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WEEKLY COMMENT: FRIDAY 1 AUGUST 2014

1. The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* ("the Employee Allowances Tax Amendment Act 2014 ") received the Royal assent on 30 June 2014. Last week I look at the amendments relating to black hole expenditure, other than the amendments relating to company administration costs.

2. This week I look at the company administration costs amendments and related expenses covered in IS 14/04 *Income tax: Deductibility of company administration costs* released by Inland Revenue on 22 July 2014. Next week I will look at the remaining types of expenses covered in IS 14/04.

Enacted amendment relating to expenses in paying dividends

3. Effective from the beginning of the 2014-15 income year, s. 50 of the Employee Allowances Tax Amendment Act 2014 has inserted a new s. DB 63, which allows a company a deduction for expenditure incurred in:

   (a) Authorising, allocating, or processing, the payment of a dividend; or

   (b) Resolving a dispute concerning authorising, allocating, or processing, the payment of a dividend.

4. The explanation in *Commentary* to the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* ("the *Commentary*") is as follows:

   "Proposed new section DB 63 of the Income Tax Act 2007 allows companies a deduction for all direct costs associated with the payment of a dividend. This does not include the amount of the dividend itself. …

   The dividend payment process involves authorising, allocating and paying the dividend, as well as addressing any disputes arising over its allocation. Expenditure incurred during this process is a mixture of capital and revenue. However, requiring taxpayers to separately track or apportion this expenditure into its deductible and non-deductible constituent parts could result in disproportionate compliance costs and uncertainty for taxpayers."

5. It is stated in paragraph 64 of IS 14/04 that, in the Commissioner's opinion, s. DB 63 provides a deduction for all expenses usually encountered by a company in paying dividends. (Note that this supercedes the Commissioner's previous view, expressed in the draft interpretation statement that preceded IS 14/04, that costs associated with allocating and paying dividends and disputes over dividends are not deductible because such costs are incurred in applying profits and/or are capital expenditure.)

Enacted amendment relating to periodic company listing fees

6. Effective from the beginning of the 2014-15 income year, s. 50 of the Employee Allowances Tax Amendment Act 2014 has inserted a new s. DB 63B, which allows a listed company a deduction for expenditure incurred as periodic fees of a recognised exchange for maintaining the registration of the company on the exchange.

7. It is noted in the *Commentary* that:

   "Listed companies incur expenditure on an annual listing fee to maintain registration on a recognised stock exchange. Allowing this expenditure to be deductible recognises that its benefit persists for one year only, and is a necessary expense for a listed company."

8. Note that "recognised exchange" is defined in s. YA 1 as a recognised exchange market in New Zealand or elsewhere or one that is approved by the Commissioner, with the three features of bringing together buyers and sellers, listing of prices, and provides a medium for the determination of arm's length prices. It is stated in IS 14/04 that generally licensed markets under the *Financial Markets Conduct Act 2013* will be a "recognised exchange" as defined.

9. Periodic listing fees are distinguished from initial or additional listing fees in IS 14/04. The Commissioner considers that the true character of the advantage sought or obtained by a company from incurring periodic listing fees is to maintain the advantages that the initial or additional listing fees have secured. It is noted in IS 14/04 that s. DB 63B allows a deduction for periodic listing fees to "all companies, whether or not they are carrying on a business or income-earning activity".

Initial and additional listing fees discussed in IS 14/04

10. By contrast, the Commissioner considers that initial and additional listing fees are not deductible on account of being capital expenditure. The reasons advanced in IS 14/04 are as follows:

    (a) Listing a company's shares or debt securities facilitates capital raising because it enhances the marketability of a company's securities by providing liquidity to investors;

    (b) Listing on the market raises the profile of a company and, therefore, helps build a company's goodwill;

    (c) While not all expenditure that creates goodwill is of a capital nature, listing fees paid to facilitate the acquisition of additional capital (equity or debt) are capital expenditure;

    (d) Case law has established that subscribing for shares is a contribution to the capital structure of the company (*FCT v The Midland Railway Co of Western Australia* [1952] HCA 5, (1952) 85 CLR 306) and expenditure incurred in borrowing money to raise capital is generally of a capital nature (*Texas Land & Mortgage Co v Holtham (Surveyor of Taxes)* (1894) 3 TC 255 (QB)).

