Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

Deductions and shortfall penalties

Decision date | Rā o te Whakatau: 3 September 2024

Issue date | Rā Tuku: 7 March 2025

TDS 25/04

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Subjects | Kaupapa

Income tax and GST input tax deductions: Whether expenditure incurred by the Taxpayer on educational courses, motor vehicle costs, home office costs, power, insurance, rent, advertising, website, eftpos, and stock was deductible. Some of the expenses were incurred before the business commenced and/or before the GST registration date.

Whether the Taxpayer was liable for shortfall penalties for not taking reasonable care.

Taxation laws | Ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GSTA), the Income Tax Act 2007 (ITA 2007), and the Tax Administration Act 1994 (TAA).

Summary of facts | Whakarāpopoto o Meka

1. The Taxpayer was an individual.
2. Customer and Compliance Services (CCS) agreed that the Taxpayer was in business and about the nature of the business. However, the parties did not agree about when the business commenced.
3. The dispute concerned deductions for expenses claimed in income tax returns for a number of income years, and input tax deductions claimed in GST returns for recent return periods. The disputed expenses were for educational courses, motor vehicle costs, home office costs, power, insurance, rent, advertising, website, eftpos and stock.
4. In particular, some of the expenses claimed by the Taxpayer related to:
    - Income tax and GST input tax deductions claimed for educational courses undertaken by the Taxpayer.
    - Income tax deductions for motor vehicle and home office expenses for which insufficient details had been provided.
    - GST input tax deductions claimed for expenses that were incurred prior to the effective date of the Taxpayer's GST registration.

Issues | Take

5. The main issues considered in this dispute were:

- When did the Taxpayer's business commence?
- Whether the Taxpayer was entitled to income tax deductions for educational expenses.
- Whether the Taxpayer was entitled to income tax deductions for motor vehicle and home office expenses.
- Whether the Taxpayer was entitled to the disputed input tax credits for goods and services.
- Whether the Taxpayer was liable for shortfall penalties for not taking reasonable care.

6. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

7. The Tax Counsel Office decided on the balance of probabilities that:

- The evidence provided by the Taxpayer did not go close to establishing that the Taxpayer commenced business prior to the date CCS argued was the business commencement date.
- The educational expenditure for the course in the New Zealand Certificate in Business was a deductible expense. However, the Taxpayer had not demonstrated that they were entitled to income tax deductions for the remaining educational expenses.
- The Taxpayer had not proved that the motor vehicle and home office expenses claimed were deductible.
- The Taxpayer was entitled to input tax credits for the purchase of stock, even though the expense pre-dated the GST registration. However, the Taxpayer had not demonstrated they were entitled to input tax deductions claimed for expenditure related to power, insurance, rent, advertising, website and eftpos, and educational studies.
- The Taxpayer was liable for shortfall penalties for not taking reasonable care on all income tax and input tax deductions claimed other than for the New Zealand Certificate in Business and the stock.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

8. Except for proceedings relating to evasion or similar act or obstruction, the onus of proof is on the taxpayer to show that an assessment is wrong, why it is wrong, and by how much it is wrong.[1] However, if the taxpayer proves, on the balance of probabilities, that the amount of an assessment is excessive by a specific amount, the taxpayer's assessment must be reduced by the specific amount.[2]

9. The standard of proof required is the balance of probabilities.[3]

10. It is appropriate that the same onus and standard of proof be applied in the disputes process as in challenge proceedings. TCO considered whether the Taxpayer has discharged the onus of proof in the context of the issues raised by the parties in the dispute, based on the documentary evidence put before it.

Issue 1 | Take tuatahi: When did the Taxpayer's business commence?

11. CCS argued that the Taxpayer's business commenced at a certain time (CCS's commencement date). The Taxpayer argued that the business commenced approximately four years earlier (Taxpayer's commencement date).

12. TCO noted that the leading case on the meaning of "business" in the tax context was *Grieve*.[4] Further, TCO noted that actions that were merely preparatory to the commencement of a business did not constitute a business.[5] TCO considered the following relevant principles regarding the commencement of business could be drawn from case law:

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1 Section 149A(2) of the TAA. See also *Case V17* (2002) 20 NZTC 10,192, *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC), and *Vinelight Nominees Ltd v CIR (No 2)* (2005) 22 NZTC 19,519 (HC).

2 Section 138P(1B) of the TAA.

3 *Yew v CIR* (1984) 6 NZTC 61,710 (CA), *Case Y3* (2007) 23 NZTC 13,028, and *Case X16* (2005) 22 NZTC 12,216.

4 *Grieve v CIR* (1984) 6 NZTC 61,682 (CA).

