TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTOTANGA WHAKATAU Ā-TURE> WHAKAWĀ

Income tax: timing of deduction; deduction for schedular income expenses

Decision date | Te Rā o te Whakatau: 6 July 2022

Issue date | Te Rā Tuku: 2 November 2022

TDS 22/18

Subjects | Ngā kaupapa

Income tax: timing of deduction, allowable deduction for schedular income expenses.

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner or CIR	Commissioner of Inland Revenue
ITA	Income Tax Act 2007
TRA	Taxation Review Authority
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ngā ture tāke

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

Facts | Ngā meka

1. The Taxpayer is an individual. The Taxpayer operates a farm on their property.
2. The Taxpayer claimed self-employment losses from farming in their 2020 income tax return. During the course of this dispute, the parties agreed the income from farming should be returned in the 2021 tax year. The Taxpayer considered this meant their expenses and depreciation loss from farming should also be re-returned in the 2021 tax year. However, Customer & Compliance Services, Inland Revenue (**CCS**) argued that these should remain returned in the 2020 tax year.
3. As well as operating a farm, the Taxpayer worked as an independent contractor in a different city from which the Taxpayer resides (the other city). The Taxpayer travelled to, and rented accommodation in, the other city to perform this work. The Taxpayer was required to attend the offices of the organisation they worked for in the other city on a weekly basis. The Taxpayer also travelled between their home city and the other city weekly to attend to the farm during this period.

4. The Taxpayer claimed expenses against their schedular income in the 2020 tax year. These consisted of the cost of travel between the two cities and meals and accommodation in the other city. CSS argued these expenses were not deductible.

Issues | Ngā take

5. The main issues considered in this dispute were:

- whether a deduction for expenses and depreciation loss from farming was allowed to the Taxpayer in the 2020 tax year or the 2021 tax year; and
- whether the Taxpayer was allowed the following deductions for expenses against their schedular income:
  - the costs of return trips between the Taxpayer's home city and the other city;
  - the costs of meals in the other city; and
  - accommodation expenses in the other city.

Decisions | Ngā whakatau

6. The Tax Counsel Office (**TCO**) concluded that:

- the expenses and depreciation loss from farming is an allowable deduction to the Taxpayer in the 2020 tax year (and not the 2021 tax year); and
- the schedular income expenses at issue were not an allowable deduction to the Taxpayer.

Reasons for decisions | Ngā take mō ngā whakatau

Issue 1 | Take tuatahi: Timing of expenses and depreciation loss deductions

7. The Taxpayer claimed self-employment losses from farming in their income tax return for the 2020 tax year, but agreed, during the dispute that the income from farming should be returned in the 2021 tax year. However, the Taxpayer considered the expenses and depreciation loss from farming should also, as a result, be returned in their 2021 income tax return, because the income to which the expenditure is related is

income in the 2021 tax year, and income and related expenditure should be recognised together in the same period.

8. CCS argued that these expenses and the depreciation loss were incurred in the 2020 income year and should be deductible in the 2020 income tax return.

9. The statutory framework of the ITA for the recognition of income and expenses for tax purposes is clear. A global approach is required, under which income and allowable deductions are allocated to an income year under particular timing rules, rather than separate calculations of net income or loss for each source of income. While separate calculations for each source of income, or matching, might be required for financial accounting purposes, in the absence of explicit statutory direction it is not required for tax purposes.

10. A person's taxable income for a tax year is made up of the person's annual gross income and annual total deduction for the year, minus any available net loss.[1] Under s BC 3, a person's annual total deduction is the total of their deductions that are allocated to the corresponding income year.

11. Section DA 1 provides the general permission for allowable deductions, which relevantly provides that a person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent that the expenditure or loss is incurred by them in deriving their assessable income (the general permission).

12. Deductions are allocated to an income year under s BD 4. The general rule under s BD 4 is that a deduction for an amount of expenditure or loss is allocated to the income year in which the expenditure or loss is incurred. Section BD 4(3) requires regard to be had to case law for allocation of expenditure or loss to an income year, which requires some people to recognise expenditure or loss on an accrual basis and others on a cash basis, and more generally defines the concept of incurrence.

