

Team Manager
Technical Services
Office of the Chief Tax Counsel
National Office
Inland Revenue
PO Box 2198
Wellington

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Tax

Grant Thornton New Zealand Ltd
L13, AXA Centre
80 The Terrace
PO Box 10712
Wellington 6143
T +64 (0)4 474 8500
F +64 (0)4 474 8509
www.grantthornton.co.nz

Dear Sir

Treatment of employee-related payments – sections CE 5(3)C and CW 17(1)-(3) of the income tax act 2007 – IG3162

Attached is Grant Thornton's submission on the above named statement. We also made a submission on a previous statement by way of a submission dated 11 December 2007.

This latest submission is confined to, generally, one point where we disagree with the analysis in the latest draft statement, but it is a point that strikes at the crux of the issue of whether these employee related payments are taxable in the hands of the employee.

We now set out our main submission but would be pleased if you would review our previous submission as it is our impression that some points may not have been considered fully by IRD as it has been conveyed to us that IRD had incorrectly assumed that we agreed with their interpretation, as strange as that appears to us. We are however conscious that once various submissions are reported in a summary format certain issues are "lost in translation". Therefore we would be happy to meet with you and discuss these matters in person if you felt necessary for greater clarification.

Summary

- Our specific conclusion is that no reliance can be placed on cases such as *Haenga*, *Belcher*, and *Hunter* as these cases were decided in relation to the specific wording of clause 8 of the old Fourth Schedule of the income tax Act 1976 that for expenditure to be deductible to an employee it had to be a "condition of employment" that the employee incur such expenditure. Therefore the requirement set out in paragraph 124 that "The employee must be (or will be) performing an obligation under the contract of employment or service at the time the expenditure is (or is likely to be) incurred is incorrect at law and is definitely not "compatible with the current legislation"(para 126).
- Our general conclusion is that insofar as the Interpretation Statement relies on case law decided in relation to the old Fourth Schedule, and its interrelation with the various limitations – capital, private and domestic etc etc – it does so in error. Further reliance on overseas case law that is based on specific employment deduction provisions similar to the Fourth Schedule is likely to be of limited benefit.

- There is only one requirement that needs to be satisfied before the limitation tests are applied – that the expenditure is incurred as part of the employee’s income earning process. Case law that will assist in determining this deductibility will be based on general deductibility case law and not on employment deductibility case law.

Condition of employment – cases decided under fourth schedule of previous Income Tax Acts

A crucial point made in our previous submission was that IRD’s reliance on the cases *CIR v Haenga* (1985) 7 NZTC 5,198; *CIR v Belcher* (1988) 10 NZTC 5,164; *Hunter v CIR* (1990) 12 NZTC 7,169, was incorrect due to the fact that these cases were decided in relation to the old Fourth Schedule and in particular in relation to Clause 8 of that Schedule which stated:

8. Expenditure incurred by the taxpayer for the purposes of, **and as a condition of, his employment**, not being expenditure of any of the kinds referred to in any of the foregoing provisions of this Schedule. (Our Emphasis)

The Courts decided in each case that the expenditure was incurred “as a condition of employment”, as Clause 8 stipulated and therefore the expenditure was deductible for income tax purposes.

IS 3162 makes the following statements:

119. The Commissioner considers that the approach taken in *CIR v Haenga*, *CIR v Belcher*, and *Hunter v CIR* is consistent with the general principles of deductibility despite these cases being decided under the specific employment deductibility regime provided in the Fourth Schedule of the Income Tax Act 1976. Whilst there is no longer the requirement that the expenditure is incurred “for the purposes of, and as a condition of ... employment”, there is still a requirement that the expenditure has the required type of relationship with the operations and activities that constitute the income-earning process. In terms of section CW 17, this relationship is with the employee’s income from employment or service. Therefore, the same interpretation can apply to the deductibility test in section CW 17 when considering whether the expenditure is of a private or domestic nature.

126. The Commissioner acknowledges that the courts did not expressly formulate these requirements, even in relation to the legislation that *CIR v Haenga*, *CIR v Belcher*, and *Hunter v CIR* were decided under. However, the cases are considered to be the leading decisions in the area of the tax deductibility of employment-related expenditure, and from them the Commissioner has formulated the requirements that he considers compatible with the current legislation. This is because the type of expenditure that section CW 17 payments relate to frequently raises the issue as to whether the expenditure has a private or domestic element.

In paragraph 119 the statement correctly points out that there is no longer a requirement that expenditure be as a condition of employment but that it is still a requirement that the expenditure has a required relationship with the income earning process. It then however, illogically in our view, concludes that the “same interpretation can apply” even though that requirement that the interpretation is based upon is no longer in existence! We consider that the only requirement is that there is a nexus with the income earning process. Any requirement that the expenditure be incurred “as a condition of employment” is now as obsolete as the Fourth Schedule itself.