5 *Birmingham & District Cattle By-Products Co Ltd v IRC* (1919) 12 TC 92.

- For a business to exist it is fundamental that there has been more than mere preparation.[6]
- A commitment to engage in business must have been made. But the activity must go beyond merely establishing the profit-making structure.[7]
- Ordinary current business operations must have begun (ie, conduct that it is hoped will ultimately yield a profit if persisted in).[8]
- Activities being carried on continuously that are an integral part of the income-earning process will indicate that a business has commenced.[9]

13. TCO considered that the evidence provided by the Taxpayer did not go close to establishing, on the balance of probabilities, that the Taxpayer commenced business prior to CCS's commencement date. TCO noted that the evidence provided by the Taxpayer was limited. That evidence did not establish operations and transactions of a sufficient scale, or sufficient commitment of time, money and effort to establish a business.

14. TCO concluded that the Taxpayer did not commence the business, or income earning activity, before CCS's commencement date.

15. Accordingly, the rest of TCO's analysis proceeded on the basis that the Taxpayer's business commenced on CCS's commencement date.

Issue 2 | Take tuarua: Income tax deductions for educational expenses

16. The Taxpayer claimed expenses for educational studies incurred (for the most part) before CCS's commencement date. CCS argued that the educational expenses could not be claimed for three alternative reasons:

- There was no nexus between the expenditure and the business or income-earning activity.
- The expenditure was prior to the commencement of the business or income-earning activity.
- The expenditure was of a private and/or capital nature.

6 *Calkin v CIR* (1984) 6 NZTC 61,781 (CA).

7 *Calkin v CIR* supra.

8 *Calkin v CIR* supra.

9 *Whitfords Beach Pty Ltd v FCT* 83 ATC 4277 (FCAFC).

17. TCO considered that there were two alternative grounds under which a deduction was permitted under s DA 1 of the ITA 2007 (sometimes referred to as the first and second limbs of s DA 1). A deduction was allowed for expenditure or loss incurred by a person:

    - in deriving their assessable income, or
    - in the course of carrying on a business for the purpose of deriving their assessable income.

18. TCO noted that the alternative grounds were not cumulative. Expenditure or loss would be deductible under s DA 1 if only one of the alternative grounds was met.

19. Among the many cases analysed, TCO specifically considered cases on the deductibility of educational expenditure, such as *Case N2* and *Case Q18*.[10] Those cases established that the expenditure on education would be deductible when it was for continuing relevant education, undertaken at the time when the income-earning process already existed, and where the expenditure was made with a view to increase a person's earnings. In such cases there was sufficient nexus, and the expenditure is not of a private or capital nature.

20. TCO considered that the educational expenditure for the course in the New Zealand Certificate in Business, Level 4, was a deductible expense. TCO noted that the reasoning in *Case N2* and *Case Q18* applied to this expenditure for this course. TCO considered that it met the nexus with the income earning process that had already begun after CCS's commencement date. Skills acquired during this course could be said to be reasonably necessary to run the business, and in the nature of continuing education. The expenditure on this course was not excluded by the private or capital limitation.

21. However, TCO considered that the courses to obtain other qualifications were not deductible, as the Taxpayer had not established, based on the information provided, that there was a sufficient nexus between the business or income-earning activity and that expenditure.

22. In addition, there was a relatively small amount claimed for which no evidence or explanation had been provided by the parties. TCO considered that this expense was not deductible as the Taxpayer had not provided the required evidence to support this.

[10] *Case N2* (1991) 13 NZTC 3,012, *Case Q18* (1993) 15 NZTC 5,100.

Issue 3 | Take tuatoru: Income tax deductions for home office and motor vehicle expenses

23. The Taxpayer claimed deductions for motor vehicle expenses and home office expenses (rent and power). CCS argued that the Taxpayer had not provided sufficient information to support the deductions.

24. Section 22 of the TAA states that a taxpayer who carries on an activity or business for the purpose of deriving assessable income is required to keep sufficient records to enable the taxpayer's deductions to be readily ascertained. TCO noted that in the absence of business records it is very difficult for a taxpayer to prove that an income tax assessment made or proposed by the Commissioner is wrong.[11]

Motor vehicle expenses

25. TCO observed that under subpart DE of the ITA 2007, deductions were allowed for expenditure for the business use of a motor vehicle (s DE 2(1)). As part of this, subpart DE sets out the rules for determining the proportion of business use to total use, when a person uses a motor vehicle partly for business purposes and partly for other purposes (s DE 2(1)(a)).

26. The Taxpayer's emails to CCS referred to logbooks, however none have been provided. Therefore, TCO considered it was not possible to verify whether they comply with the logbook requirements in s DE 7, and whether the business proportion of the use of the motor vehicle could be ascertained in reliance on the logbooks.