13. Case law provides that the appropriate and proper system will depend to some extent on the nature of the taxpayer. For a non-trading individual, the cash system of accounting is the most appropriate, where income is "derived" when payment is received. In the case of a trading entity, the accrual system of accounting is usually appropriate and proper method of accounting for tax purposes. In an accrual system, income may be "derived" when it is earnt, and expenditure may be "incurred" independently of payment of expenses. The relevant income and corresponding

[1] Sections BC 4 and BC 5.

expenditure are brought in or accrued in one year together, irrespective of actual receipt of money.[2]

14. In the leading case on when expenditure is "incurred", the Privy Council determined that for an outgoing to have been "incurred", the taxpayer must have either paid or become "definitively committed" to the expenditure.[3] The question is whether, "in light of all the surrounding circumstances, a legal obligation to make a payment in the future can be said to have accrued."[4]

15. TCO concluded that the expenses and depreciation loss at issue were deductible in the 2020 tax year (and not in the 2021 tax year) for these reasons:

- The Taxpayer should recognise their income and losses from farming, as a trading activity, on an accrual basis. Under an accrual system, the Taxpayer's farming income can be derived prior to receipt of payment and expenditure may be incurred independently of payment of expenses (and thereby income and expenditure incurred in earning that income are considered together).
- The Taxpayer's expenses from farming under dispute were invoiced during the 2020 income year, at which point the Taxpayer had a legal obligation and was definitively committed to pay the amounts invoiced. Therefore, these farming expenses were incurred by the Taxpayer in the 2020 income year and formed part of the Taxpayer's annual total deduction for the 2020 tax year under s BC 3.
- For the expenses that the Taxpayer did not provide invoices to support their deduction claim, the evidence showed these expenses have been paid by the Taxpayer during the 2020 income year. On this basis, these amounts would have been incurred by the Taxpayer during the 2020 income year at the latest, and therefore incurred in that year under s BD 4, and deductible to the Taxpayer in their 2020 tax year under s BC 3.
- In terms of the requirement that a "depreciation loss"[5] satisfies the general permission for deductibility (that is, the loss is incurred), s EE 1(4)(a) provides that an amount of depreciation loss is treated as being incurred in the income year for which it is calculated. On the basis that the amount of depreciation loss at

[2] *Case F156* (1984) 6 NZTC 60,343 (TRA) at 60,346. See also *Whitworth Park Coal Ltd (in Liq) v Commissioner of Inland Revenue* [1961] AC 31; 28 TC 531 (HL).

[3] *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351 (PC) at 12,353.

[4] At 12,355.

[5] "Depreciation loss" is defined in s YA 1 to mean "a loss that a person has in the circumstances set out in section EE 1(2)" and includes "a deduction for depreciation that a person was allowed under an earlier Act".

issue was a calculation for the 2020 income year, the amount was treated as being incurred in the 2020 income year. It therefore forms part of the Taxpayer's total annual deduction for the 2020 tax year under s BC 3.

Issue 2 | Take tuarua: Deduction for schedular income expenses

16. The issue is whether the Taxpayer is allowed a deduction for expenses against their schedular income derived from their work as an independent contractor, made up of travel, meal and accommodation costs.

17. The Taxpayer argued the amounts under dispute were deductible because they were required to be in the other city on a weekly basis to perform their contracting work, but during the same period, required to attend to their farm in their home city. The Taxpayer also argued their meal expenses claim was deductible because the amount claimed is less than the additional cost of their meals when travelling as compared to the cost of meals at home.

18. CCS considered the amount at issue was not deductible to the Taxpayer because the expenses had not been incurred in deriving assessable income and were of a private nature.

19. As mentioned in Issue 1, the general permission for allowable deductions is provided in s DA 1. To satisfy the general permission, the expenditure must have the necessary relationship with both the taxpayer concerned and the gaining or producing of the person's assessable income.[6] In the Australian case, *Federal Commissioner of Taxation v Payne*,[7] the Australian High Court held that this means the outgoing must be incurred "in the course of" gaining or producing the assessable income[8], but excludes outgoings, which although incurred *for the purpose of* deriving assessable income, are not incurred *in the course of* doing so.[9]

20. The general limitations contained in s DA 2 override the general permission. Section DA 2(2) provides for the private limitation, which states a person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature.

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[6] *Commissioner of Inland Revenue v Banks* (1978) 3 NZTC 61,236 (CA). See also *Buckley & Young Ltd v Commissioner of Inland Revenue* (1978) 3 NZTC 61,271; [1978] 2 NZLR 485 (CA).

[7] *Federal Commissioner of Taxation v Payne* 2001 ATC 4,027 (HCA).

[8] *Banks* at 61,241 to 61,242; *Payne* at [9] and [25].

[9] *Payne* at [16].

21. The Court of Appeal in *Commissioner of Inland Revenue v Haenga*[10] recognised the application of the private limitation will often raise the same questions as that under the general permission. Relevantly, the Court recognised the answer is complicated where the advantage for which the expense is incurred may serve private and income earning purposes. Basic items, such as food, clothing and shelter, while in one sense have a relation to the derivation of income, are ordinary living expenses and properly characterised as consumption. Such expenses are not incidental and relevant to the derivation of income merely because they are necessary in that sense.[11]

Travel expenses

22. The Taxpayer sought to deduct their cost of travel between their home city and the other city in their personal car.

23. Applying the principle in *Payne*, the cost of travel between two unrelated places of work could not be said to be incurred in the course of deriving income from either and is therefore not an allowable deduction.

