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Interpretation Statement - QWB00082 - Income Tax Deductibility of Farmhouse Expenses

Introduction

1. The New Zealand Law Society welcomes the opportunity to comment on Interpretation Statement *QWB00082 – Income Tax - Deductibility of Farmhouse Expenses* (Interpretation Statement).

2. The purpose of the Interpretation Statement, which is stated as applying mainly to sole traders and partnerships, is to withdraw and replace a number of long-standing policies concerning the deductibility of expenses relating to farms and farmhouses. For reasons unspecified by the Commissioner, other than the more complex nature of farm ownership structures that exist today, the deductibility treatment under these policies (listed at paragraph 23 of the Interpretation Statement) is no longer considered appropriate and it is proposed that the policies be withdrawn and replaced.

3. In order to bring deductibility of farmhouse expenditure, interest expenditure and fixed line telephone charges into line with the deductibility provision contained in Part D of the Income Tax Act 2007, the Commissioner proposes to withdraw the current blanket concession, which allows a flat 25% deduction for farmhouse expenses without any evidence as well as a 100% deduction for interest and rates.

4. The Interpretation Statement proposes that the deductibility criteria for farmhouse expenses will be based on the type of entity or structure that owns/operates the farming business, and who lives in the farmhouse.

5. Where the farm is owned and operated or leased and operated by a sole trader or partners of a partnership, there will be a requirement for the taxpayer to determine whether the farm is a "Type 1" or "Type 2" farm.[1] Where the farm falls into the Type 1 category and the sole trader or partner of the partnership lives in the farmhouse, the sole trader or partnership will be entitled to claim 15% of farmhouse expenses without the requirement to provide supporting evidence. Where however the farm falls within the Type 2 farm category and the sole trader

[1] A Type 1 farm is a farming businesses where the cost of the farmhouse (including curtilage and improvements) is 20% or less of the total cost of the farm (Type 1 farms) and a Type 2 farm is a farming businesses where the cost of the farmhouse (including curtilage and improvements) is more than 20% of the total cost of the farm.

or partner of the partnership lives in the farmhouse, the sole trader or partnership will be required to use the apportionment method (referred to as "the practical approach") which is outlined at paragraphs 90 to 103 of the Interpretation Statement.

6. The comments in this submission are limited to the application of the proposed "practical approach" to sole traders and partners of partnerships.

Comments

7. As stated at paragraph 80 of the Interpretation Statement, there is a clear prohibition in the Income Tax Act 2007 for the deductibility of expenses that are of a private or domestic nature. The general proposition is that an expense must be apportioned between business and private purposes.

8. The Commissioner states at paragraph 84 that expenses incurred on one's own house, including a farmhouse, are inherently private in nature. While acknowledging that part of a farmhouse can be used for business purposes, it is the Commissioner's view that to the extent that a farmhouse is used for business purposes, the deductibility of those expenses should be determined on the same basis as home office expenses using the approach in *CIR v Banks* (1978) 3 NZTC 61,236.

9. The Interpretation Statement provides at paragraphs 90 and 91 that:

    a. where it is possible to dissect an expense into deductible and non-deductible amounts, that method should be used first;

    b. where dissection is impracticable or impossible the expense will need to be apportioned on some fair and reasonable basis between the business and private portions of the expense.

10. The apportionment method prescribed requires the taxpayer to first determine whether or not they operate a Type 1 or Type 2 farm.

11. The Commissioner is of the view (at paragraph 91) that the likelihood of deductions being obtained for private expenditure is greatest in situations where:

    a. the person incurring the expense lives in the farmhouse; and

    b. the cost or value of the farmhouse represents a significant proportion of the overall cost or value of the farm.

12. The Commissioner's rationale therefore for the distinction between Type 1 and Type 2 farms is that in a Type 1 farm situation the farmhouse expenses are likely to represent a very small proportion of the overall cost of the farm, and therefore the private element of any expenses will be minimal.

13. To ensure that the compliance costs associated with calculating deductions for interest and the farmhouse expenses do not outweigh the tax consequences of any deductions available, the Commissioner has proposed prescribed levels of deductions that will be available for Type 1 farms without the requirement for supporting evidence. Therefore for Type 1 farms the Commissioner will accept that 15% of the farmhouse is used for business purposes without supporting evidence.

14. Type 1 farmers would still be entitled to do an actual use calculation if they consider that the business use of the farmhouse is greater than 15%. Farmers operating Type 1 farms would

also continue to be entitled to claim a deduction for 100% of interest relating to the farmhouse.

