Interpretation Statement IS 09/01

FINES AND PENALTIES – INCOME TAX DEDUCTIBILITY

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

APPLICATION

1. This statement applies to fines and penalties imposed on a person under a statute or regulation.
2. This statement does not apply to:
    - fines and penalties imposed under a contract or as the result of a dispute between two commercial parties;
    - penalties for the late payment of an amount where the underlying amount payable is not payable as the result of a breach of statute or regulation; or
    - legal fees incurred in defending a fine or penalty.
3. Whether fines and penalties outside the scope of this statement are deductible will depend on the particular circumstances of the taxpayer and the nature of the fine or penalty. Where there is doubt as to the deductibility of such a fine or penalty, it may be necessary to obtain advice from a tax advisor.

OVERVIEW

4. In several decided cases, a deduction for fines and penalties has been denied — either for failing the statutory nexus test or on public policy grounds. This statement examines the leading cases on fines and penalties with a view to determining the correct test or tests that apply in a New Zealand context. In many situations it will be clear that the breach of law (and associated fine or penalty) is too remote from the income-earning process. However, the statement concludes that irrespective of whether the statutory nexus is met, fines and penalties are not deductible in New Zealand because of the application of public policy considerations.
5. Fines and penalties are not deductible in New Zealand irrespective of whether the:
    - infringement for which the fine or penalty is imposed forms part of criminal proceedings;
    - fine is imposed by the court or another body;
    - fine is imposed on the taxpayer, its employees, or a third party;
    - taxpayer intended to break the law; or
    - fine is imposed in respect of a strict liability offence.
6. The item *Deductibility of fines and levies paid by hotel licensees*, *Tax Information*

Bulletin Vol 6, No 13 (May 1995) sets out the Commissioner's view on the deductibility of certain expenditure incurred by hotel licensees. The discussion in the item that relates to the deductibility of fines paid by licensees does not reflect the law as it stands, so, to that extent, the item has been withdrawn effective from 15 October 2009 and taxpayers taking a taxpayer's tax position after that date should not rely on the May 1995 item. However, where a taxpayer has previously taken a tax position in reliance on the statement, the Commissioner will not be devoting staff time and resources to investigating and reassessing in such cases.

CHARACTER OF FINE OR PENALTY

7. This statement reviews the deductibility of payments that are in the nature of fines and penalties. When referring to fines or penalties, this statement is referring to forms of financial punishment imposed for carrying out some kind of prohibited activity and generally payable to the state or a representative of the public. The statement starts by reviewing the character or identifying features of fines and penalties. The relevant tests for deductibility are then applied with these characteristics in mind. The *Oxford English Dictionary* (11th ed, 2006) provides the following definitions:

> **Fine:** A certain sum of money imposed as the penalty for an offence ... A penalty of any kind ...
>
> **Penalty:** A punishment imposed for breach of law, rule, or contract; a loss or disadvantage of some kind, prescribed by law for an offence, or agreed upon by the parties concerned in the case of breach of contract; *esp.* the payment of a sum of money imposed in such a case, or the sum of money itself; a fine.

STATUTORY TEST OF DEDUCTIBILITY

8. Section DA 1(1) is the general deductibility provision. It provides:

> 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 –
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> (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.

9. In short, under section DA 1(1) an amount is an allowable deduction if a sufficient relationship is established between the expenditure or loss incurred and the derivation of income: *CIR* v *Banks* (1978) 3 NZTC 61,236, 61,240; *Buckley*

and Young v *CIR* (1978) 3 NZTC 61,271, 61,274.

10. However, in several decisions the courts have denied a deduction for fines and penalties, even in situations where it would appear that the required relationship has been established.

DEDUCTIBILITY OF FINES AND PENALTIES

United Kingdom

11. *IRC v Alexander von Glehn and Co Ltd* (1919) 12 TC 233 is a leading case on fines and penalties. It followed the principles in the earlier English case of *Strong v Woodifield (Surveyor of Taxes)* 5 TC 215 (which it acknowledged was in a different context) and was also consistent with the decision in *IRC v Warnes* [1919] KB 444. *Alexander von Glehn* involved a company that carried on an exporting business and was fined £3,000 for exporting goods to Russia without taking appropriate precautions to ensure their ultimate destination was not enemy territory. The company's claim to deduct that sum was rejected by the English Court of Appeal. In reaching its decision, the Court of Appeal considered that, because the fine was imposed on the company for breaking the law, the expense could not be connected with or arising out of the company's trade.