In relation to paragraph 126 we submit that the cases were indeed leading cases in the area of the tax deductibility of employment related expenditure. The current Income Tax Act does not however allow for the deduction of employment-related expenditure and these cases are therefore irrelevant in the current context as what has to be decided is whether the expenditure incurred by employee would have been deductible without the current employment limitation and, of course, without the existence of the Fourth Schedule.

Further as mentioned in our previous submission the courts found that a finding that once the tests in the old sections 104 and 105(2)(b) were met the deduction was not barred under section 106(1)(j). Refer to the quotation from *Haenga* at paragraph 115 of IG 3162, which states:

It was noted in *Haenga* (NZTC p 5,207; NZLR p 128 [TRNZ p 50]) that the exclusion of expenditure made on private matters comes from the requirement of the first limb of s 104 (and s 105(2)(b)) which limits deductions to expenditure incurred in gaining assessable income, **and the express inclusion in s 106(1)(j) may be regarded as having been inserted by way of precaution or emphasis.** That links tests (1) and (3). (Our emphasis)

... And where that test is met the expenses are properly characterised as work related expenses: they are of an employment not a private or domestic character and deductibility in terms of s 105(2)(b) and the Fourth Schedule cl 8 involves a finding that deduction is not barred under s 106(1)(j) (Belcher NZTC p 5,171 NZLR p 717 [TRNZ p 120]).

Therefore the courts felt they did not have to consider whether the expenditure was of a private or domestic nature and therefore are of no assistance in this case and are definitely **not** compatible with the current legislation. It should be noted that as a result of the courts decisions, Clause 8 of the Fourth Schedule was amended to read, with effect from 1 April 1984:

8. Expenditure incurred by the taxpayer for the purposes of, and as a condition of, his employment, not being expenditure of any of the kinds referred to in any of the foregoing provisions of this Schedule and **not being expenditure that consists of or is in relation to sums or matters of any of the kinds referred to in section 106 of this Act.** (Our emphasis)

Therefore if the cases referred to had been decided in cases related to expenditure post 1 April 1984 and therefore had to consider the limitations expressed in section 106 of the Income Tax Act 1976, in particular the private and domestic expenditure limitation and the capital limitation then the statement made in paragraph 126 would be valid but they were not and therefore the statement is incorrect.

We would further note that the examples given by the statement do not appear to require that the expenditure has been incurred as a result of a specific condition of an employment agreement but we have proceeded on the basis that it does.

Conclusion

Our conclusion, if we take the requirements set out in paragraph 23 of IG3162 as an example, is that there is no requirement that the employee must be performing an obligation under a contract of employment because as noted above that “requirement” is derived from case law related to the specific consideration of Clause 8 of the Fourth Schedule to the Income Tax Act 1976, which we have proved is not relevant to the current provisions.

Rather the requirement is merely that the expenditure is incurred as part of the employee’s income earning process as part of the process of deriving income from employment. This, in our view, also brings the “policy” into line with what happens on a day-to-day basis. That is, there is no way that employers in deciding whether the payment is taxable or not revert to the employment contract to see whether there is a specific obligation to incur this expense on behalf of the employer etc (even excluding the fact that most employment contracts contain the catch all clause such as “and any other duties as directed by the employer” which makes this requirement nonsensical).

Application of cases relating to other clauses of the fourth schedule

We note that there are various other cases relating to other clauses of the Fourth Schedule which will suffer the same problem. That is, they are arguably not relevant in determining taxability of payments made under the current provisions.

For example Clause 7 of the Fourth Schedule previously provided:

Expenditure incurred in respect of the use of a private dwelling in connection with the carrying on of the employment of the taxpayer where a room or other defined area in that dwelling is used wholly or principally for that purpose....

As a result if there was not a room set aside, or a defined area, but rather the taxpayer merely used various areas of the house, dining room table, spare room for visitors etc then no claim could be allowed. It is also a common misconception that the “room or defined area” requirement also applied (or currently applies) to taxpayers who receive income from non-employment sources. This is not the case and will not apply to employees who receive reimbursement from their employer for the use of their home for employment purposes. Nor will the costs be limited to repairs, electricity/gas and insurance as it was under Clause 7 of the Fourth Schedule and therefore costs such as interest on mortgages and depreciation would be able to be reimbursed by employers and would constitute exempt income to the employees.

We have not had the time to review all the case law cited in IG3162 but consider that the same argument would apply as we have set out in relation to the “private and domestic” limitation above i.e. it is not relevant/applicable because it is based on the specific provisions of the Fourth Schedule which do not apply in the current situation.

Yours faithfully



Greg Thompson
Partner