Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA TŪMATAITI

Deductibility of bonus payments

Decision date | Rā o te Whakatau: 12 March 2024

Issue date | Rā Tuku: 14 August 2024

TDS 24/17

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Subjects | Kaupapa

Income tax: deductibility of bonuses; whether issue of shares to fund bonuses are income; tax avoidance

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007.

Facts | Meka

1. The Arrangement was that Company A and Company B (associated companies) engaged a number of people (a mixture of independent contractors and employees (the Workers)) to provide services to each company. After the sale of a portion of Company A shares , both companies paid bonuses to the Workers, funded by the issue of shares to shareholders. If gross bonuses were deductible to the company for income tax purposes, additional bonus payments were to be made to selected Workers (equal to the tax benefit from deductions).
2. PAYE was deducted from the bonus payments that were made to employees of the two companies.
3. The bonus payments made by Company A and Company B to the Workers were not any of the following:
    - of a private or domestic nature;
    - incurred in deriving exempt income;
    - incurred in deriving employment income;
    - incurred in deriving non-resident passive income of the kind referred to in s RF 2(3);
    - incurred in deriving non-residents' foreign-sourced income;
    - related to establishing, acquiring, or enlarging the permanent structure of businesses of Company A and Company B; or
    - required to be paid as an obligation under the Share Agreement.
4. The bonus payments to the Workers:
    - recognised the effort of Workers for their services;

- encouraged ongoing strong performance in the future; and
- were intended to incentivise the Workers ongoing participation in the company.

5. After the sale of Company A shares, Company A and Company B received an injection of funds from their shareholders through the issue of shares. This helped meet the cost of the bonuses.

Issues | Take

6. The main issues considered in this ruling were:

- Whether the bonus payments that Company A and Company B made to the Workers were deductible under s DA 1.
- Whether s DA 2 applied to the bonus payments Company A and Company B made to the Workers.
- Whether s CG 4 applied to the Arrangement.
- Whether s BG 1 applied to the Arrangement.

Decisions | Whakatau

7. It was concluded;

- The bonus payments Company A and Company B made to the Workers were deductible under s DA 1 at the time the expenditure was incurred.
- Section DA 2 did not apply to the bonus payments Company A and Company B made to the Workers.
- Section CG 4 did not apply to the Arrangement.
- Section BG 1 did not apply to the Arrangement.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Deduction under s DA 1

8. A person is allowed a deduction for an amount of expenditure or loss to the extent that they incur it in deriving their income, or to the extent that they incur it in the course of carrying on a business for the purpose of deriving their income. These are referred to as the first and second limbs of s DA 1.

9. As both companies were carrying on a business, the second limb was considered in detail.

10. Under the second limb, the expenditure or loss must be "incurred in the course of carrying on" a business. A sufficient relationship (or nexus) must exist between the expenditure and the business that is being carried on.[1]

11. The following general principles are drawn from case law on s DA 1:

- For a cost to be deductible, a relationship (or nexus) must exist between the cost and the person's income-earning process. It is a question of fact and degree in each case.
- The true character of the cost and its relevance to the taxpayer's income-earning process are relevant for deciding whether that relationship exists. This includes looking at the scope of the taxpayer's income-earning process (that is, how their income is earned) and the factual situation at the time the cost is incurred.
- For a cost to be deductible, it does not need to be linked to a particular item of income. Also, income does not need to be produced in the same year the cost was incurred.
- The business must incur the cost as part of its operations to earn its income. Whether a business incurs a cost as part of its operations to earn income is usually determined objectively. However, subjective matters may be relevant where the cost was incurred by choice and the relationship between the cost and the business operations is more indirect and remote.
- Longer-term objectives can be considered. In relation to expenditure incurred in carrying on a business, a deduction may be available for costs incurred to protect or advance a business, or to avoid or reduce expenditure.