24. The question of the deductibility of travel expenses might also be framed in terms of the application of the private limitation, but for the specific rule under s DE 2 that allows a deduction for expenditure incurred for the "business use" of a motor vehicle, which overrides the private limitation.[12] However, the lack of sufficient connection between the expenses and assessable income that prevents deductibility under the general permission applies equally to the consideration of deductibility under s DE 2, given that "business use" is defined in s YA 1 to mean "travel undertaken by the vehicle wholly in deriving the person's income".[13]

25. TCO decided that the Taxpayer's travel expenses were not deductible because:

- The travel occurred in the intervals between the two unrelated income producing activities, being the Taxpayer's farming activities in their home city and their work as an independent contractor in the other city, and not while the Taxpayer was engaged in either activity.
- The costs arose from the need for the Taxpayer to be in a position where they could set about the tasks from which assessable income would be derived.

[10] *Commissioner of Inland Revenue v Haenga* (1985) 7 NZTC 5,198 (CA).

[11] *Haenga* at 5,206 to 5,207.

[12] See s DE 2(13).

[13] This is consistent with the discussion in Commissioner's Interpretation Statement IS3448 "Travel by motor vehicle between home and work deductibility of expenditure and FBT implications".

- The costs were for travel "to one's work" and "from one's work", as opposed to "on work" for either activity.

Meal expenses

26. The Taxpayer claimed deductions for meal expenses incurred while the Taxpayer was in the other city. The Taxpayer argued the amounts claimed were the "extra cost" of the meals in the other city, where they were required to perform their work as an independent contractor, as compared to meals at home.

27. As a general proposition, case law has established that the cost of meals is not deductible, being a private matter, properly characterised as consumption and an ordinary living expense.[14]

28. The Taxation Review Authority (**TRA**) in *Case E80*[15] indicated that an extra cost on meals eaten "out of town" may have sufficient nexus with the income earning process if the quantum of extra cost could be proved. The TRA again considered the "extra cost" issue in *Case F117*[16], where they considered that the meal expenses in that case were deductible as the result of abnormal working conditions arising from the taxpayer's occupation and represented expenses over and above the ordinary cost of eating meals prepared at home. The case law indicates the deductibility of the "extra cost" of meals can only be deductible if incurred as a requirement of a taxpayer's work.[17]

29. TCO decided that the meal expenses were not deductible to the Taxpayer because:

- The meal expenses were properly characterised as consumption and an ordinary living expense. They did not satisfy the statutory nexus with the derivation of income in the other city and were of a private and domestic nature.
- To the extent any extra cost (compared to the cost of meals at home) could be proved, these were not incurred as a requirement of the Taxpayer's contracting work.

[14] *Haenga*; *Federal Commissioner of Taxation v Cooper* 91 ATC 4396 (Full Federal Court, Sydney).

[15] Case *E80* (1982) 5 NZTC 59,421 (TRA).

[16] *Case F117* (1984) 6 NZTC 60,125 (TRA).

[17] See Commissioner's Interpretation Statement IS 21/06 "Income tax and GST Treatment of Meal Expenses".

Accommodation expenses

30. The Taxpayer claimed deductions for accommodation expenses incurred while staying in the other city for their contracting work.

31. As a general principle, the costs of accommodation, like meals, are of a private nature, exclusively referrable to living as an individual member of society and a domestic expense relating to the household or family unit.[18]

32. Accommodation costs incurred to put oneself in a position to work, for example in a different location away from home, is not incurred in gaining or producing the income or incurred while carrying on the income producing activity and therefore does not satisfy the statutory nexus with the derivation of income.[19] However, this can be contrasted with a situation where expenses are incurred as a requirement to the income earning activity, and not merely due to the person's personal decision ordinarily arising on the provision of shelter.[20]

33. TCO concluded that the accommodation expenses incurred by the Taxpayer were not deductible because:

- The accommodation expenses did not satisfy the statutory nexus with the derivation of income from contracting work and, being exclusively referrable to living as an individual member of society, are of a private and domestic nature.
- The expenses were incurred to put the Taxpayer in a position to work in the other city rather than having been incurred in income derivation from that work. They had arisen because of the Taxpayer's personal preferences, as opposed to the peculiarities of the contracting work.

[18] *Haenga* at 5,206.

[19] *Case G57* (1985) 7 NZTC 1,251 (TRA); *Case M128* (1990) 12 NZTC 2,825 (TRA).

[20] *Commissioner of Inland Revenue v Hunter* (1990) 12 NZTC 7,169 (CA).