

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA  
TŪMATAITI

# Deductibility of retention payments

Decision date | Rā o te Whakatau: 13 October 2023

Issue date | Rā Tuku: 7 December 2023

TDS 23/20

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## Subjects | Kaupapa

Income tax: Deductibility of expenditure, general permission, capital limitation, consolidated group deductions, timing of deductions.

## Taxation laws | Ture tāke

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

## Facts | Meka

1. The arrangement in this ruling involved a New Zealand based company (Company A), wholly owned by Company B and a member of a consolidated group of companies (Consolidated Group). Company A and the Consolidated Group were the Applicants.
2. Company B entered into an agreement to sell its interest in Company A to a third party. Upon completion of the sale, Company A ceased membership of the consolidated group (Sale Transaction).
3. Prior to the Sale Transaction, Company A entered into retention agreements with key staff (Retention Agreements). The Retention Agreements were made by offer and accepted as variations to the employment agreements of the key staff.
4. The Retention Agreements entitled the key staff to bonus payments calculated by reference to their salaries (Retention Payments). The objective of the Retention Payments was to incentivise key employees to remain in their employment to enable the ongoing smooth running of Company A's business while the option to sell the business was being considered.
5. The Retention Payments were made prior to the completion of the Sale Transaction and were conditional on the employees remaining continuously employed by Company A on the relevant payment dates.
6. The Applicants considered that a portion of the Retention Payments were capital in nature as they were made to employees involved in the Sale Transaction (Capital Portion). The Applicants accepted that the Capital Portion is not deductible.

## Issues | Take

7. The main issues considered in this ruling were:

- whether the Retention Payments are deductible under s DA 1;
- whether the Retention Payments (other than the Capital Portion) are denied deduction under s DA 2(1);
- whether ss FM 12 and DV 17(3) apply to deny deductions for the Retention Payments; and
- whether the deductible portion of the Retention Payments are deductible in the income year they are paid under s BD 4.

## Decisions | Whakatau

8. Based on the specific facts of this ruling application, the Tax Counsel Office (TCO) decided that:
  - the Retention Payments are deductible under s DA 1;
  - the capital limitation in s DA 2(1) does not apply to deny a deduction in respect of the Retention Payments (other than the Capital Portion);
  - sections FM 12 and DV 17(3) do not apply to deny the deduction; and
  - section BD 4 allocates the deduction to the income year in which the payments were made.

## Reasons for decisions | Pūnga o ngā whakatau

### Issue 1 | Take tuatahi: Deductibility under s DA 1

9. The general rules for deductibility of expenditure are contained in subpart DA. Section DA 1 is the general permission.
10. 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.
11. 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.<sup>1</sup>

12. TCO considered the general permission is satisfied because:
  - the Retention Payments had been incurred on payment to the key employees, and
  - the payments were made by Company A as part of carrying on its business.
13. Therefore, the Applicants are allowed a deduction for the Retention Payments.

## Issue 2 | Take tuarua: Application of the capital limitation

14. For an amount that satisfies s DA 1 to be deductible, none of the general limitations in s DA 2 can apply. The relevant general limitation is the capital limitation in s DA 2(1).
15. The Court of Appeal in *Trustpower*<sup>2</sup> summarised the general (common law) 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*<sup>3</sup> and *Nchanga*<sup>4</sup>. 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*.<sup>5</sup> 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

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<sup>1</sup> *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.

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

<sup>3</sup> *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 (HCA).

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

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

character of the particular payment. The five indicia, as summarised by the Court of Appeal in *McKenzies*<sup>6</sup>, 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*.
16. TCO considered that this issue was very finely balanced because the Retention Payments, while incurred as an incentive to retain key staff, were also incurred in the course of the Sale Transaction (ie, disposing of a capital asset).<sup>7</sup>
17. The Applicants stated that the purpose of the Retention Payments was the continuity of key staff in Company A while its options were being considered, prior to the Sale Transaction. The expenditure on the Retention Payments was calculated, from a practical and business point, to affect the retention of staff in the business while the possible sale of the business was considered.
18. On balance, TCO concluded that the Retention Payments were revenue (and not capital) in nature. Therefore, the capital limitation in s DA 2(1) does not apply to deny a deduction in respect of the Retention Payments other than to the calculated Capital Portion.

### Issue 3 | Take tuatoru: Consolidated group rules

19. The purpose of the consolidation rules is to treat the members of a consolidated group as if they were a single company (s FM 2). Section FM 3(2) requires each company to

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

<sup>7</sup> See for example *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295 where the payment was not deductible as business had ceased; *CIR v New Zealand Forest Research Institute Limited* (2000) 19 NZTC 15,690 (Privy Council) where payment was part of consideration for assets.

calculate the amount that would be its taxable income, as modified by ss FM 4 to FM 13.

20. Sections FM 12 and DV 17(3) operate to deny a deduction for expenditure incurred by a company if the deduction would be denied to the consolidated group, treating the group as one company.
21. TCO considered that the Retention Payments kept their revenue nature, because the payments were calculated, from a practical and business point, to effect the retention of staff in the business while the possible sale of the business was considered.
22. TCO concluded that ss FM 12 and DV 17(3) would not apply to deny any deduction for the Retention Payments in the group context.

## Issue 4 | Take tuawhā: Timing

23. Subpart BD sets out the general rules for income, deductions and timing. Section BD 4 provides the general rule that a deduction will be allowed in the income year that the expenditure is incurred, unless there is a specific provision in Parts D to I that provides for that expenditure to be allocated on a different basis. Section BD 4(3) also provides that when determining the time at which an item of expenditure has been incurred, regard must be had to case law which requires some people to recognise expenditure or loss on an accrual basis and others on a cash basis.
24. TCO considered that the starting point must be that the Retention Payments were incurred when they were paid on the basis that is when the obligation to pay them arose. It was also considered that none of the provisions in Parts D to I apply.
25. TCO concluded that, in accordance with s BD 4, the deduction for the Retention Payments (other than the Capital Portion) is allocated to the income year (or part income year) in which the payments were made.