Bonus payments by Company A and Company B to the Workers

12. To determine whether there was a sufficient nexus between the bonuses and the income-earning process, it was necessary to identify the advantage the taxpayer was seeking to gain from the expenditure.

13. The Agent stated that both Company A and Company B sought to make the discretionary payments to recognise the effort of specific individuals during their growth phases. These individuals were instrumental in growing each of the companies and the companies wanted to ensure that they retained these Workers going forward.

[1] *CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young* Ltd v CIR (1978) 3 NZTC 61,271 (CA).

Company A and Company B were also commercially motivated to encourage ongoing strong employee performance to support future business performance.

14. TCO concluded that there was sufficient nexus between the bonus payments made by Company A and Company B to the Workers for both companies to take a deduction under s DA 1 at the time they incurred the expenditure.

Issue 2 | Take tuarua: General limitations (s DA 2)

15. An amount will be deductible where none of the limitations in s DA 2 apply. TCO concluded that, based on the Arrangement description, the only limitation that could apply was the capital limitation.

16. There are a number of cases that have considered whether payments made to employees were capital or revenue in nature. The principles extracted from these cases include:

    - Expenditure incurred to provide an incentive to employees in order to motivate, retain or recruit staff is ordinarily deductible.
    - Expenditure connected to the sale of a business will ordinarily be capital and non-deductible. Where employee expenditure is incurred in the context of a sale of a business, the facts must be carefully considered to determine whether there is a connection to the sale of the business.

17. The bonus payments were stated in the Arrangement description to be made in respect of services provided by the Workers, and to encourage them to stay with the companies in the future. Such services were directly related to Company A's and Company B's income earning process.

18. The payments were not related to establishing, acquiring or enlarging the permanent structure of the business (as recorded in the Arrangement description).

19. Both Company A and Company B's businesses continued after the Share Sale, with engagement of the Workers in the business continuing after this time. The payments were not made in connection with the cessation of a business.

20. TCO concluded that s DA 2 did not apply to the bonus payments Company A and Company B made to the Workers.

Issue 3 | Take tuatoru: Does s CG 4 apply to the Arrangement

21. Section CG 4 provides that when a person is allowed a deduction for expenditure or loss, and then derives an amount by way of insurance, indemnity or other payment relating to the expenditure or loss, the amount derived is income to the extent of the deduction.

22. For s CG 4 to apply to the Arrangement, all of the following must be met:

- The person must be allowed a deduction.
- The person derives an amount relating to the expenditure or loss, whether through insurance, indemnity or otherwise. This can be split into three parts:
  - The person derives an amount.
  - The amount is relating to the expenditure or loss.
  - The amount is derived through insurance, indemnity or otherwise.
- The amount is not income under another part of the Act.

23. The question was whether the amount received by the company from shareholders by way of consideration for the issue of shares was income under this provision.

24. TCO concluded that s CG 4 did not apply to the Arrangement as the amount received for the issue of shares was not "relating to the expenditure" on the bonuses.

25. The causal connection between the receipt of share issue proceeds and the payment of the bonuses was not sufficiently strong on the facts of this case. This included because Company A and Company B were not legally obligated to apply the share issue proceeds to pay the bonuses.

26. Therefore, s CG 4 could not apply to the Arrangement, because the "relating to" requirement was not met.

Issue 4 | Take tuawhā: Whether s BG 1 applies

27. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. Section GA 1 enables the Commissioner to make an adjustment to counteract a tax advantage obtained from or under a tax avoidance arrangement.

28. The Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289 considered it desirable to settle the approach to applying s BG 1. This approach is referred to as the Parliamentary contemplation test, which is an intensely fact-based inquiry. *Ben Nevis* has been followed in subsequent judicial decisions.

