part of the balancing exercise for the use of its discretion and held applying the usual principals that "… there is no reason why the Commissioner should be subject to this proceeding continuing without being protected as to costs".

General observations were also made in regards to section BG 1:

a. At present, the tide is running strongly in favour of the Commissioner of Inland Revenue in tax avoidance litigation. The tax team in the Crown Law Office has had such success in its tax avoidance cases as to have a significant effect on the Government's financial position.

The Court held that appropriate security would be $90,000 payable in two tranches. The proceedings are stayed pending payment of security by the plaintiff.

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as the Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

GET YOUR TIB SOONER ON THE INTERNET

This *Tax Information Bulletin* (*TIB*) is also available on the internet in PDF at **www.ird.govt.nz**

The *TIB* index is also available online at **www.ird.govt.nz/aboutir/newsletters/tib/** (scroll down to the bottom of the page). The website has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you would prefer to get the *TIB* from our website, please email us at **tibdatabase@ird.govt.nz** and we will take you off our mailing list.

You can also email us to advise a change of address or to request a paper copy of the *TIB*.