12. In *Mann v Nash* (1932) 16 TC 523, 529, Rowlatt J, referred to *Alexander von Glehn*, and observed that:

> the decision in the case was that payment of those penalties was nothing to do with the trade or business; it was not an expense for the earning of the profits, but it was an expense in the form of an inconvenience which supervened later when the profits were made, because illegality had been committed in the course of earning them.

13. The early United Kingdom decisions suggest that a deduction is denied on the basis that the required statutory connection or nexus between the fine or penalty and trading is absent.

14. More recently, the House of Lords in *McKnight (Her Majesty's Inspector of Taxes) v Sheppard* [1999] 3 All ER 491 discussed *Alexander von Glehn*. Lord Hoffmann had no doubt that *Alexander von Glehn* was correct. However, he observed (at p 485) that "the Court of Appeal was curiously inarticulate about why the fine was not money expended for the purposes of the trade". His Lordship considered (at p 496) that the reason a fine is not deductible is not found in "the broad general principle of what counts as an allowable deduction". Lord Hoffmann considered that the reason relates to the particular character of a fine or penalty. On this point, he said (at p 486):

> [A fine or penalty's] purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden of the rest of the community by deduction for the purposes of tax. This, I think, is what Lord Sterndale MR meant when he said that the fine was imposed 'upon the company personally'.

15. This reasoning as to why a deduction for a fine or penalty is denied is commonly

referred to as the “public policy” reasons.

Australia

16. The Australian courts have approached this matter in a similar way. *Herald & Weekly Times Ltd v FCT* (1932) 2 ATD 169 is a case dealing with the deductibility of damages for libel. The High Court held that the damages in that case were deductible. However, in the course of its judgment the High Court referred to the deductibility of fines and penalties. Gavan Duffy CJ and Dixon J said in their joint judgment (at p 172):

> The penalty is imposed as a punishment on the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character as a trader.

17. Under this view, a fine or penalty is not incurred by an offender acting in the capacity of a trader because it fails to satisfy the requisite statutory connection as a relevant outgoing incurred in deriving assessable income.

18. *Magna Alloys and Research Pty Ltd v FCT* 80 ATC 4,542 considered whether the taxpayer was able to deduct legal costs in the defence of criminal proceedings. The court found that the payments were deductible. In the course of their judgment, Deane and Fisher JJ expressed unease as to the reasons given for denying deductibility in earlier cases on the deductibility of fines and penalties. Deane and Fisher JJ preferred to base the denial on public policy considerations. They said (at p 4,563):

> It is somewhat difficult to understand how it can be maintained, as an unqualified proposition, that the nature of a penalty severs it from the expenses of trading. Recurrent penalties for parking infringements incurred by a delivery man and per diem penalties for unlawfully using premises for business or commercial purposes in contravention of zoning requirements are not, for example, logically severed from the expenses of trading. The same can be said of fines imposed for actually engaging in some unlawful activities, such as illegal bookmaking or soliciting, the purposes of earning assessable income. If, when the matter directly arises for decision in the Australian courts, it is to be held that all fines and penalties are to be denied deductibility under the Act, **it would seem preferable that it be on the basis of some perceived overriding consideration of public policy which precludes deductibility**. Even in that event however, it would not necessarily follow that, as a matter of overriding principle, a deduction should be refused in respect of a taxpayer’s costs of defending the proceedings in which the penalty was imposed upon him.
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> [Emphasis added]

19. In *Mayne Nickless Ltd v FCT* (1984) 15 ATR 752 (Supreme Court of Victoria), the taxpayer, a transport operator who ran armoured cars, had incurred a multitude of fines and penalties related to a variety of motoring offences. Ormiston J examined all the relevant authorities and concluded that none of the outgoings was deductible.

20. In relation to the fines imposed directly on the company and paid by it, Ormiston

J followed earlier High Court decisions and found that the payments were not deductible. Ormiston J also held amounts paid by the company for fines and penalties imposed on employees, independent contractors, or persons other than the taxpayer should be precluded on the grounds of public policy (at p 772):

> The critical feature of the fines and penalties are that they are imposed for purposes of the law in order to punish breaches thereof and that makes it undesirable that they should be deductible, whether for serious or minor regulatory offences and **whether they are imposed directly on the taxpayer or on its employees or third party contractors**. In the latter case the policy of the law ought not to differ whether or not the money was originally paid by, **or the original liability fell on, persons other than the taxpayer**.
>
> [Emphasis added]

21. In discussing public policy, Ormiston J continued (at p 772):

> Many aspects of public policy have been and remain controversial largely because the courts have attempted to express and apply policies which did not derive directly from the common law or statute, but were derived from what were said to be accepted social or economic beliefs at the time. These beliefs have not always remained constant, so that difficulties arise in determining whether 'public policy' can change or expand.

