

INTERPRETATION STATEMENT: IS 17/02

INCOME TAX – DEDUCTIBILITY OF FARMHOUSE EXPENSES

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

This Interpretation Statement considers the deductibility of expenditure relating to a farmhouse that forms part of a farming business. The Interpretation Statement withdraws and replaces a number of *Public Information Bulletin* and *Tax Information Bulletin* items about certain expenses for which farmers can claim deductions (these are listed at [24] of this Interpretation Statement). According to these items, the Commissioner has permitted full-time farmers to claim full deductions for both rates and interest payable on farm mortgages, and has allowed all farmers to claim 25% deductions on expenses relating to the farmhouse. The Commissioner considers that the deductions allowed in those items are no longer appropriate and the general rules of deductibility and apportionment, as explained in this Interpretation Statement, will apply.

However, in situations where the compliance costs of calculating the private use element far outweighs any likely deduction, the Interpretation Statement allows some sole traders and partners of partnerships to claim an automatic 20% deduction (a more realistic amount) for farmhouse expenses and 100% deductions for rates and interest. These deductions are allowed when the value of the farmhouse is 20% or less than the total value of the farm. This Interpretation Statement will apply from the commencement of a taxpayer's 2017-2018 income year.

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Summary

1. The Commissioner has a number of long-standing policies concerning the deductibility of expenses relating to farms and farmhouses. These policies appear to have originated in the 1960s at a time when farm ownership and operating structures were generally less complicated than they are today. As part of the process of reviewing the existing policies, the Commissioner has also sought to clarify the principles for deductibility across a variety of ownership structures.
2. In reviewing these policies, the Commissioner's main concern is to allow farmers to deduct farmhouse expenses that are business related, while ensuring that deductions are not claimed for expenses that are private in nature. In undertaking this exercise, the Commissioner needs to balance the strict application of the law with the associated compliance costs of doing so, while maintaining equity between taxpayers and protecting the integrity of the tax system.
3. Farming businesses may be structured in many different ways. Whether farmhouse expenses are deductible will depend on a number of factors, including who owns the farmhouse, who operates the farming business, and who lives in the farmhouse.
4. Against this background, deductions being obtained for private expenditure is most likely in situations where:
 - the person incurring the farmhouse expenditure lives in the farmhouse; and
 - the value of the farmhouse represents a significant proportion of the total value of the farm.
5. A person living in the farmhouse and incurring the farmhouse expenditure will be a natural person and could be any of the following:
 - a sole trader (see [77]);
 - a partner in a partnership (see [77];
 - an employee or shareholder-employee (see [112]);
 - a shareholder, beneficiary or other natural person not involved in the farming business (see [114]).
6. While the principles in this Interpretation Statement apply mainly to sole traders and partners in partnerships, a summary of the treatment of farmhouse expenses incurred by different entities in different situations may be found in the table at [126].

General principles

7. The deductibility of expenditure relating to a farmhouse (farmhouse expenses) must be determined under the general permission, general limitations and the specific deduction provisions in Part D of the Income Tax Act 2007. A deduction is available under the general permission only where the expenses have the necessary relationship both with:
 - the taxpayer concerned, and
 - the gaining or producing of their assessable income or with the carrying on of a business for that purpose.
 - It is a matter of degree and a question of fact whether a sufficient relationship exists. For example, a person operating a farming business may claim a full deduction for farmhouse expenses where the farmhouse is rented out or provided to an employee.
8. It is important to note that this Interpretation Statement is only concerned with farming operations that are businesses. For more information on what constitutes a business, please see the discussion of *Grieve v CIR* (1984) 6 NZTC 61,682 (CA) in the commentary to BR Pub 09/06: "Lease surrender payments received by a landlord – Income tax treatment" (*Tax Information Bulletin* Vol 21, No 6 (August 2009): 37).
9. If an expense satisfies the general permission, it may still not be deductible due to the application of the general limitations. For example, a person is denied a deduction for an expense to the extent to which it is of a capital nature. For farmhouse expenses, the private limitation may apply where the person incurring the expenses lives in the farmhouse. When a person lives in a farmhouse, any expense they incur on that farmhouse must be apportioned between business and private use based on the particular facts in each case. This is the same treatment that applies for expenses incurred by other taxpayers on private houses when they are used for business purposes, eg, home offices.
10. Some expenses may be deductible under a specific provision in Part D. For example, most companies need no nexus with income to claim a deduction for interest expenses. For other taxpayers, interest expenses will still need to satisfy the general permission to give rise to a deduction.
11. Generally, for all farming businesses, where it is possible to **dissect** an expense into deductible and non-deductible amounts, that method should be used first (see [62] and [66] below). Where an expense relates to both the business and private use of the farmhouse, **dissection** may be impractical or impossible. In this situation, the expense will need to be **apportioned** on some fair and reasonable basis between the business and private portions of the expense. **Apportionment** will be necessary when a farmer lives in the farmhouse and uses part of it for business purposes (see table at [126] below). This will generally arise, for example, when sole traders and partners of partnerships live in the farmhouse. The Commissioner considers that apportionment of farmhouse expenses based on time and space would generally be an appropriate method. This is consistent with other businesses.
12. On the other hand, some expenses will be incurred on the farm as a whole (including the farmhouse). In this situation, the proportion of the expenses that relate to the private use of the farmhouse must be determined. An apportionment based on time and space might not provide an accurate division between expenses that relate to the farmhouse and expenses that relate to the rest of the farm. The Commissioner considers that an appropriate method of apportionment is one that is based on the value of the farmhouse (being the value of the farmhouse,

curtilage and improvements to the farmhouse) as a proportion of the total value of the farm and improvements. The Commissioner will accept a formal valuation or a reasonable estimate of the values of the farmhouse (including curtilage and improvements) and farm. The relative costs of the farm and farmhouse may be a reliable approximation of value at a particular point in time.

