**DavidCo Limited**
**CHARTERED ACCOUNTANTS**

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

**WEEKLY COMMENT: FRIDAY 8 AUGUST 2014**

1. This week I continue looking at the tax deductibility of company administration costs by looking at the remaining types of expenses covered in IS 14/04 *Income tax: Deductibility of company administration costs* released by Inland Revenue on 22 July 2014. I also take the opportunity to review some of the principles of tax deductibility and apportionment discussed in the introductory section to IS 14/04.

**Principles of deductibility**

2. Section DA 1 of the *Income Tax Act 2007* is called the **general permission** under which a person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss (subject to the anti-avoidance rule in s. GB 33), **to the extent to which** the expenditure or loss is:

   (a) Incurred by the person in deriving the person's:

      (i) Assessable income; or

      (ii) Excluded income; or

      (iii) Combined assessable income and excluded income; or

   (b) Incurred by the person in the course of carrying on a business for the purpose of deriving the person's:

      (i) Assessable income; or

      (ii) Excluded income; or

      (iii) Combined assessable income and excluded income.

3. The following principles of deductibility drawn from case law are referred to in IS 14/04:

   (a) For expenditure to be deductible there must be a sufficient relationship between the expenditure and the taxpayer's income-earning process. It is a question of fact and degree in each case: *CIR v Banks* [1978] 2 NZLR 472 (CA); *Buckley & Young Ltd v CIR* [1978] NZCA 22, (1978) 3 NZTC 61,271.

   (b) Determining whether the necessary relationship exists requires considering the true character of the expenditure and its relevance to the taxpayer's income-earning process. This includes considering the scope of the taxpayer's income-earning process and the factual situation at the time the expenditure was incurred: *Banks; Buckley & Young*.

   (c) For expenditure to be deductible a particular item of expenditure need not be linked with a particular item of income. Also, income need not have been produced in the year of

expenditure: *Commissioner of Taxation (NSW) v Ash* [1938] HCA 68, (1938) 5 ATD 76 (HCA) at 78*; Eggers v CIR* (1988) 10 NZTC 5,153 (CA).

(d) Paragraph (b) of s DA 1(1) applies only to taxpayers who are carrying on a business. In contrast to s DA 1(1)(a), under s DA 1(1)(b) expenditure need not be directly related to the derivation of income but is deductible when incurred in carrying on a business for the purpose of deriving income. This permits a broader approach:

(i) To be expenditure incurred in carrying on a business, the expenditure must be incurred as part of the taxpayer's business operations to obtain assessable income: *FCT v Wells* 71 ATC 4,188 (HCA); *John Fairfax and Sons Pty Ltd v FCT* [1959] HCA 4.

(ii) Whether expenditure has a sufficient relationship to the taxpayer's business operations is usually determined from objective matters. However, subjective matters may be relevant where the expenditure was incurred by choice and the relationship between the expenditure and the business operations is more indirect and remote: *Banks* at 477; *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4,542 (FCAFC) at 4,548, 4,558–4,559; *Fletcher v FCT* 91 ATC 4,950 (HCA) at 4,957; *Putnin v FCT* 91 ATC 4,097 (FCAFC); *Schokker v FCT* 99 ATC 4,504 (FCAFC).

(iii) Longer-term objectives can be considered. A deduction is permitted for expenditure incurred to protect or advance a business or to avoid or reduce expenditures: *Europa Oil (NZ) Ltd (No 2) v CIR* (1974) 1 NZTC 61,169 (CA) at 61,196–61,197; *Cox v CIR* (1992) 14 NZTC 9,164 (HC) at 9,168.

4. The general permission in s. DA 1 must be read subject to the **general limitations** in s. DA 2. The particular limitation that are stated to be of relevance to the deductibility of company administration costs and discussed in IS 14/04 is the **capital limitation** in s. DA 2(1) under which a person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature.

5. Based on the governing approach set out in *BP Australia Ltd v FCT* [1965] UKPC 23, [1965] 3 All ER 209 (PC) and recently endorsed by the New Zealand High Court in *Trustpower Ltd v CIR* [2013] NZHC 2,970 (I discussed the *Trustpower* case on feasibility studies in *Weekly Comment* 21 March 2014), seven tests (which could overlap) have been identified to assist in determining whether expenditure is capital or revenue in nature:

(a) The **need or occasion** that calls for the expenditure (which can form the basis for applying other tests): *Birkdale Service Station Ltd v CIR* [2000] NZCA 325, (2000) 19 NZTC 15,981 (CA); *Commissioners of Inland Revenue v Carron Company* (1968) 45 TC 18 (HL).