22. *Madad Pty Ltd v FCT* [1984] 15 ATR 1,118 was the first time this issue had come directly before the full Federal Court. *Madad* concerned the deductibility of a penalty imposed on the taxpayer under the Trade Practices Act 1974. The court considered that the penalty was not deductible (at p 1,124):

> We are of the view that the deductions claimed should not be allowed. We placed this decision on the basis of the acceptance in *Snowden and Willson* [99 CLR 431]... of what was said in the cases we have referred to. The acceptance in the High Court, albeit by way of dicta, of the earlier dicta in England and in *Herald and Weekly Times* [(1932) 2 ATD 169] ... indicates in our view an approach to the construction of s 51(1) which we should follow.
>
> The approach may well have its origins in public policy. In any event, it has been of long standing, and having in mind the application it must have had over many years, we should not disturb it, for reasons similar to those stated by Dixon CJ in *Lunney's* case [100 CLR 478].

Canada

23. The Canadian courts initially denied deductions for fines or penalties on the basis of overriding public policy considerations. For example, in *King Grain and Seed Co Ltd v Minister of National Revenue* (1961) 26 Tax ABC 436, the taxpayer operated a fleet of trucks and sought to deduct a highway fine levied against it for overloading one of its trucks. The Tax Appeal Board disallowed the claim, stating (at p 439):

> [It] would be contrary to accepted principles if the present appellant, King Grain and Seed Company, was allowed to deduct the amount of this fine … and thus be enabled to share with the public revenue the loss which it was condemned by reason of its own negligence.

24. Over time, however, the Canadian courts have modified their approach. *Day & Ross Ltd v The Queen* [1976] CTC 707 was a trucking case in which the taxpayer

had incurred fines in excess of $70,000 over several years for the violation of various highway weight restrictions. The Federal Court held that the fines were deductible. This was followed in the Canadian Federal Court of Appeal in *Amway of Canada v The Queen* [1996] 2 CTC 162. In *Amway*, the Federal Court of Appeal recognised that:

> [t]here emerges in the jurisprudence and the literature a recognition of two possible criteria for deciding whether amounts expended for the payment of fines or penalties should be deductible as a business expense. The first test is whether it was an expense incurred for the purpose of earning income. ...
>
> The second criterion sometimes invoked is that of public policy: that is, even if the expense was incurred to produce income would it be contrary to public policy to allow a taxpayer to reduce his net income, and thus save taxes, by virtue of having been obliged to pay a fine or penalty for some wrongdoing?

25. The court in *Amway* discussed *Alexander von Glehn* and continued (at p 171):

> An observation made by Lord Sterndale, M.R. is of interest given the later developments in Canadian jurisprudence. He stated:
>
> > Now what is the position here? This business could perfectly well be carried on without any infraction of the law at all. This penalty was imposed because of an infraction of the law and that does not seem to me to be, any more than the expense which had to be paid in the case of *Strong v. Woodifield* [(1906) 5 T.C. 215] appeared to Lord Davey to be, a disbursement or expense which was laid out or expended for the purpose of such trade, manufacture, adventure or concern; nor does it seem to me, though this is rather more questionable, to be a sum paid on account of a loss connected with or arising out of such trade, manufacture, adventure or concern.
>
> This concept of avoidability of a penalty, as a test of whether its payment amounts to a business expense, has been developed, I believe correctly, in decisions of the Federal Court Trial Division.

