Inland Revenue
Te Tari Taake

20 December 2023

[redacted]

Dear [redacted]

Thank you for your request made under the Official Information Act 1982 (OIA), received on 28 November 2023. You requested the following:

> *I have a keen interest in tax and recently learned about denied deductions, other than the Private Limitation in DA 2, I wondered what other forms of denied deductions were there for example say losses lost due to breach of shareholder continuity and breach of the bct test. What other examples of denied deductions are there?*

Denied deductions

The Income Tax Act 2007 (the Act) allows deductions to be offset against a person's annual gross income. The Act provides a "general permission" under section DA 1 which allows a deduction if it is linked to an income earning process or a business and also "general limitations" under section DA 2. There are also further specific sections which supplement or override to the general permission. The key areas are summarised below, however the relevant part of the Act is part D of the Act, which is available at: legislation.govt.nz/act/public/2007/0097/latest/DLM1512301.html. It is also important to note there is a large amount of case law in this area.

- The general permission is a key part to whether an expenditure or loss is deductible. This usually requires that an expenditure or loss is incurred in deriving assessable income or in the course of a business carried on to derive assessable income.
- The general limitations prohibit deductions for certain types of expenditure, for example expenditure of a capital nature or expenditure incurred in deriving exempt income. Each of the general limitations, to the extent applicable to the expenditure or loss, overrides the general permission. The general limitations include:
- The capital limitation - A person is denied a deduction for an expenditure or loss to the extent to which it is of a capital nature.
- The private limitation - A person is denied a deduction for an expenditure or loss to the extent to which it is of a private or domestic nature.
- The exempt income limitation - A person is denied a deduction for an expenditure or loss to the extent to which it is incurred in deriving exempt income.
- The employment limitation - A person is denied a deduction for an expenditure or loss to the extent to which it is incurred in deriving income from employment.
- The withholding tax limitation - A person is denied a deduction for an expenditure or loss to the extent to which it is incurred in deriving non-resident passive income.
- The non-residents' foreign-sourced income limitation - A person is denied a deduction for an expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income.
- An important concept is that if an amount is to be deductible in the first place, a taxpayer must have incurred it. Case law determines whether an amount has been incurred.

- Expenditure or losses may be apportioned into deductible and non-deductible amounts.

Part D of the Act also details a number of specific rules for expenditure types incurred in deriving assessable income or in the course of a business to derive assessable income. These rules supplement or override the general permission and allow some expenditure as deductible and conversely deny deductions in some circumstances. Examples of these include:

- Denying a portion of expenditure incurred on specific forms of entertainment - subpart DD
- Denying land contouring costs for those deriving income under the provisions dealing with disposal of timber – subpart DP
- Denying a life insurer deductions for premiums in specific circumstances – subpart DR

It is also important to note that Part E of the Act (viewable in the same link above) details a number of timing and quantifying rules. These rules can reduce or address the timing of deductions in specific circumstances. An example of this is the limitation of foreign investment fund losses under the comparative value methodology in section EX 51 of the Act.

Inland Revenue's website provides some specific information on common deductions, which can be found at: ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/types-of-business-expenses.

This is the basic structure of the deduction's regime in the Act. The other items that you have mentioned include tax losses impacted by a breach in shareholder continuity and the business continuity test. These rules do not technically deny deductions, rather they deal with the treatment of a tax loss which is carried forward to a future year. Entities, such as a company, may have a loss in one year which arises because deductions are greater than the assessable income. This tax loss can then be carried forward to a future year to be offset against a future year's net income. The continuity rules and business continuity test are in place to ensure that the losses generated are enjoyed by the largely the same shareholders (in the case of the continuity rules) or largely the same business (in the case of the business continuity test) and where these are breached the losses are reduced. These rules are detailed in Part I of the Act.

Publishing of OIA response

We intend to publish our response to your request on Inland Revenue's website (www.ird.govt.nz) as this information may be of interest to other members of the public. This letter, with your personal details removed, will be published in its entirety. Publishing responses increases the availability of information to the public and is consistent with the OIA's purpose of enabling more effective participation in the making and administration of laws and policies and promoting the accountability of officials.

Thank you for your request.

Yours sincerely

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