(b) Whether the expenditure is **recurrent** in nature (suggesting a revenue outlay) or a once and for all payment (suggesting a capital outlay): *Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes)* (1910) 5 TC 529; *BP Australia*; *Sun Newspapers Ltd v FCT* [1938] HCA 73, (1938) 61 CLR 337.

(c) Whether the expenditure is sourced from **fixed capital** (which suggests a capital expense) **or circulating capital** (which comes back as part of the trading operations): *BP Australia*; *John Smith & Son v Moore (Inspector of Taxes)* [1921] 2 AC 13 (HL); *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 (HC); *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834 (HC).

(d) Whether the expenditure creates an **identifiable asset.** Where an asset of a capital nature has been acquired or where money is spent on improving the asset, making it

more advantageous or getting rid of a disadvantageous asset, the expenditure will be on capital account: *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 (HL); *CIR v McKenzies* (1988) 10 NZTC 5,223 (CA).

(e) Whether the expenditure is a once and for all payment producing assets or advantages that are of an **enduring benefit**: *British Insulated and Helsby Cables Ltd v Atherton* [1925] All ER Rep 623 (HL) at 629; *Anglo-Persian Oil Co Ltd v Dale* (1931) 16 TC 253 (KB) at 262; *McKenzies.*

(f) How the expenditure is treated under **ordinary principles of commercial accounting**: *FCT v James Flood Pty Ltd* [1953] HCA 65, (1953) 88 CLR 492; *Broken Hill Theatres Pty Ltd v FCT* [1952] HCA 75, (1952) 85 CLR 423.

(g) Whether the expenditure is on the **business structure** or **business process** (regular expenditure on the process by which regular returns are obtained): *Buckley & Young* at 61,274*; Sun Newspapers*; *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HC).

**Apportionment**

6. The phrase "to the extent to which" in s. DA 1 contemplates apportionment. Apportionment can be distinguished from dissection: *Ronpibon Tin NL v FCT* [1949] HCA 15, (1949) 78 CLR 47. Dissection would be possible for a composite amount that relates to, say, an itemised invoice, or to several things or services with discrete parts. However, the court noted in *Ronpibon Tin* that entire sums, that could serve two or more objects, such as directors' fees, are not normally able to be dissected so are subject to apportionment.

7. There are circumstances where dissection or apportionment would not apply: this is where a predominantly deductible payment secures two advantages, and the non-deductible advantage is merely ancillary to the deductible advantage and does not affect the true character of the payment: *Buckley & Young*. This was exemplified in Christchurch Press Company Ltd v CIR (1993) where wages of employees who were engaged in installing a capital asset did not cease to be capital expenditure, even though there may have been a secondary revenue-related reason for the expenditure of improving the production of the newspaper.

8. In *Buckley & Young,* Richardson J commented that the appropriate basis for apportionment of expenditure will depend on the circumstances.

**Accounting fees associated with company administration costs**

9. The Commissioner's view is that accounting fees do not of themselves create a category of deductible expenditure. The correct tax treatment of accounting fees depends on whether the underlying transaction or issue requiring the fees to be incurred is of a capital or revenue nature. Examples provided are:

(a) *Case Y17* [2007] NZTRA 17, (2008) 23 NZTC 13,171 (which concerned the timing of the deduction for accounting fees) and Determination E12 (which provides an exemption from the unexpired expenditure timing rule for "mandatory accounting costs" incurred for the purpose of meeting statutorily imposed information requirements) imply that accountancy fees incurred for the preparation of annual financial accounts and tax returns by a company operating a business are deductible; however

(b) In *Case K50* (1988) 10 NZTC 411 accounting costs incurred by the taxpayer to investigate whether to purchase a veterinary practice were found to be capital costs and not

deductible, and in Australian *Case E29* 73 ATC 241 accounting fees incurred by a company incorporated for an enterprise that was eventually not established.

**Legal fees associated with company administration costs**

10. Like accounting fees, the Commissioner's view is that the correct tax treatment of legal fees associated with a company's administration costs will depend on the purpose for which such services have been employed. As noted by Dixon J in *Hallstroms*, legal fees take the quality of an outgoing of a capital nature or an outgoing on account of revenue from the cause or the purpose of incurring the expenditure.