13. These general principles apply to all farming businesses, regardless of the type of entity incurring the expenditure and the ownership structure of the farming business.

Reducing compliance costs where private element of farmhouse expenses is minimal

14. For larger farming businesses carried on by sole traders and partners in partnerships, the farmhouse may represent a small proportion of the overall value of the farm. In this situation, the private element of any expenses will be minimal. However, the compliance costs associated with calculating deductions for interest and other farmhouse expenses outweigh the tax consequences of any deductions available. Accordingly, this Interpretation Statement sets out circumstances in which the Commissioner will accept prescribed levels of deductions for farmhouse expenses incurred by sole traders and partners who live in the farmhouse. This is instead of always requiring deductions for farmhouse expenses to be based on actual use.
15. The Commissioner will accept a practical approach to apportioning farmhouse expenses in this situation. This approach has been developed to mitigate compliance costs for farms with a low private-use element. The approach is based on a new distinction between:
 - farming businesses where the value of the farmhouse (including curtilage and improvements) is 20% or less of the total value of the farm (Type 1 farms); and
 - farming businesses where the value of the farmhouse (including curtilage and improvements) is more than 20% of the total value of the farm (Type 2 farms).
16. The value of the farmhouse (including curtilage and improvements) and farm can be used to determine the extent of the private use of the farmhouse. The Commissioner will accept a formal valuation or a reasonable estimate of the values of the farmhouse (including curtilage and improvements) and farm. To reduce compliance costs, the respective costs of the farmhouse and farm may also be used to determine whether the farm is a Type 1 or Type 2 farm.
17. The term “curtilage” refers to the land surrounding the farmhouse that is used primarily for private purposes. The curtilage may be fenced (like a backyard) or not. If the curtilage is not fenced, the Commissioner will accept a reasonable estimate of the curtilage area and its value.
18. Farmers who live in the farmhouse on Type 1 farms may determine whether expenses are deductible under the general permission and general limitations as set out in this Interpretation Statement. However, the Commissioner will also accept that 20% of the farmhouse is used for business purposes without any supporting evidence. As a result, such farmers can claim 20% of all farmhouse expenses as deductible business expenses. In addition, these farmers may continue to claim 100% of the interest costs relating to the farmhouse and 100% of rates.

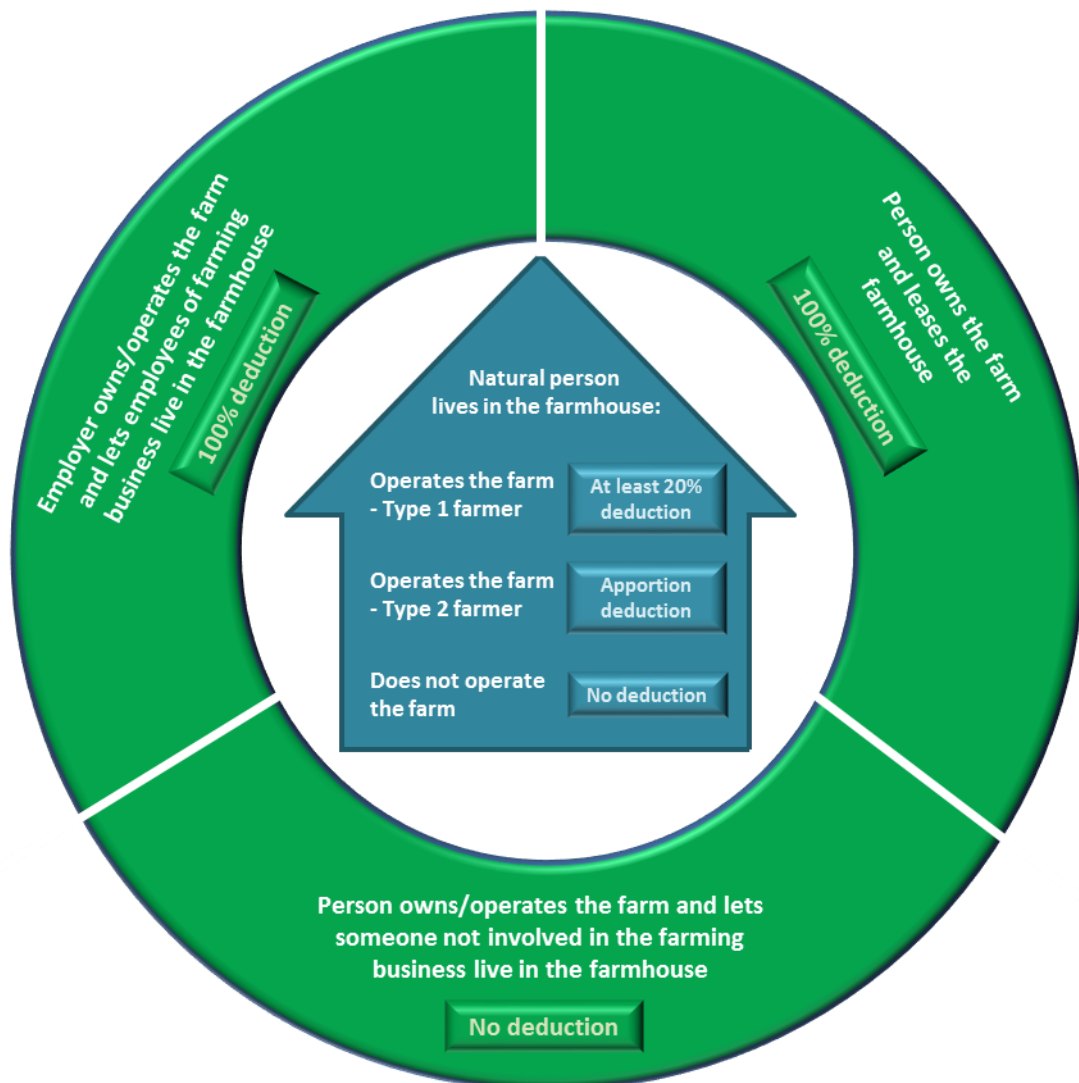
19. Farmers who live in the farmhouse on Type 2 farms must determine whether expenses are deductible under the general permission and general limitations as set out in this Interpretation Statement.