26. The court in *Amway* continued (at p 172):

> With respect to the first criterion I believe that one legitimate test of whether fines should be deductible as a business expense is that of avoidability of the offences... In adopting this test of avoidability of the offences leading to fines, and thus the avoidability of this particular type of expense, I do not purport to pronounce a more general rule concerning the deductibility of other types of expense. The question here is not: could the taxpayer have run his business more cheaply? It is: could the taxpayer have reasonably been expected to run his business in consistent conformity to this kind of law?
>
> ...
>
> Secondly, in my view it is contrary to public policy to allow the deduction of a fine or penalty as a business expense where that fine or penalty is imposed by law for the purpose of punishing and deterring those who through intention or a lack of reasonable care violate the laws. In a case such as the present the penalties are fixed by statute (albeit that the Minister first remitted about one third of the penalty and ultimately settled for less than one third of the total penalty owing under statute). It would frustrate the purposes of the penalties imposed by Parliament if after paying those penalties exigible by law a taxpayer were then able to share the cost of that penalty — and the higher his marginal rate of taxation the more he could share — with other taxpayers of Canada by treating it as a deductible expense and thus reducing his taxable

> income. Such a result would, I believe, clearly be contrary to public policy. Suggestions that instead a court imposing a penalty can augment it in anticipation of the accused being able to deduct the fine from his taxable income are not applicable to a situation such as this where the penalties are specifically defined by statute. Nor do I believe that sentencing courts should be required to anticipate the value of an income tax deduction to a penalized party. For this reason I think that the deductibility of penalties set by courts exercising their discretion should be subject to the same rules as I have elaborated above in respect of a penalty set by statute.

27. Under this approach, for a fine or penalty to be deductible, the taxpayer needs to satisfy two requirements. First, the fine or penalty must have been incurred for the purpose of producing income, and this condition is satisfied only where the incurring of the fine or penalty is considered to be an unavoidable incident of carrying on the business. In other words, could the taxpayer have been reasonably expected to run a business in consistent conformity to this kind of law? The focus is on whether the taxpayer could reasonably be expected to avoid breaking the law.

28. The second requirement requires an examination of the public policy concerns behind the particular fine or penalty. In the view of the Federal Court of Appeal in *Amway* (at p 173):

> it is contrary to public policy to allow the deduction of a fine or penalty as a business expense where that fine or penalty is imposed by law for the purpose of punishing and deterring those who through intention or a lack of reasonable care violate the laws.

29. Canada has since introduced legislation to prohibit the deductibility of fines and penalties.

New Zealand

30. Several cases in New Zealand have considered the deductibility of fines and penalties.

31. *Robinson v CIR* [1965] NZLR 246 considered whether fines imposed on the taxpayer by the New Zealand Law Society constituted a "loss exclusively incurred in the production of assessable income". Tompkins J considered whether the fines were similar to a penalty inflicted by a court for a breach of the law, which would preclude the deduction, or whether the fines were so different in character that they did not come within the prohibition. Tompkins J said (at p 250):

> **In my opinion there is no distinction in principle between a claim to be entitled to deduct from assessable income a fine imposed by the Disciplinary Committee and a fine imposed by a Court**. It seems to me that all the passages quoted from the cases of *Commissioners of Inland Revenue v Warnes, Commissioners of Inland Revenue v Von Glehn, and Herald and Weekly Times Ltd v Federal Commissioner of Taxation* ... apply in principle to such a fine. It is inflicted on the offender as a penal liability; it is a fine imposed on the offender for professional misconduct; it is inflicted on the offender as a personal deterrent and a punishment.
>
> ... a payment of damages for professional negligence is a loss which is in truth exclusively incurred as part of the operations reasonably incidental to the

> production of income because it is a loss arising directly out of and in the course of the practice of the profession; the risk of overlooking a time limit due to pressure of work or other negligent acts is one which must be necessarily incidental to the practice. **But the fine imposed for the negligent act is quite different from the payment of damages suffered by a client by reason thereof. It is a personal penalty imposed as a personal deterrent and punishment and not a loss incurred in the legal business**. It has no relation to what would be called a trading loss in an ordinary business. Whether it is a capital loss I am not called upon to decide. But I am clear that it is a loss which comes within s 110 of the Land and Income Tax Act 1954 and is not deductible.
>
> ... Here it seems to me that the fines totalling £500 are certainly a loss in the sense that the appellant has had to pay the fine. They are, of course, incurred during the time that the income was being produced. It is noteworthy, however, that the fines were partly imposed because the appellant failed to answer letters from the Law Society relating to the complaint and that can have little to do with the production of income. But is it fairly incidental to the carrying of the appellant's profession that he should be guilty of professional misconduct so as to render him liable to fines? I think not. **They are a punishment imposed on him personally rather than a loss suffered in the practice of his profession**.
>
> [Emphasis added]

32. The taxpayer in *Case F126* (1984) 6 NZTC 60,174 was sentenced to imprisonment and fined in relation to dealing in illicit drugs. The Taxation Review Authority considered (at p 60,172) that this case did not seem to be "an appropriate one to endeavour to distinguish it from the principles laid down in *Robinson's* case".