11. However, s. DB 62 allows a deduction for some legal fees up to the amount of $10,000. Legal fees are defined for the purpose of s. DB 62 as fees for legal services provided by a person who holds a practising certificate issued by the New Zealand Law Society or an Australian equivalent. If the $10,000 limit is exceeded, the legal fees must be treated in the normal way.

**Audit fees**

12. Audit fees are generally deductible because the function of an audit is to disclose the company's business to its shareholders or financiers and, therefore, expenditure on an audit has the necessary relationship with the business carried on by the company. Even if the company has the option not to appoint an auditor but chooses to do so, the appointment will generally be dictated by business ends. English and Canadian cases are cited as authority supporting the deductibility of audit fees:
    (a) The discussion in the UK decision in *Caparo Industries plc v Dickman* [1990] UKHL 2, [1990] 1 All ER 568 (HL) suggests there is a relationship between the auditing of a company's accounts and the company's business because it would not be possible for a company to make appropriate decisions as to the use of its funds if its accounts were not accurate.
    (b) The Canadian cases *British Columbia Power Corporation v MNR* 67 DTC 5,258 (SCC) and *Boulangerie St-Augustin Inc v The Queen* 95 DTC 164 (TaxCC) establish that a company's expenses in communicating with its shareholders can be considered a necessary part of carrying on business through a company and that those communications can be part of the process of earning business income. The Commissioner considers that one aspect of communicating with shareholders will be ensuring the accuracy of the information via the audit process.

**Share registry expenses**

13. Consistent with the above discussion on audit fees, the Commissioner considers that share registry expenses are another aspect of communicating with shareholders, due to the need to establish the identity and contact information of the company's shareholders. The share register identifies who the shareholders are and facilitates the company's ability to communicate with them.

14. The Supreme Court of Canada in *British Columbia Power* did not refer to another Canadian case *Distillers Corporation Seagrams Ltd v MNR* 58 DTC 1,168 in which the Exchequer Court held that expenditure on services of transfer agents and registrars of a company's shares was incurred in connection with the administration of the capital structure of the company and was not deductible. In *Boulangerie* (TaxCC), the court considered that *Distillers* had been implicitly reversed by the Supreme Court in *British Columbia Power*.

15. In the Commissioner's view the Canadian decisions in *British Columbia Power* (SCC) and *Boulangerie* (TaxCC) and (FCA) are consistent with the New Zealand test of deductibility. Moreover, *Carron Company* and other cases suggest that:
    (a) The fact that expenditure relates to dealings with a company's shareholders does not necessarily mean that the expenditure is not deductible; and
    (b) The cost of meeting obligations relating to a company's capital structure is not necessarily capital expenditure.

16. The New Zealand courts have not considered the issue of whether share registry costs have the necessary relationship with a company's business operations. The Commissioner notes that such expenditure is required whether or not a company is in business. In the Commissioner's stated view the New Zealand courts "are likely to take an approach that reflects the commercial realities of the relationship between a company and the business it carries on. Such an approach would be consistent with the findings of Richardson J in *Banks*". In the Commissioner's opinion, sufficient support exists for the view that, once a company is chosen as the entity through which a business activity is to be carried on, generally the administrative costs of maintaining the company will meet the general permission.

**Statutory return fees**

17. The expenditure discussed under this heading is the cost of filing certain information with the Companies Office as part of the disclosure requirements in the *Companies Act 1993*. This includes: Notice of change of registered office, Notice of change of address for service and the Annual return.

18. Complying with these requirements is an administrative matter to ensure that there is accountability for persons carrying on business through a company. Such expenditure is required to be met by all companies, regardless of whether the company is carrying on business. To that extent, it may be argued that such expenses are not dictated by the business ends.

19. The Commissioner states that where a company is not carrying on a business, it would not be possible to establish a relationship between the statutory filing fees and any business. However, where a company is carrying on a business, it is likely that a court would hold that expenditure incurred by a company in complying with statutory obligations relating to the administration of the company is deductible, being expenditure that is analogous to maintenance expenditure. In the Commissioner's view, the commercial necessity for the expenditure provides strong grounds for finding that expenditure on such filing fees should be regarded as having the required relationship to the business operations of a company.

**Summary Table in IS 14/04**

20. IS 14/04 contains a useful Table on page 6 summarising the deductibility of company administration costs.

Arun David, Director

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