Telephone rental and fixed line charges

20. Farmers who operate their business from home may claim 50% of their telephone rental charges, unless they can show that the actual business use of the telephone is greater than 50%. This is the existing practice for other home based businesses.

Approach in this Interpretation Statement

21. This Interpretation Statement applies the general principles to two broad situations:
- a person who lives in the farmhouse and incurs farmhouse expenses (see discussion from [74] below); and
 - a person who does not live in the farmhouse and incurs farmhouse expenses (see discussion from [116] below).
22. The following diagram provides a general summary of the treatment of farmhouse expenses incurred by persons in various capacities. The diagram assumes that the other general limitations (other than the private limitation) do not apply. Unless otherwise indicated, a person can include a sole trader, partner in a partnership, trustee, or company. For more detailed summaries, please refer to the tables at [111] and [126].



Introduction

23. This Interpretation Statement is about the Commissioner's long-standing policy to allow full-time farmers to claim full deductions for rates and interest and all farmers to claim 25% of the expenses relating to the farmhouse (eg, insurance, electricity, repairs and maintenance, etc). Many of these concessions were negotiated with the farming industry in the 1960s. This Interpretation Statement updates and replaces these concessions with a revised approach.
24. This Interpretation Statement supersedes all previous Inland Revenue statements on farmhouse expenses. The following publications state that the Commissioner will allow farmers to claim deductions for certain expenses incurred on the farmhouse:
 - 'New Arrangements With Farmers — Some Further Deductions', *Public Information Bulletin* No 14 (September 1964): 6;
 - 'Farmers leasing Farm from Trust – Rental Portion Applicable to Dwellings', *Public Information Bulletin* No 89 (January 1977): 4;

- 'Policies We're Reviewing', *Tax Information Bulletin* Vol 4, No 8 (April 1993): 3;
 - 'Farmhouse interior decoration expenses – deductibility', *Tax Information Bulletin* Vol 6, No 14 (June 1995): 24; and
 - 'Farm lease payments – deduction for cottage', *Tax Information Bulletin* Vol 7, No 8 (February 1996): 32.
25. In addition to the specific deductions set out in these publications, it was generally accepted that the Commissioner would allow a deduction of 25% of farmhouse expenses to reflect the use of the farmhouse as an administrative base for the farm.
26. The following deductions for farmhouse expenses have generally been accepted as available to farmers:
- mortgage interest on the farm, including the farmhouse, for full-time farmers (100%);
 - rates (100%);
 - home telephone rental for full-time farmers (100%);
 - electricity for the farmhouse (25%);
 - repairs and maintenance for the farmhouse (25%);
 - farmhouse interior decoration expenses (25%);
 - general deduction for expenses for the farmhouse (25%); and
 - rent applicable to a farmhouse when the farmer leases the farm (25%).
27. To the extent that they refer to these deductions, the publications listed at [24] are updated and replaced by this Interpretation Statement.
28. In addition, the policy statement on 'Telephone rental deductions for businesses based at home', *Tax Information Bulletin* Vol 5, No 12 (May 1994): 2, explicitly did not apply to farmers. The policy statement said that farmers could continue to claim 100% deductions for the cost of telephone rental for farmhouse telephones. This Interpretation Statement modifies that position and farmers are now allowed the same deductions as other taxpayers. All farmers who operate their business from home must now follow the existing practice of other home based businesses and claim up to 50% of the cost of telephone rental, unless they can show that the actual business use of the telephone is greater and a higher percentage is justified.

Analysis

29. This Interpretation Statement considers the deductibility of farmhouse expenses. A farmhouse is one example of a building on a farm property. As with other types of expenses, the starting point is the general permission and general limitations. In addition, specific deductions may be available under other provisions in Part D.
30. The first part of this Interpretation Statement sets out the general principles of deductibility and discusses some of the specific deduction provisions that might apply to farmhouse expenses. In addition, this Interpretation Statement discusses some methods of dissecting and apportioning farmhouse expenses that are not fully deductible. This Interpretation Statement then applies these principles to two broad scenarios:
- the farmhouse expenses are incurred by a person living in the farmhouse; and

- the farmhouse expenses are incurred by a person not living in the farmhouse.
31. The second part of this Interpretation Statement then sets out a practical approach to apportioning farmhouse expenses that the Commissioner will accept.
 32. The final part of this Interpretation Statement sets out some examples that illustrate how the general principles and the practical approach set out in this Interpretation Statement apply to some common situations.

Deductibility of expenses

33. There are many different ways that farming businesses are structured. Whether farmhouse expenses are deductible will depend on a number of factors, including who owns the farmhouse, who operates the farming business and who lives in the farmhouse.
34. It is important to note that this Interpretation Statement is only concerned with farming operations that are businesses. For more information on what constitutes a business, please see the discussion of *Grieve v CIR* (1984) 6 NZTC 61,682 (CA) in the commentary to BR Pub 09/06: "Lease surrender payments received by a landlord – Income tax treatment" (*Tax Information Bulletin* Vol 21, No 6 (August 2009): 37).
35. The general rules for deductions are contained in subpart DA of the Act. In short, the deductibility of an expense is determined as follows:
 - The general permission must be satisfied in any situation where a deduction is sought by a taxpayer (s DA 1).
 - Even if the general permission is satisfied, a deduction for such an expense may be denied if a general limitation applies (s DA 2).
 - However, the subparts that follow subpart DA provide for specific rules that may apply to supplement or override both the general permission and the general limitations (s DA 3(1) and (4)).
36. In addition, as will be discussed below, some expenses may need to be dissected or apportioned between deductible and non-deductible amounts.