27. Therefore, TCO considered that the Taxpayer had not provided sufficient records.

28. Further, in the absence of actual records, TCO considered that the deduction for the motor vehicle was limited to the lesser of the proportion of actual business use, and 25% of the total use of the vehicle (s DE 4). As the Taxpayer had not provided sufficient evidence about what the actual business use of the vehicle was, TCO considered the actual business use should be treated as zero. Therefore, no deduction was available to the Taxpayer for the motor vehicle.

29. In summary, TCO concluded that the Taxpayer had not proved, on the balance of probabilities, that the motor vehicle expenses claimed were deductible.

[11] *Case 1/2012* (2012) 25 NZTC 1-013.

Home office expenses

30. The deductibility of home office expenses depended on the application of the general deductibility principles already stated in this summary. This was unless the taxpayer relied on s DB 18AA of the ITA 2007, which provided taxpayers with a simplified method for determining the total amount that could be deducted for the business use of premises that were partly used for business purposes and partly used for other purposes. This included home offices.

31. In correspondence to CCS, the Taxpayer referred to square meters for the home office when working out the expense amounts. Therefore, TCO understood that the Taxpayer was relying on s DB 18AA (although this was not expressly stated by the Taxpayer).

32. CCS requested the Taxpayer to provide the calculations for the home office expenses claimed, including a floor plan for the whole house. CCS stated that this would have enabled them to verify the area of the house that was actually used for the home office.

33. TCO noted that although the Taxpayer's entitlement to a deduction was not dependent on a particular type of record being maintained (for example, an invoice), there still must be sufficient records to verify the expenditure (s 22 of the TAA). In the absence of sufficient records, it was very difficult for the Taxpayer to prove on the balance of probabilities that CCS's proposed adjustments were wrong (*Case 1/2012*).

34. TCO considered that, based on the information provided by the Taxpayer, there were insufficient records available to verify the Taxpayer's claims for the deduction for the home office expenditure in the income tax returns.

35. Therefore, TCO concluded that the Taxpayer had not proved, on the balance of probabilities, that these expenses could be claimed.

Conclusion

36. TCO concluded that CCS was correct in not allowing the motor vehicle and home office expenses as claimed by the Taxpayer in the income tax returns.

Issue 4 | Take tuawhā: Entitlement to disputed input tax credits for goods and services

37. The Taxpayer claimed input tax deductions for pre-registration expenses (educational courses, power, insurance, rent, advertising, website, eftpos and stock). CCS argued

that educational courses acquired prior to GST registration were not deductible under s 20(3C)(a) of the GSTA.

38. Similarly, CCS argued that the input tax deductions claimed for power, insurance, rent, advertising, website and eftpos were not deductible. This was because they were goods or services acquired in previous years that were not available to be used by the Taxpayer post-registration as they were already used up.

39. As a preliminary matter, TCO noted that under s 20, only a registered person could deduct input tax paid when acquiring goods and services against the output tax charged on supplies made by the person in the same period (s 20(3)). Persons who were not registered for GST could not claim input tax.

40. Under s 21B, a registered person may make an adjustment under s 21, if the person:

- before becoming a registered person, acquires goods and services on which tax has been charged under s 8(1) (s21B(1)(a)), and
- at the time of registration, or at a later time, uses the goods or services for making taxable supplies (s 21B(1)(b)), and
- meets the tax invoice or adequate records requirements (s 21B(3)(a)), and
- in identifying the "percentage actual use" of goods and services in the first adjustment period, uses a method that provides a fair and reasonable result (s 21B(3)(b)).

41. TCO considered that:

- Input tax deductions for the pre-registration expenses for education could not be claimed because the Taxpayer had not used the educational services in making taxable supplies at the time of, or after, registration. Although the benefits from the education may have had positive effects on the business, the services themselves were not provided after the Taxpayer registered for GST, and they were used up by the Taxpayer prior to registration. This meant they could not be used to make taxable supplies at, or after, registration.
- Input tax deductions for the pre-registration expenses on power, rent, advertising, eftpos, insurance and website were for services that were also all used up prior to the Taxpayer registering for GST. For that reason, the Taxpayer could not have used these services in making taxable supplies at the time of, or after, registration.
- In relation to the input tax deductions for stock, CCS's basis for proposing to disallow the input tax deductions was because the individual supplies were under $5,000 and no adjustment was permitted under s 21(2)(b). However, TCO

considered this was not a requirement for pre-registration expenses under s 21B of the GST Act. In TCO's view the correct focus under s 21B was to establish whether or not at the time of registration, or at a later time, the Taxpayer had used, or would use, any of the stock in making taxable supplies. Therefore, TCO considered the proposed adjustments should not be made because the basis of CCS's argument was incorrect.