33. However, the Taxation Review Authority suggested (at p 60,177) that, in certain circumstances, a fine and penalty may be treated as:

> akin to an operating cost of [the taxpayer's] business, in the nature of fines for parking infringements or loading offences as a business expense [provided] a sufficient and an appropriate relationship [can be found] between the gaining or producing of assessable income and the expenditure for the fine.

34. *Case K62* (1988) 10 NZTC 504 concerned a claim by a self-employed taxpayer for a deduction for the payment of three traffic fines. The Taxation Review Authority agreed with the Commissioner's submission that the classical position regarding the deductibility of fines and penalties is that no deduction is available for any penalty or fine paid for a breach of law. However, during the course of its determination, the Taxation Review Authority observed that (at p 506):

> it is conceivable that traffic fines could, in special circumstances, be deductible business expenditure even under New Zealand law. For instance, if a mail courier company is required by an important customer to urgently deliver a package to a downtown city office, it may reasonably be only able to carry out the instructions by double parking and (possibly) incurring a traffic infringement notice. In that situation, the traffic fine might well be deductible under sec 104 of the Income Tax Act 1976.

35. The taxpayer in *Case* L15 (1989) 11 NZTC 1,113 was involved in an accident while driving home. He was subsequently convicted and fined and disqualified

from holding a driver's licence for 12 months. The taxpayer claimed a deduction for the legal fees incurred in defending the prosecutions, the court fine and costs, and the repair costs of both cars.

36. The Taxation Review Authority referred to *Case K62* where it said that a deduction might be available in special circumstances. However, in this case no deduction was allowed because (at p 1,116):

> the objector had incurred the fine and Court costs because of criminal conduct. That activity was not conducted in the course of any income earning process. That expenditure was of a private character and could not be deductible. Such connection as there may be between the fine (and Court costs) and the income producing activity or process of the objector as a real estate agent is insufficient for tax deductibility. In any event, under my interpretation of New Zealand law, expenses resulting from a breach of the law are generally not deductible.

37. In *Nicholas Nathan Ltd* v *CIR* (1989) 11 NZTC 6,213, a deduction was disallowed for fines imposed under the Trade and Industry Act 1956 as a result of a company importing goods in excess of its licence. In dealing with the general issue of the deductibility of fines Sinclair J said (at p 6,217):

> When one analyses the problem in light of the various decided cases, ..., any severance based on illegality is somewhat artificial and **it is preferable to rely upon public policy considerations which, in reality, form the basis of the earlier decisions**.
>
> [Emphasis added]

38. His Honour continued (at p 6,218):

> From an overall appreciation of all the decisions, I am of the view that where a fine or penalty is imposed by the Courts resulting from a breach of the law, no deduction ought to be allowed for to do so would be to prefer business lawbreakers over individuals as the business lawbreaker would obtain the benefit of deductibility of the amount of the fine or penalty whereas the individual would have to bear that particular expense personally. Additionally it would tend to allow, and encourage, lawbreaking and in some instances, to even treat it as a legitimate business option resulting in deductibility.

39. The most recent case to consider the deductibility of fines is *Case Z6* (2009) 24 NZTC 14,068. *Case Z6* involved the deductibility of fines imposed on a transport company for alleged overloading of its trucks. Barber DJ considered previous case law from New Zealand, Australia, the United Kingdom, and Canada and concluded the fines were not deductible. The conclusion was based on there being insufficient nexus and also public policy reasons:

> [109] However, it seems to me that a business should operate within the law. The disputant's business of carting logs on large trucks and trailers is able to comply with the law, but there is expense involved in weight-of-load compliance and such non-compliance can involve a relatively modest amount of annual fines. It seems to me to be illogical to seek to deduct fines relating to a breach of the law as if they were a business expense, because they relate to activities which do not confirm to the law and so are not within the permitted scope of the business. **I consider that a penalty/fine arising from a taxpayer's illegal activities** (i.e. transporting too-

heavy a load) **cannot have a sufficient nexus with the taxpayer's income earning process so as to create deductibility for that cost of the fine**.

...