General permission

37. The general permission is contained in s DA 1. Section DA 1(1) and (2) provide:

DA 1 General permission

Nexus with income

- (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
 - (a) incurred by them in deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income; or
 - (b) incurred by them in the course of carrying on a business for the purpose of deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income.

General permission

- (2) Subsection (1) is called the **general permission**.

38. Section DA 1 therefore provides two bases for deduction:
- The first is for expenses or losses incurred by the person in deriving their assessable or excluded income (see s DA 1(1)(a)).
 - The second is for expenses or losses incurred in carrying on a business for the purpose of deriving assessable or excluded income (s DA 1(1)(b)).
39. The leading authorities on the principles of deductibility are the Court of Appeal judgments in *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Limited v CIR* (1978) 3 NZTC 61,271. These cases are authority for the following principles:
- A deduction is available under the general permission where the expense has the necessary relationship both with the taxpayer concerned and with either the gaining or producing of their assessable income or with the carrying on of a business for that purpose. This requires a focus on the relationship between the advantage gained or sought to be gained by the expense and the income-earning process, which in turn requires a focus on the true character of the payment made.
 - It is a matter of degree and a question of fact whether such a sufficient relationship exists.
 - The phrase "to the extent to which" contemplates that an expense may be apportioned between its deductible and non-deductible components.
40. For an expense to be deductible under s DA 1, a sufficient relationship (nexus) must exist between the expense incurred by the taxpayer and the deriving of assessable income or the carrying on of a business for the purpose of deriving assessable income.
41. It is important to note that in determining the deductibility of an expense, the focus is on the character of the expense from the point of view of the taxpayer who has incurred the expense. This may be determined by identifying the advantage gained or sought to be gained by the taxpayer in incurring that expense.
42. Whether an expense is deductible will depend on the particular facts of each case. In the context of farmhouse expenses, it will be necessary to determine who has incurred the expense and in what capacity.
43. However, a deduction is not available under s DA 1 to the extent the general limitations in s DA 2 apply.

General limitations

44. The general limitations are contained in s DA 2. The limitations that will most commonly apply to farmhouse expenses are the capital limitation, private limitation and employment limitation. Section DA 2 relevantly provides:

DA 2 General limitations

Capital limitation

- (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

Private limitation

- (2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

...

Employment limitation

- (4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.

....

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

45. This Interpretation Statement primarily considers the application of the private limitation and the employment limitation to determine whether an expense is deductible. Under s DA 2(2), a person is denied a deduction for an expense to the extent to which it is of a private or domestic nature. Under s DA 2(4), a person is denied a deduction for an expense to the extent to which it is incurred in deriving income from employment.
46. However, in any given situation, it is important to determine whether any of the other general limitations apply. This will depend on the particular facts of each case. For example, under s DA 2(1), a person is denied a deduction for an expense to the extent to which it is of a capital nature. The capital limitation is beyond the scope of this Interpretation Statement. For more information and analysis on the application of the capital limitation, please see IS 12/03: "Income Tax – Deductibility of repairs and maintenance expenditure – general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68.
47. The general limitations override the general permission: s DA 2(7). However, the general limitations need not be applied unless the expense first has the requisite nexus with deriving income and satisfies the general permission.

Special provisions relating to interest

48. Deductibility of interest is determined under ss DB 6 and DB 7. Section DB 6 overrides the capital limitation, but the general permission must still be satisfied and the other general limitations still apply: s DB 6(4). Section DB 7 (which applies to most companies) supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply: s DB 7(8).
49. Under s DB 6, a person is allowed a deduction for any interest incurred, except for penalty interest under s DB 1. An interest deduction is not subject to the capital limitation. However, any interest deduction must still satisfy the general permission in s DA 1 (ie, a nexus must still exist between the interest incurred and the assessable income derived) and is subject to the other general limitations (including the private limitation).
50. How the borrowed capital was used must be considered when determining whether interest incurred is deductible: *Pacific Rendezvous Limited v CIR* (1986) 8 NZTC 5,146 (CA); *Eggers v CIR* (1988) 10 NZTC 5,153 (CA); and *CIR v Brierley* (1990) 12 NZTC 7,184 (CA). As Richardson J suggests in *Banks* at 61,246, determining the deductibility of interest will ordinarily involve the same considerations as determining the deductibility of other expenses under the general permission. Under the current legislation, this is because interest expenses must satisfy the general permission to be deductible: s DB 6(4).
51. Under s DB 7, most companies need no nexus with income to claim a deduction for interest expenses. Where s DB 7 does not apply to a particular company (for instance qualifying companies), interest expenses will need to satisfy s DB 6 to be deductible.

Deductions available under other regimes

52. The following discussion briefly explains some other regimes in the Act that may apply when considering the deductibility of farmhouse expenses.

Employer pays employee remuneration

53. Expenses incurred by an employer on employee remuneration are generally deductible to the employer under the general permission. This is because employee remuneration expenses, such as salary and wages, are an ordinary incidence of carrying on a business. (However, some employee expenses may still be subject to the capital limitation: *Christchurch Press Company Ltd v CIR* (1993) 15 NZTC 10,206 (HC).)
54. Expenses incurred by the employer in providing accommodation to an employee in connection with their employment (s CE 1B) and maintaining that accommodation will also generally be deductible to the employer under the general permission. The value of accommodation provided to an employee under s CE 1B is income to the employee under s CE 1. Commissioner's Statement CS 16/02 – Determining "Market Rental Value" of Employer-Provided Accommodation provides guidance on determining the value of farm housing provided to employees.