15. For farms that fall within the Type 2 category there is no prescribed minimum level of deductions that are available without evidence. All deductions must be determined under the general permission and general limitations contained in sections DA 1 and DA 2 of the Income Tax Act 2007.

16. Type 2 farmers may only claim deductions for expenses, including interest, which relate to the actual business use of the farmhouse. For expenses that relate to the farm and the farmhouse, the Commissioner will accept an apportionment of these expenses based on the cost of the farm and farmhouse (including curtilage and improvements made to the farmhouse). However when making the apportionment, the farmer must undertake a “home office” calculation like any other taxpayer that carries on their business from home. The calculation must be based on actual use (e.g., on a time and space basis) regardless of whether there is a dedicated home office or different parts of the house are used in the business.

17. The Law Society considers that the Type 2 approach is unlikely to meet the objective of balancing the strict application of the laws of deductibility with the associated cost of compliance, while maintaining equity between taxpayers. The suggested approach fails to recognise the unique nature of farming businesses by attempting to treat these taxpayers in the same way as any taxpayer who operates their business from home.

18. There are some significant differences between farming businesses and other types of taxpayer who operate businesses and/or derive income from their home. Typically a farmer is required to live at or very near to their place of work. This is because the nature of their work is tied to the land and farming is generally carried on 24 hours a day seven days a week, rather than typical business hours. For these reasons and others the farmhouse constitutes a significant building that often forms an integral part of the overall farming business.

19. A farming business in the Law Society’s view cannot readily be compared to any other business conducted from home. Farmhouses will more often than not be used for multiple functions within the farming business which extend beyond a typical home office as outlined in *Case N35* (1991) 13 NZTC 3,308. In order to carry out a calculation on a time and space basis, the taxpayer farmer would need to keep a daily record of the use of the farmhouse. The difficulty with adopting this type of approach is that it is possible that the cost of trying to calculate a fair apportionment based on time and space could well exceed the cost of the deductions claimed.

20. While the Law Society supports an apportionment method being prescribed for farmers, it does not consider that the proposed “practical approach” is in fact very practical.

21. The Commissioner is of the view that there is a greater likelihood of deductions being obtained for private expenditure in situations where:

    - the person incurring the farmhouse expenditure lives in the farmhouse; and
    - the cost or value of the farmhouse represents a significant portion of the overall cost or value of the farm.

22. It is possible that the opposite may be true, in that a taxpayer who lives in the farmhouse could feasibly have a higher degree of deductible expenditure because the farmhouse

probably forms an integral and necessary part of the farming business that more often than not requires the farmer to be on the farm or close to the farm.

23. It is also feasible that some farming business that do not require large areas of land to operate the farming business are more likely fall into the Type 2 category than Type 1. These types of farming taxpayers may be operating small-scale business and under the proposed approach are more likely to incur high compliance costs which would outweigh the benefit of claiming the deductions.

24. The summary set out at paragraph 118 fails to account for a number of different scenarios that could occur. For example, where the farm land is owned by a trust but the use and occupation of the land and the farmhouse is provided to a beneficiary of the trust who operates the farming business as a partnership (e.g. a husband and wife partnership).

25. It is common that the trustees will grant a beneficiary the use and occupation of the land and farmhouse for no consideration or on the basis that the beneficiary meets all the outgoings in relation to the land/farmhouse. Often this can occur without there being a formal lease in place as between the trustees of the trust and the beneficiaries who operate the farming business from the trust land.

26. Based on example 7, the partnership would only be entitled to claim deductions for farmhouse expenses if there was a lease in place as between the trustees of the trust and the partnership. Further, the Type 1 and Type 2 distinction would be required to be carried out based on the cost of the farm to the trust, given that the beneficiary partnership does not own the farm or farmhouse and as such there is "cost" to the partnership for the purpose of determining whether the farm is a Type 1 or Type 2 farm.

27. If the Commissioner is going to make distinctions between various types of entities or structures for the purposes of determining the ability to claim deductions for farmhouse expenses, then further categories and examples of numerous types of scenarios that could occur will need to be created/provided.

28. The Law Society is supportive of the Commissioner providing a method to enable farming taxpayers to determine the deductibility of expenditure in a clear and cost-effective way, however the rationale for Type 1 and Type 2 farmers does not necessarily achieve this objective.

29. The Law Society agrees that a de minimis threshold for deductions without evidence should continue, but considers that concessions should be available without the need for a distinction between Type 1 and Type 2 farms.

Conclusion

30. This submission was prepared with assistance from the Law Society’s Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

Kathryn Beck
President