[111] In any case, **under the doctrine of precedent** I am bound, by the 1989 High Court decision of *Nicholas Nathan Ltd and Anor v CIR* where Sinclair J held that **deductibility of fines should not be allowed on the grounds of public policy**. It would be contrary to public policy to allow such fines paid by logging transport companies to be deducted from their revenue earnings. It makes no difference to my reasoning whether the objector company incurred the fines or whether its drivers incurred them but the objector paid them. The public policy approach readily leads to a denial of deductibility for fines; but the nexus approach is not so easy to apply.

[Emphasis added]

40. Barber DJ also distinguished (for deductibility purposes) illegal businesses from legal businesses that have fines imposed on them for breaches of the law:

> [110] I realise that there are activities which are illegal/criminal, e.g. drug dealing, types of gambling, dealing in stolen goods, and (until recently) prostitution, but which the IRD (in confidence) have treated as businesses and taxed after allowing appropriate deductions (but not for fines). At law, those activities seem to be businesses if there is a sufficient level of activity and the intention of profit. However, the present case is about the deductibility of fines imposed for breach of the law as distinct from assessibility of profits of a business activity which is illegal and allowable deductions when assessing that profit.

41. In the course of his judgment (and after considering relevant earlier case law), Barber DJ concluded that fines were not deductible irrespective of whether the:

- infringement for which the fine or penalty is imposed forms part of criminal proceedings;
- fine is imposed by the court or another body;
- fine is imposed on the taxpayer, its employees, or third party contractors;
- the taxpayer intended to break the law; and
- fine is imposed for a strict liability offence.

SUMMARY OF THE JUDICIAL APPROACHES TO THE NON-DEDUCTIBILITY OF FINES AND PENALTIES

42. From the above cases the following trends and principles can be extracted:

  a) The courts of New Zealand, Australia, and United Kingdom all deny a deduction for any payment in the nature of a fine or penalty.

  b) In reaching this conclusion, the two main strands of reasoning are that the payment fails to satisfy the requisite statutory deductibility test and overriding public policy considerations exist.

  c) In the early cases, the United Kingdom and Australian courts considered that, because a fine or penalty is imposed for breaking the law or to punish an offender, it necessarily followed that the payments made lack sufficient connection with the expenses of trading, so were non-deductible.

d) In certain circumstances it is conceivable that the incurring of the fine or penalty has a strong connection with the derivation of income. Dicta in some cases suggest that a deduction may be available if a sufficient and an appropriate relationship can be found between the gaining or producing of assessable income and the expenditure for the fine (see, eg, *Case F126* and *Case K62*).

e) More recent Australian, United Kingdom, and New Zealand cases now support the public policy approach (*McKnight v Sheppard*, *Madad*, *Nicholas Nathan*).

f) *Robinson* makes it clear that there can be no distinction in principle between a claim to be entitled to deduct a fine imposed by a disciplinary committee and one imposed by a court.

g) Case law also supports the view that fines and penalties paid on behalf of an employee or independent contractor are not deductible to the party paying the fine (*Mayne Nickless*, *Nicholas Nathan*, *Case Z6*). While the cases acknowledge that nexus may be satisfied where a taxpayer (for commercial reasons) voluntarily pays fines imposed on an employee or contractor, it has nonetheless been consistently held that public policy considerations prohibit deductions in such cases. It is also noted that additional income tax implications (such as PAYE) could arise where a taxpayer pays a fine on behalf of a third party.

h) The Commissioner's view is that the prohibition on deductibility also applies to taxpayers paying fines on behalf of other third parties, irrespective of the relationship between the person incurring the fine and the person paying it (such as an advisor paying a fine on behalf of a client). It could be argued that the payment of a fine in such circumstances is more akin to a payment of damages and deductibility should not be denied. However, it is considered that the situation is analogous to payments of fines incurred by employees and contractors and the public policy considerations set out above would be defeated if any person was allowed a deduction. Further, Ormiston J arguably contemplated the extension of the prohibition to other third parties, when he noted "[in] the latter case the policy of the law ought not to differ whether or not the money was originally paid by, or the original liability fell on, persons other than the taxpayer".

ROLE OF PUBLIC POLICY

43. Public policy is based on the premise that the law should serve the public interest. It assists judges in the concurrent development of the common law and statutory interpretation.