Employer incurs expenses on account of, or reimburses, an employee

55. An employer may reimburse an employee for expenses the employee incurs in connection with their employment. Alternatively, an employer might pay for expenses incurred by an employee as "expenditure on account" of that employee. In both these situations, the employee has incurred the expenses. These amounts will be deductible to the employer if the general permission is satisfied.
56. These amounts will be exempt income to the employee to the extent the employee would be allowed a deduction if they incurred the expenses and if the employment limitation did not exist: ss CW 17(1) and (2). This is provided the expenses are not private or capital in nature. Where the expenditure on account or reimbursement does not satisfy ss CW 17(1) or (2), those amounts will be assessable to the employee under s CE 1.

Employer provides employee with fringe benefit

57. Costs incurred by an employer in providing a fringe benefit will be deductible if the general permission is satisfied.
58. In some situations an employer may incur expenses to provide an employee with a non-monetary benefit in connection with their employment. An example might be where an employer incurs and pays the employee's power bill (or other expenses for the private use of a farmhouse). The "on premises exemption" in s CX 23 does not apply because "premises of a person" is defined to exclude premises occupied by an employee of the person for residential purposes. Therefore the employee has received an unclassified fringe benefit under s CX 37. The employer will be liable for fringe benefit tax to the value of the fringe benefit.

Company pays dividends to shareholders and shareholder-employees

59. Dividends paid by a company are not deductible. A dividend is a transfer of value from a company to a shareholder where the cause of the transfer is their shareholding in the company. An example might be where a company allows a shareholder (who is not an employee) to live in a farmhouse for no rent or for rent less than market value. Another example is where a company pays any private expenses on behalf of a shareholder in that company or incurs expenses that would have been private had they been incurred by the shareholder. Such amounts will be dividends to the shareholder. A dividend derived by a person is income of the person: s CD 1.

60. Section CD 20(1) provides that an unclassified fringe benefit provided by a company to a shareholder-employee may be treated as a dividend if the company so elects.

Appropriate methods of apportionment

61. The general permission and general limitations use the phrase "to the extent". It is well accepted that this phrase indicates that an expense may need to be apportioned into deductible and non-deductible amounts. An example is where the farmhouse is used for both business and private purposes. Apportionment may also be necessary under a specific deduction provision (if that provision does not override the general permission or general limitations).
62. The leading case on apportionment in New Zealand is *Banks*. In *Banks*, Richardson J drew a distinction between dissecting and apportioning expenses. This distinction was drawn from the Australian High Court decision of *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 59. Where an expense has distinct and severable deductible and non-deductible components, it can be divided or dissected. An amount may be dissected where there are distinct and severable components that are subject to different tax treatments (such as assessable and non-assessable income, or revenue and capital, or private expenses). Dissection would be possible, for example, for a composite amount that relates to an itemised invoice or to several things or services with discrete parts.
63. In contrast, where a single outlay serves two or more objects indifferently, dissection is impractical. Here, apportionment on a fair and reasonable basis (such as time, area or some other quantifiable basis) applies.
64. In *Buckley & Young*, Richardson J considered at 61,282, what apportionment method would be appropriate for a house used for both business and private purposes:
- The circumstances of the particular case will usually determine what is the most apt way of deciding how much of the expenditure is attributable to the deductible item. For example, where an asset, such as a house or car, is used for both business and private purposes, the apportionment of total expenses may fairly be based on the use (and in some cases availability for use) for business purposes and private purposes respectively. Even so, it is impossible to prescribe any precise formula applicable to all cases. Each such case depends on its own circumstances. It is the yardstick of factual use, or availability for use for business purposes, that satisfies the requirements that the apportionment must be fair, not arbitrary, and must be done as a matter of fact.
65. The Commissioner considers that, based on *Banks*, a general rule of apportionment of farmhouse expenses is not appropriate and each case must be considered on its own facts.
66. The Commissioner considers that where it is possible to dissect expenses into deductible and non-deductible amounts, that method should be used first. This may be possible, for example, with premiums for insurance policies on wholly private assets, private toll calls, and rates charges that are specifically charged on private houses (ie, the amounts are charged per house). Where dissection is impractical or impossible, the expense will need to be apportioned on some fair and reasonable basis.
67. Where an expense relates only to the farmhouse, and cannot be dissected between deductible and non-deductible amounts, the expense will need to be apportioned. The Commissioner considers that apportionment of farmhouse expenses based on time and space will generally be an appropriate method. This was the method used by the taxpayer in *Banks* and accepted by the Court of Appeal. Such expenses would include household electricity, repairs and maintenance, telephone

rental and fixed line charges, insurance policies that only cover the farmhouse and other expenses incurred only on the farmhouse.

68. Some expenses will be incurred on the farm as a whole (including the farmhouse). In this situation, the proportion of the expense that relates to the private use of the farmhouse must be determined. Also, some expenses will be calculated with reference to the value of the farm and improvements. In these situations, the Commissioner considers that an appropriate method of apportionment is one that is based on the value of the farmhouse (being the value of the farmhouse, curtilage and improvements to the farmhouse) as a proportion of the total value of the farm and improvements. This is because an apportionment based on time and space might not provide an accurate division between expenses that relate to the farmhouse and expenses that relate to the rest of the farm. An example where an area-based apportionment might not be appropriate is where the farmhouse is a small proportion of the area of the farm, but a high proportion of the value of the farm.
69. The Commissioner will accept a formal valuation or a reasonable estimate of the values of the farmhouse (including curtilage and improvements) and farm. In order to reduce compliance costs, the Commissioner will also allow farmers to use the respective costs of the farm and farmhouse. The costs of the farm and farmhouse must be comparable and show the relative market values at a particular point in time.
70. However, the time and space method could still be used to calculate how much of the farmhouse expenses are used for business purposes and are therefore deductible. Expenses that might warrant using such a method include mortgage interest attributable to the farmhouse.
71. In addition to the deductions allowed under the Act as set out above, the Commissioner will accept an updated approach to the apportionment of farmhouse expenses in place of the original policies. This approach is explained below under the heading 'Practical Approach' (see below from [91]).