11. There is a short discussion in IS 14/04 on expenditure on borrowing money that is deductible under s. DB 5 (discussed in detail in IS 13/03 *Income Tax – deductibility of expenditure incurred in borrowing money – Section DB 5*). To be expenditure incurred in borrowing money, the expenditure must be incurred under a contractual obligation entered into in connection with the establishment of a loan: *Ure v FCT* 80 ATC 4,264 (NSWSC). It was noted in the draft interpretation statement released in 2011 that preceded IS 14/04 that a

deduction would be available under s. DB 5 for listing fees paid in relation to the issue of debt securities.

Enacted amendments relating to direct costs of shareholders' meetings

12. Effective from the beginning of the 2014-15 income year, s. 50 of the Employee Allowances Tax Amendment Act 2014 has inserted a new s. DB 63C, which allows a company a deduction for expenditure incurred in holding an annual meeting of the shareholders of the company to consider the affairs of the company.

13. However, a deduction will specifically be denied for expenditure incurred in holding a special or extraordinary meeting of the shareholders of the company. This prohibition overrides the general permission, so that costs that may be ordinarily deductible are non-deductible if they relate to holding a special or extraordinary meeting.

14. It is stated in the *Commentary* that:

    "AGMs are an annual, recurring cost of doing business as a company, while special shareholder meetings are often held to consider a material change in the business of the company. Allowing a deduction for AGM costs while denying a deduction for special shareholder meeting costs ensures that taxpayers are not subject to disproportionate compliance costs or uncertainty over the tax treatment of shareholder meeting costs, and approximates the capital-revenue criteria."

15. It is stated in IS 14/04 that the Commissioner considers that expenditure incurred in holding a meeting comprises only the costs directly incurred in physically holding or conducting the meeting. Expenditure likely to be incurred by companies for a shareholders' meeting can be divided into two categories:

    (a) Expenditure in holding a meeting; and

    (b) Other expenditure incurred in relation to a meeting.

16. Only direct expenditure incurred in holding a meeting is deductible (for annual meetings) and non-deductible (for special meetings) under s. DB 63C. Direct expenditure in holding a meeting is listed in IS 14/04 as follows:

    (a) Venue hire and other costs related to preparation of the venue (e.g. hire of audiovisual equipment);

    (b) Refreshments provided to those attending the meeting;

    (c) Printing, publishing, postage and advertising of notices of the meeting;

    (d) Preparation of resolutions;

    (e) Travel for directors and other persons required to attend the meeting;

    (f) Any other costs directly related to physically holding or conducting the meeting.

17. Indirect expenditure, on the other hand, is not covered by s. DB 63C. This would include any other expenditure such as consultants' fees or internal costs incurred in the preparation of reports to the board specifically on matters concerning the meeting, and costs relating to determining the contents of meeting agendas, reports and shareholder resolutions, or polling shareholders on likely voting decisions.

Deductibility of indirect expenditure on meetings discussed in IS 14/04

18. IS 14/04 contains quite a detailed discussion on the deductibility of indirect expenditure incurred for various types of meetings:

    (a) An annual meeting;

    (b) A meeting to consider alteration of a company's constitution;

    (c) A meeting to consider alteration of shareholders' rights;

    (d) A meeting regarding making arrangements with creditors;

    (e) A meeting concerning liquidation of a company;

    (f) A meeting to approve a major transaction under the *Companies Act 1993*;

    (g) A meeting to consider ratification of directors' actions or breaches of their duty to the company; and

    (h) A meeting of a target company's shareholders to consider a takeover offer.