42. Accordingly, TCO concluded that the Taxpayer was entitled to input tax credits for the purchase of stock, even though the expense pre-dated the GST registration. However, TCO concluded the Taxpayer had not demonstrated they were entitled to input tax deductions claimed for expenditure related to power, insurance, rent, advertising, website and eftpos, and educational studies.

Issue 5 | Take tuarima: Shortfall penalties

43. CCS considered that the Taxpayer was liable for a shortfall penalty for not taking reasonable care of 20% for each tax shortfall identified for the relevant GST and income tax returns (under s 141A of the TAA). CCS also considered that the penalties should be reduced by 50% under s 141FB of the TAA. The Taxpayer did not agree.

44. Section 141A imposes a shortfall penalty of 20% on a tax shortfall if a taxpayer does not take reasonable care in taking a tax position, if the following requirements are satisfied:

- The Taxpayer has taken a taxpayer's tax position.
- The Taxpayer's tax position has led to a tax shortfall.
- The Taxpayer has not taken reasonable care in taking the taxpayer's tax position.

45. It was not disputed that the Taxpayer had taken a tax position in each of the relevant tax returns in relation to the various income tax deductions and GST input tax deductions that were the subject of the dispute.

46. TCO considered it was evident that the Taxpayer's tax positions resulted in too little tax being paid (a tax shortfall) because the Taxpayer incorrectly claimed deductions for expenses as explained under the substantive headings above in this summary.

47. TCO subsequently considered whether the Taxpayer had taken reasonable care in taking the tax positions.

48. Relevantly, in *Case W4*, Judge Barber said that the test of "reasonable care" is whether a person of ordinary skill and prudence would have foreseen as a reasonable

probability or likelihood that an act or failure to act would cause a tax shortfall.[12] This is having regard to all of the circumstances. Further, Judge Barber said that whether the taxpayer acted intentionally is not a consideration. He said that it is not a question of whether the taxpayer actually foresaw the probability that the act or failure would cause a tax shortfall, but whether a reasonable person in the taxpayer's circumstances would have foreseen the tax shortfall as a reasonable probability.

Income tax

49. TCO considered that the Taxpayer had not taken reasonable care in relation to educational expenses claimed in the income tax returns. There was a significant lack of evidence that the Taxpayer commenced the business before CCS's commencement date. And there was no evidence that the Taxpayer checked their assessment on this matter including through seeking advice. A reasonable person could not have concluded that the costs of these earlier educational courses were business expenditure in that context. There was no credible argument that had been evidenced that established a sufficient nexus between these expenses and the Taxpayer's business. There is therefore no reasonable basis for taking these tax positions, and a reasonable person would have foreseen the possibility of a tax shortfall arising by taking these positions. Consequently, the lack of reasonable care penalty applied.

50. TCO noted that the penalty did not apply to the deductible expense for the Certificate in Business, for which there was a sufficient nexus (as there is no tax shortfall).

51. In relation to the income tax deduction claims for the motor vehicle and the home office, TCO considered there was no evidence of adequate records being maintained to support the claims. A reasonable person would not have failed to maintain adequate records in this context. And, by failing to maintain such records, would have foreseen the possibility of a tax shortfall arising. Therefore, the lack of reasonable care penalty applied.

GST

52. Input tax deductions for the pre-registration expenses for education were denied because the Taxpayer had not used the educational services in making taxable supplies at the time of, or after, the registration. Although the benefits from the education may have had positive effects on the business, the services themselves were not provided after the Taxpayer registered for GST, and were used up by the Taxpayer prior to the registration. Therefore, they could not have been used to make taxable supplies at, or

[12] *Case W4* (2003) 21 NZTC 11,034.

after, registration. TCO considered no reasonable person could have taken the Taxpayer's tax positions on those expenses, particularly without seeking advice on this matter. A reasonable person would therefore have foreseen that taking these tax positions would lead to tax shortfalls. Therefore, the lack of reasonable care penalty applied.

53. Input tax deductions for the pre-registration expenses on power, rent, advertising, eftpos, insurance and website were for services with a short lifespan and were also all used up prior to the Taxpayer registering for the GST. For that reason, the Taxpayer could not have used those services in making taxable supplies at the time of, or after, the registration. This would have been evident to a reasonable person considering this matter. And, it would have also been foreseeable that taking these tax positions would lead to a tax shortfall. Therefore, the lack of reasonable care penalty applied.

54. TCO agreed with CCS that the Taxpayer qualified for a reduction of the shortfall penalty by 50% under s 141FB.