Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA TŪMATAITI

Deductibility of expenditure

Decision date | Rā o te Whakatau: 14 March 2023

Issue date | Rā Tuku: 20 June 2023

TDS 23/09

Subjects | Kaupapa

Income tax: Deductibility of expenditure, general permission, capital limitation.

Taxation laws | Ture tāke

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

Facts | Meka

1. The Applicant is a New Zealand based company that develops, manufactures and sells a range of products (the Applicant). As a manufacturer, the Applicant is subject to safety legislation and other regulatory requirements from New Zealand and the export markets that it supplies. As part of this framework, the Applicant is sometimes required to have a specific regulatory registration to allow it to manufacture and export products to or for its customers.
2. The Applicant has a number of registratons with an overseas regulator in respect of products it manufactures for a customer (referred to as a commercial supply agreement). The ruling is in respect of these particular registrations.
3. The Applicant incurs expenses to renew these regulatory registrations and implement new regulatory standards. These expenses would include staff labour, product testing (both in-house and third-party external testing), engagement with third party consultants and write-off of trial products (the registration costs). The relevant regulatory registrations are expected to last for a term of five years but may be subject to earlier renewal for a change in the standards or in the product specification.

Issues | Take

4. The main issues considered in this ruling were:
   - whether the registration costs are deductible under s DA 1;
   - whether s DA 2(1) applies to deny a deduction for the registration costs.

Decisions | Whakatau

5. Based on the specific facts of this ruling application, the Tax Counsel Office (TCO) decided that the registration costs for the particular registrations:

- are deductible under s DA 1; and
- section DA 2(1) does not apply to deny the deduction.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: General permission (s DA 1)

6. Section DA 1 provides for the general permission for deductibility of expenditure.

7. Section DA 1(1)(a) provides for the deductibility of expenditure that is incurred in deriving assessable income. Section DA 1(1)(b) provides for the deductibility of expenditure incurred in the course of carrying on a business for the purpose of deriving assessable income. The first limb requires a nexus with the deriving of assessable income, and the second a nexus with the carrying on of a business.

8. It is a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and the derivation of income, or the carrying on of a business for the purpose of deriving income. The phrase "the occasion of the loss or outgoing should be found in whatever is productive of the assessable income" is a helpful way both of characterising the factual inquiry that the application of the statutory language requires and of describing the nexus that is the focus of that inquiry.[1]

9. TCO considered that the registration costs are incurred undertaking the necessary work to renew the product registrations with the overseas regulator so that the Applicant can continue to sell the products in that overseas market.

10. TCO concluded that the general permission is satisfied, on the condition that the registration costs must have a direct link to the work required to register the products with the overseas regulator.

Issue 2 | Take tuarua: Capital limitation (s DA 2(1))

11. For an amount to be deductible, it must not be caught by any of the exclusions in s DA 2. The relevant exclusion is the capital limitation in s DA 2(1).

[1] *CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA), *NRS Media Holdings v C of IR* (2018) 28 NZTC 23-079, *Ronpibon Tin NL v FCT* (1949) 78 CLR 47.

12. The Court of Appeal in *Trustpower*[2] helpfully summarised the general principles that apply for distinguishing between capital and revenue expenditure. The relevant principles to be applied are as follows:

- The best guides for distinguishing between capital and revenue expenditure are the general principles stated in *Hallstroms*[3] and *Nchanga*[4]. Those cases indicate that it is necessary to consider what the expenditure is calculated to effect from a practical and business point of view (*Hallstroms*). The contrast between the two forms of expenditure corresponds to the distinction between the costs of creating, establishing, acquiring or enlarging the permanent structure of the business (capital), and the costs of using the structure to earn income, or performing the income earning operations (revenue) (*Nchanga*).
- The general principles in *Hallstroms* and *Nchanga* were adopted by the Privy Council in *BP Australia*.[5] The Privy Council suggested five indicia that could be considered to determine if an expenditure is capital or revenue in nature. These indicia are guides only and are not determinative. In the end the answer will depend on a close examination of the facts of the particular case and the character of the particular payment. The factors, as summarised by the Court of Appeal in *McKenzies*[6], are:
    - the need or occasion which called for the expenditure;
    - whether the payments were made from fixed or circulating capital;
    - whether the payments were of a once and for all nature producing assets or advantages which were of an enduring benefit;
    - how the payments would be treated under ordinary principles of commercial accounting; and
    - whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.
- In many cases it will not be necessary to look to the *BP Australia* indicia because the answer will already be clear from an application of the general principles stated in *Hallstroms* and *Nchanga*.

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[2] *CIR v Trustpower Ltd* [2015] NZCA 253 at [51]-[71], [74]-[76].

[3] *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 (HCA).

[4] *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 at 960 (PC).

[5] *BP Australia Ltd v Commissioner of Taxation for the Commonwealth of Australia* [1966] AC 224 (PC)

[6] *CIR v McKenzies (NZ) Ltd* [1988] 2 NZLR 736 (CA).

13. In applying the principles in *Hallstroms* and *Nchanga*, the primary question to be asked is what the registration costs are calculated to effect from a practical and business point of view – do they relate to the Applicant's permanent structure or its income earning process?

14. TCO considered that the particular registrations that are the subject of the registration costs allow the Applicant to distribute the products in that particular overseas market for its customer. The registrations only apply to the specified products and last for five years (unless a specification or standard change requires an earlier renewal). This indicates that the true character of the advantage sought is the continued manufacture and export of the customer's products to derive assessable income from the commercial supply agreement. Having the registrations and keeping those registrations current and up to date with standards is a necessary part of making that supply.

15. Therefore, it was concluded that the registration costs are a cost of performing the income earning operations of the Applicant rather than any acquisition or expansion of the permanent structure of the Applicant's business.

16. This conclusion is supported by the application of the *BP Australia* indicia. In particular:

    - The need or occasion that calls for the registration costs is to ensure safety regulations continue to be met so that the Applicant can continue to distribute the products in the overseas market. This suggests the expenditure is operational and will be revenue in nature.
    - The recurrent nature of the registration costs to ensure that the products meet, and continue to meet, safety standards so the products can continue to be exported supports the view that the expenditure is of a revenue nature but is not determinative.
    - The renewal of registrations and the monitoring of changing standards are continuous and no enduring benefit or identifiable asset in the sense used in case law[7] is created by the registration costs.
    - The registration costs are part of the ordinary business of the Applicant, being compliance costs relating to the continued supply of the products in a highly regulated environment. This is a cost of operating the Applicant's business rather than establishing the business structure.

[7] *Strick (IT) v Regent Oil Co Ltd* [1966] AC 295; *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA) at 5,240; *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801.

17. TCO concluded that the registration costs are revenue (and not capital) in nature, and therefore, the capital limitation in s DA 2(1) does not apply to deny a deduction in respect of the registration costs.