29. The Tax Counsel Office's approach in making this decision is consistent with Interpretation Statement: IS 23/01 Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007 (3 February 2023) (IS 23/01). IS 23/01 will not be replicated in this TDS but in summary the steps are as follows:

- Understanding the legal form of the arrangement. This involves identifying and understanding the steps and transactions that make up the arrangement, the commercial or private purposes of the arrangement and the arrangement's tax effects.
- Determining whether the arrangement has a tax avoidance purpose or effect. This involves:
    - Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
    - Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts. Artificiality and contrivance are significant factors.
    - Considering the implications of the preceding steps and answering the ultimate question under the Parliamentary contemplation test: Does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?
- If the arrangement has a tax avoidance purpose or effect that is not the sole purpose or effect of the arrangement, consider the merely incidental test. The merely incidental test considers many of the same matters that are considered under the Parliamentary contemplation test.

30. Taking into account all of the relevant facts and circumstances (noting that as this is a summary it may not contain all the facts or assumptions relevant to the decision and, therefore, cannot be relied on) TCO concluded as follows.

The steps and transactions that make up the "arrangement"

31. TCO considered that the "arrangement" for s BG 1 purposes comprised of the following steps:

- Company A's shareholders sold a portion of their shares.

- Company A and Company B also issued new shares to its shareholders. Both companies used the proceeds from the share issue to pay discretionary bonus payments to the Workers.
- Further bonuses were payable to selected Workers if their gross bonuses were deductible by Company A and Company B for income tax purposes.

32. The Applicant stated that the commercial or private purposes of the Arrangement were:

- That both Company A and Company B made the discretionary payments to recognise the effort of specific individuals during their growth phases. These individuals were instrumental in growing each of the companies and the companies wanted to ensure that they retained these Workers going forward.
- Company A and Company B were also commercially motivated to encourage ongoing strong performance in the future.

The tax effects of the arrangement

33. TCO considered that the Arrangement would give rise to the following tax effects:

- A deduction for the amount of bonus expenditure incurred by Company A and Company B under s DA 1.
- Section DA 2 did not apply to the bonus payments.
- Income did not arise to Company A or Company B under s CG 4.
- PAYE was payable by Company A and Company B on PAYE income payments (as defined in s RD 3).
- Timing provisions in s EA 4 and s DB 51 may apply to offset the deduction under s DA 1 (for employees).
- The bonus payments were income of Workers (if they were New Zealand resident, or non-resident and subject to New Zealand income tax because the services were performed in New Zealand).
- For any of the Workers where the payment was for services performed outside New Zealand by a non-resident, these would not be subject to non-resident contractors' tax.

34. TCO was only ruling on ss DA 1, DA 2 and CG 4 under black letter law.

35. TCO noted the above tax effects were not controversial and consistent with Parliament's purpose on how the black letter law provisions should operate.

36. In regard to the deductibility provisions, the Courts have held that Parliament's purpose for those provisions is that deductions can be claimed where:

- the taxpayer incurs the real economic consequences of the payment;
- the expenditure is incurred as a matter of commercial reality;
- the expenditure is not a contrivance or artificial; and
- the taxpayer is engaged in business activities for the purposes of deriving income.

37. In relation to the above principles, and understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts:

- Company A and Company B bore the economic consequence of the payment of the bonuses. There was a real outflow of the funds when the bonuses were paid.
- It was within regular commercial reality of the operation of a company that to the extent that current year profits or retained earnings were insufficient to meet anticipated expenditure, debt or equity sources may be used to meet this expense.
- There were no indications from the documentation or surrounding circumstances that the expenditure was contrived or artificial. The circumstances suggested that the transactions took place with a view to carrying out the regular objectives of a bonus – to incentivise and/or retain employees.
- Company A and Company B were engaged in business to derive income.

38. Based on the above, TCO considered the Arrangement, when viewed in a commercially and economically realistic way, made use of the specific provisions in a manner consistent with Parliament's purpose. Therefore, the Arrangement did not have a tax avoidance or effect, and s BG 1 would not apply to the Arrangement.

39. It was not necessary for TCO to consider the merely incidental test under the third step of the s BG 1 approach.