Application of the general principles

72. As noted above, the Commissioner's various policy statements have applied for many years. Some of the policy statements assume that the farm is owned by an individual or partnership. These days, farm ownership is often more complicated, with companies and trusts involved in the ownership structure. Further, often the farming assets are not owned by the entity that carries on the farming business. All of these different structures and options make it difficult for the Commissioner to set out the correct tax treatment for each variation.
73. However, having considered a range of different structures, the Commissioner considers that the most useful distinction to draw for people incurring farmhouse expenses is between those where the person incurring the expenditure lives in the farmhouse and those where they do not.

Farmhouse expenses incurred by a person living in the farmhouse

74. The following analysis considers the deductibility of farmhouse expenses incurred by each type of person living in a farmhouse. Because of similarities of treatment, they are grouped as follows:
- sole traders and partners in partnerships who operate the farming business;
 - employees and shareholder-employees;
 - shareholders, beneficiaries of trusts and other natural persons who are not involved in operating the farming business.

75. The occupants of the farmhouse might own or rent the farmhouse, or they might be provided the farmhouse as accommodation (eg, under a trust deed, or as part of their employment).
76. It is important to remember that for the general permission to be satisfied, the person incurring the expense must be deriving income from the farm or farmhouse.

Sole traders and partners in partnerships who operate the farming business

77. Some farms are owned and operated by sole traders or partnerships. Such persons may live in the farmhouse and derive business income from the farm. The following analysis shows that where they incur farmhouse expenses:
 - expenses incurred on one's own shelter are inherently private;
 - no distinction exists between full-time and part-time farmers; and
 - farmhouse expenses may be deducted to the extent that the farmhouse is used for the farming business.

Expenses incurred on one's own shelter are inherently private

78. In *CIR v Haenga* (1985) 7 NZTC 5,198, Richardson J in the Court of Appeal considered that an expense properly characterised as consumption (eg, food, clothing and shelter) is not incidental and relevant to the derivation of income merely because it is necessary in the sense that it maintains the individual and, in turn, his or her ability to perform his or her employment.
79. In *Hunter v CIR* (1989) 11 NZTC 6,242 (HC), the taxpayer sought to claim a deduction for the expenses he incurred in relocating to a new city where those expenses exceeded his reimbursement entitlement. The expenses related to the sale of his family home and the purchase of a new one. The issue was whether these expenses were private or domestic in nature and therefore not deductible. McGechan J in the High Court held that the relocation expenses were incurred primarily for private or domestic purposes. McGechan J suggested that determining where the line falls is an exercise of judgment based on the facts of the case, at 6,260:

As *Haenga's* case illustrates, an expenditure which in its essential character may seem a paradigm case of private or domestic expenditure may as a result of other factors be characterised otherwise. It is useful to look for nexus between the expenditure, and the income production or intended income production. In the end, whether there is sufficient nexus to take an expenditure out of the private or domestic character and into a deductible work-related classification involves a value judgment. It may simply be putting the matter another way to apply a test distinguishing between pre-requisite to earning income, and actual participation in the income earning process. In the end, an overall view must be taken. As with the ancient jibe about obscenity, at times private or domestic expenditure can be difficult to define but not unduly difficult to recognise.

80. That a farmhouse is essentially private in nature is supported by the following Taxation Review Authority (TRA) decisions: *Case E11* (1981) 5 NZTC 59,064; *Case F47* (1983) 6 NZTC 59,801; *Case G13* (1985) 7 NZTC 1,048; *Case J33* (1987) 9 NZTC 1,190; *Case K57* (1988) 10 NZTC 465. In addition, two TRA cases concerning private houses on business premises support this view: *Case H12* (1986) 8 NZTC 168, and *Case L81* (1989) 11 NZTC 1,468.
81. There is a clear prohibition in the Act for deductibility of an expense that is, in reality, of a private or domestic nature. The cases, including the Court of Appeal decision in *Haenga*, seem clear that expenses on food, clothing and shelter are private or domestic in nature when incurred by the person obtaining the benefit of the expenses. If the expense is private in nature, then no deduction is permitted

for that expense because the general limitations override the general permission. Like the enquiry into statutory nexus, the enquiry into whether an expense is of a private or domestic nature is focused primarily on the advantage sought by the payer.