44. Public policy is never static: it evolves over time. This evolution is due to the constant change in the wide sphere of interest that constitutes the public

interest. For example, changes in society's economic needs, social costs, customs, and moral aspirations can affect the public interest. Although public policy may change in response to signals from any part of society at any time, changes usually occur incrementally.

45. This functional aspect separates public policy from rules of law. Public policy is a collection of principles that judges consider the law has a duty to uphold. This distinction is important because, although a rule of law binds, a principle merely guides. If an Act incorporates a rule, that rule is binding for the purposes of the Act. In contrast, as a principle is not binding, it leaves scope for more flexible application depending on the circumstances of a particular case. However, while there is flexibility in the application of judicial principles, it is expected that judges take heed of the principles in relevant cases.

Nature of public policy in the context of fines and penalties

46. The following statements are representative of judicial statements in relation to the public policy reasons why fines and penalties should not be deductible. Ormiston J in *Mayne Nickless* said (at p773):

> Fines and penalties are imposed for purposes of the law to punish breaches. This deterrent aspect makes it undesirable for a fine to be deductible. To allow such deductions is seen as frustrating the legislative intent, as the punishment imposed will be seen to be, diminished or lightened.

47. Sinclair J in *Nicholas Nathan* said (at p 6,218):

> From an overall appreciation of all the decisions, I am of the view that where a fine or penalty is imposed by the Courts resulting from a breach of the law, no deduction ought to be allowed for to do so would be to prefer business lawbreakers over individuals as the business lawbreaker would obtain the benefit of deductibility of the amount of the fine or penalty whereas the individual would have to bear that particular expense personally. Additionally it would tend to allow, and encourage, lawbreaking and in some instances, to even treat it as a legitimate business option resulting in deductibility.

48. In both *Mayne Nickless* and *Nicholas Nathan*, the courts considered that the public interest is not served by providing a corresponding tax saving to taxpayers for fines and penalties imposed on them for breaches of the law. In particular, it is considered that allowing deductibility would diminish the punitive nature of fines and penalties, treat business lawbreakers more favourably than non-business lawbreakers, and encourage lawbreaking as a legitimate business option.

Departures, in similar contexts, from the public policy approach

49. Public policy plays an important role in relation to the tax deductibility of fines and penalties. From the perspective of serving the public interest, the general aim of the public policy approach to fines and penalties is understandable. It is interesting to note that the approach to deny deductibility has not been adopted in cases involving illegality or damages. This is because the public policy focus is

not on the unlawful conduct but on the fine itself and the reason it was imposed. For example, the public policy approach is *not* invoked to deny deductibility in three areas: for expenses legally incurred by an illegal business, illegal expenses incurred by legal businesses, and damages for civil wrongs.

Expenses legally incurred by an illegal business

50. The Act does not discriminate between legal and illegal activities (*Ministry of Finance v Smith* [1927] AC193 and *Case Z6*). The connection between the expense and the income-earning activity is relevant, not the legality of the activity. In *Nicholas Nathan*, the Commissioner submitted that the legal expenses the taxpayer incurred should be disallowed because they were incurred by the taxpayer illegally importing goods rather than for carrying on its business. The court rejected this submission. However, the court considered that as the necessity for "legal advice", after the illegal acts, was commercially prudent and an exercise of damage control, the legal costs were connected with the income-earning process. Additionally, the court was in no doubt that if the taxpayer had taken legal advice before importing the goods, the cost would have been allowed as a deductible expense.

Illegal expenses incurred by legal businesses

51. A taxpayer carrying on a lawful business that incurs illegal expenses may deduct the cost of the illegal expenses, but not the fines levied because of the outlay. For example, no issue arose in *Magna Alloys* as to the deductibility of the illegal commissions paid to employees of its customers.

Damages for civil wrongs

52. Damages are a loss suffered because of an activity prohibited or punishable by the common law but, as held in *Herald and Weekly Times*, they may be deductible.

SUMMARY OF THE NEW ZEALAND APPROACH

53. In the Commissioner's view, no income tax deduction is available in New Zealand for any fine or penalty to which this statement applies (see paragraphs 1 and 2). Irrespective of whether the statutory nexus is met, fines and penalties are not deductible in New Zealand because of the application of public policy considerations. This is the case irrespective of whether the:

- infringement for which the fine or penalty is imposed forms part of criminal proceedings;
- fine is imposed by the court or another body;
- fine is imposed on the taxpayer, its employees, or a third party;
- taxpayer intended to break the law; or
- fine is imposed for a strict liability offence.