19. The general principle with *expenditure relating to alteration of a constitution* is that it is more likely to be capital expenditure related to the business entity, rather than to the carrying on of a business. However, two cases are cited that show that expenditure to alter a constitution could be deductible:

    (a) *Commissioners of Inland Revenue v Carron Company* (1968) 45 TC 18 (HL) is a well-known case where expenditure to obtain a supplementary charter, to expand the company's borrowing powers and remove restrictions on share transfers, was held to be deductible because the changes allowed the company's business to be financed more easily and carried on more efficiently; the expenditure was in the nature of repair and modernisation of the trading machinery (question whether modernisation would be a deductible expense under the Commissioner's IS 12/03 on repairs and maintenance); and

    (b) *Truckbase Corporation v The Queen* 2006 TCC 215, (2006) DTC 2,930 (TaxCC) is a Canadian case where redrafting of shareholder agreements (which apparently had the same function as a constitution) facilitated effective management and good governance and were, again comparable to "repairs" to the initial shareholder agreements.

20. The Commissioner considers that *expenditure incurred in altering the rights of shareholders* will not satisfy the general permission (*St George Bank Ltd v FCT* [2009] FCAFC 62 cited), except in circumstances where the rights of shareholders are altered in conjunction with an alteration to the company's constitution to obtain a revenue advantage (as in *Carron Company*). If the alteration of the rights of shareholders is merely ancillary or incidental to expenditure incurred for the purpose of the company's business activities, the expenditure would be deductible.

21. The Commissioner considers that *expenditure on a shareholders' meeting to consider directors' proposals relating to creditors* is deductible. *FCT v Snowden & Willson Pty Ltd* [1958] HCA 23, (1958) 99 CLR 431 suggests that expenditure incurred in enforcing debts owed to a taxpayer and in resisting claims by debtors of the taxpayer for a reduction of their liability is deductible. The Commissioner considers that expenditure in dealing with debts owed by a taxpayer to creditors will be similarly deductible. Such costs are not expenditure that is made "once and for all" and do not bring into existence an identifiable asset.

22. By contrast, *indirect meeting costs incurred for shareholders to consider the liquidation* of a company are not deductible, because:

    (a) The expenditure is incurred in disposing of a business and ceasing to derive income, rather than in deriving income;

    (b) If a company's business has ceased, the costs will not be incurred in the course of deriving income: *Amalgamated Zinc (de Bavay's) Ltd v FCT* [1935] HCA 81, (1935) 54 CLR 295;

    (c) Costs of appointing a liquidator are expenditure incurred to distribute a company's assets.

23. The Commissioner considers that *indirect meeting costs to consider major transactions* are most likely to be non-deductible because:

    (a) The company will, most probably, already be committed to the transaction (reference is made to IS 08/02 *Deductibility of feasibility expenditure* to support a commitment to a transaction even though it may be contingent on particular factors – in this case, contingent on shareholder approval); and

    (b) Expenditure incurred once a decision is made to proceed with an acquisition is more likely to be capital expenditure (again drawing on the discussion in IS 08/02); and

    (c) It is most likely that approval of a major transaction under s. 129 of the *Companies Act 1993* occurs after the company commits to a capital transaction.

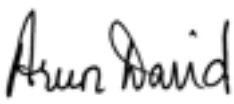
24. In the Commissioner's view, *expenditure incurred for a shareholders' meeting to consider the ratification of a breach of duty by directors* is deductible because it is incurred in exercising a management power in carrying on the company's business. The deductibility of the expenditure does not depend on the action that is ratified.

25. Finally, whether *expenditure incurred by a target company to allow shareholders to consider a takeover offer* is deductible depends on the facts of each case:

    (a) Expenditure incurred merely to provide information on a takeover offer to shareholders so as to obtain a capital benefit is capital expenditure and is not deductible. *FCT v The Swan Brewery Co Ltd* 91 ATC 4,637 (FCAFC) shows that expenditure incurred in fulfilling a statutory obligation to provide information on a takeover to shareholders related to the interests of the shareholders, and was not deductible.

    (b) Expenditure incurred in providing information to shareholders to prevent a takeover offer that would detrimentally affect the company's ability to continue its business in the same form was held to be deductible in *Boulangerie St-Augustin Inc v The Queen* 95 DTC 164 (TaxCC).

    (c) However, expenditure incurred in providing information on a takeover to shareholders to obtain a benefit of a capital nature is capital expenditure.



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