82. Despite clear authority for the proposition that an expense incurred on one's own house is private or domestic in nature, it is sometimes suggested that farmhouse expenses are fully deductible on the basis that a farmhouse is a "necessary adjunct" to a farming business. It is argued that the farmhouse is the "headquarters" for the farm and is needed on the farm to allow the farmer to be available at all hours of the day to see to stock and machinery and to afford a measure of security against theft and vandalism. Some support for this argument is found in the TRA decision in *Case N35* (1991) 13 NZTC 3,308.
83. In *Case N35*, the taxpayer was involved in a horticultural venture with her husband. One of the issues in this case was whether the deductions claimed for interest payments on the mortgage on the property should be apportioned to exclude any private or domestic expenses. Keane DJ acknowledged that the land was not fully committed to the income-earning process and observed that the "predominant use" of the land was for business purposes. However, Keane DJ went on to accept the taxpayer's contention that the home was a "necessary adjunct" to the business. Keane DJ then concluded that the land devoted to the home "does not warrant separate treatment". Keane DJ's decision that no adjustment was required appears to be based on the view that the private use of the land was of a "de minimis" nature.
84. However, the general proposition is that an expense must be apportioned between business and private purposes. The Commissioner considers that the decision in *Case N35* should be confined to its facts and should not be relied on as authority for the proposition that a farmhouse is a necessary adjunct to the farming operation. The Commissioner considers that proposition is not sustainable and is inconsistent with the cases mentioned above, including the Court of Appeal decision in *Haenga*.
85. Therefore, an expense incurred on one's own house, including a farmhouse, is inherently private in nature. But, that is not to say that parts of a farmhouse cannot be used for business purposes. Like the home office in *Banks*, to the extent that a farmhouse is used for business purposes, the expenses incurred on the farmhouse will have the requisite nexus with the derivation of income. In this situation, the expenses on the farmhouse would need to be apportioned between business and private use.

No distinction between full-time and part-time farmers

86. In the past, the Commissioner has allowed certain deductions based on whether a farmer worked on the farm on a full-time or part-time basis. However, there is no distinction in the Act between full-time and part-time farmers.
87. Instead, a deduction for an expense is allowed to the extent to which the general permission is satisfied and the general limitations do not apply. Therefore, if the taxpayer can prove that the expense has the requisite nexus with the derivation of income, then that expense will be deductible. The fact that a farmer only works part time on their farm is not relevant.

Farmhouse expenses may be deducted to the extent that they are used for the business

88. Parts of the farmhouse may be used for business purposes. In this situation, an expense relating to a farmhouse needs to be apportioned between business and

private use. An example might be where a farmer uses a room in the farmhouse as an administrative base for the farming business.

89. The farmhouse could have a designated room used for the farming business (eg, a home office). Alternatively, different parts of the house may be used at different times for business purposes. For example, the kitchen may be used to provide lunch to farm workers each day, or the dining room may be used to do the farm accounts once a week.
90. In these situations, there will need to be apportionment between business and private use of the farmhouse (see above from [61]).

Practical Approach

91. Where it is possible to dissect an expense into deductible and non-deductible amounts, that method should be used first (see [62] and [66] above). For example, a telephone bill might list toll calls made. Only expenses relating to toll calls made for business purposes will be deductible. Where dissection is impractical or impossible, the expense will need to be apportioned on some fair and reasonable basis between the business and private portions of the expense. Apportionment will be necessary when a farmer lives in the farmhouse and uses part of it for business purposes (see table at [126]). This will generally arise, for example, when sole traders and partners of partnerships live in the farmhouse.
92. In reviewing the old policies, the Commissioner's main concern is to allow farmers to deduct farmhouse expenses that are business related, while ensuring that deductions are not claimed for expenditure that is private in nature. In undertaking this exercise, the Commissioner needs to balance the strict application of the law with the associated compliance costs of doing so, while maintaining equity between taxpayers and protecting the integrity of the tax system. Against this background, the likelihood of deductions being obtained for private expenditure is greatest in situations where:
 - the person incurring the farmhouse expenditure lives in the farmhouse; and
 - the value of the farmhouse represents a significant proportion of the overall value of the farm.
93. As a result, a practical approach to apportionment has been developed to mitigate compliance costs for farms with a low private-use element. The practical approach has regard to the law and the Commissioner's powers under s 6 and 6A of the Tax Administration Act 1994. This new approach is based on a distinction between:
 - farming businesses where the value of the farmhouse (including curtilage and improvements) is 20% or less of the total value of the farm (Type 1 farms); and
 - farming businesses where the value of the farmhouse (including curtilage and improvements) is more than 20% of the total value of the farm (Type 2 farms).
94. The respective values of the farmhouse and farm may be used to determine whether the farm is a Type 1 or Type 2 farm. Generally, the value of the farm will include assets attached to the land such as farm buildings, orchards, kiwifruit vines, grape vines and shelterbelts. The valuation of the land does not normally include stock and crops. Nor does it include items of specialised plant not attached to the land. The value of the farm includes all blocks of land (even if they are on different titles) farmed together as part of the same farming enterprise.
95. The Commissioner will accept a reasonable estimate of the values of the farmhouse and farm. In some instances the rateable value will be a reasonable estimate of

the value. However, the usefulness of rateable value depends on the circumstances. For instance, although the value of the land plus capital improvements in a rates notice may be a reasonable approximation of the farm's value, the value of the farmhouse may not be as readily ascertainable. This will be the case where the rates assessment only provides a single figure for "improvements" and it is not possible to separate the value of the farmhouse from other improvements such as farm structures, vines, fencing and so on.

96. Alternatively, a bank's valuation for lending purposes or an estate agent's appraisal may also provide a reasonable estimate. However, in some cases a formal valuation will be appropriate, particularly in circumstances where a farm is close to the Type1/Type 2 threshold and they seek to be a Type 1 Farm.
97. As an alternative to value, the Commissioner will allow farmers to use the respective costs of the farm and farmhouse to reflect the relative values of the farm and farmhouse at a particular point in time. Allowing farmers to use cost is intended to reduce compliance costs by avoiding the need for a formal valuation. In order to be used in the threshold calculation, the relative costs need to be comparable and contemporaneous (eg, the cost of a farm in 1990 and the cost of a new farmhouse in 2010 are not comparable or contemporaneous).
98. The term "curtilage" refers to the land surrounding the farmhouse that is used primarily for private purposes. The curtilage may be fenced (like a backyard) or not. If the curtilage is not fenced, the Commissioner will accept a reasonable estimate of the curtilage and its value. The curtilage must be taken into account when determining the value of the farmhouse as a proportion of the overall value of the farm. This is because the curtilage is generally used for private purposes and is not used in the farming business. The extent of the curtilage, and its value, must be measured on a fair and reasonable basis. The Commissioner will accept a valuation, a reasonable estimate of the value of the curtilage, or an apportionment based on land area (ie, on a value/cost per hectare basis). Any apportionment needs to be calculated on a reasonable basis and recognise the land value of the curtilage will often be proportionately higher than the rest of the farm.
99. The Type 1/Type 2 threshold calculation generally only needs to be done once, unless circumstances change. Examples of where the calculation needs to be done again are where a Type 1 farmhouse is extended or has private-use improvements added or where a Type 2 farmer purchases an additional farming block that is farmed together (with the existing farm) as part of the same farming enterprise. The farmer only needs to do the calculation in order to show they are a Type 1 farmer or that they remain so after a change in circumstances. Generally, changes due to market fluctuations and changes that merely confirm the current position (ie, a Type 2 farmer builds an extension on their farmhouse) will not require a further calculation.
100. The next step is to apportion expenses between the business and private use of the farmhouse. For farmers operating Type 1 farms, the Commissioner will accept that 20% of the farmhouse is used for business purposes. However, Type 1 farmers are entitled to do an actual use calculation if they consider that the business use of the farmhouse is greater than 20%. The appropriate methods of apportionment are discussed at paragraph [61] onwards.
101. Farmers operating Type 1 farms may continue to claim a deduction of 100% for interest relating to the farmhouse. (This is the same as the treatment for interest for full-time farmers under the old policies.) This is a practical approach recognising the complexity of financing arrangements for larger enterprises, difficulties with tracing how funds are applied and the potential compliance costs involved.

102. Farmers operating Type 1 farms can also continue to claim a deduction of 100% for rates. The Commissioner understands that the majority of charges for Type 1 farms relate to the farming business (eg, bio-security, flood protection, rural roading charges). Further, rates assessments often do not distinguish the farmhouse from other improvements; this requires apportionment across all improvements. Also the charges themselves are often a uniform annual general charge levied against land generally and it is not possible to identify business and domestic charges. Allowing a 100% deduction is a practical approach that recognises compliance costs for Type 1 farmers outweigh any tax advantage.
103. For farmers operating Type 2 farms, there is no minimum percentage of the farmhouse that the Commissioner will accept as being for business purposes. Farmers operating Type 2 farms may only claim deductions for expenses, including interest, relating to the actual business use of the farmhouse.
104. For expenses that relate to the farm and the farmhouse (that cannot be dissected), the Commissioner will accept an apportionment of these expenses based on the values of the farm and the farmhouse (including the curtilage and any improvements made to the farmhouse).
105. When apportioning expenses between the business and private use of the farmhouse, Type 2 farmers must undertake a "home office" calculation like any other taxpayer who carries on their business from home. This calculation must be based on the actual use of the farmhouse (for example, 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.
106. The "home office" calculation will, in most cases, only need to be done once (unless the business use of the farmhouse changes). Once calculated, the "home office" percentage can be applied to all general farmhouse expenses that cannot be dissected.
107. Section 71 of the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017 has inserted a new s DB 18AA in the Income Tax Act 2007. This provides another option for calculating business use of a building that is used partly for business purposes and partly for other purposes. This calculation is well suited to situations where there is a dedicated home office.
108. The old policies distinguished between full-time and part-time farmers. As noted above, the fact that a farmer works part time on the farm is not relevant to applying the general permission.

Telephone rental and fixed line charges

109. This Interpretation Statement replaces and updates the old policy allowing farmers who operate their business from home a 100% deduction for home telephone rental. Farmers should follow the existing practice of other home based businesses. The starting point is that farmers may now claim 50% of their telephone rental charges. Farmers can still claim a higher deduction if they can show that the actual business use of the telephone is greater than 50%. There may be situations where farmers use a home telephone solely for business purposes and a 100% deduction is still justified.
110. If the farmhouse has two telephone lines, one charged at a domestic rate and the other at a commercial rate, 100% of the commercial rental is an allowable deduction. In this case, no part of the domestic rental is deductible.

Summary

111. The following table summarises the practical approach outlined above.

Farm type	Interest and rates charges	General farmhouse expenses	Fixed line telephone charges
Type 1 farms	100% deduction for rates and interest expenses relating to the farm, including the farmhouse.	Dissection where possible, then 20% deduction unless the taxpayer can substantiate a higher deduction.	50% of telephone rental charges used for both business and private purposes, unless the taxpayer can show that 50% is too low.
Type 2 farms	Dissection where possible, then apportion between farm and farmhouse on a fair and reasonable basis. Deduct amounts attributable to actual business use of the farmhouse.		50% of telephone rental charges used for both business and private purposes, unless the taxpayer can show that 50% is too low.

Employees and shareholder-employees

112. Sometimes an employee will live in a farmhouse and incur expenses on that farmhouse for the farm business. For example, an employee might use a room in the farmhouse as an office for farm business and pay for the farmhouse utilities (eg, power, telephone or water).
113. Even if an expense incurred by the employee satisfies the general permission, employees are prevented by the employment limitation from claiming any deductions for farmhouse expenses that they incur. However, an employer could reimburse an employee for expenses they incur in connection with their employment. An example might be the portion of a power bill that relates to a home office. Such reimbursement payments are exempt income to the employee when the requirements of s CW 17(2) are met (and are deductible to the employer – see [55] above).

Shareholders, beneficiaries of trusts and other natural persons not involved in the farming business

114. A company or trustees of a trust may operate the farming business and own the farmhouse. In these situations, a shareholder of the company or a beneficiary of the trust (not being employees) may live in the farmhouse and incur expenses on that farmhouse.
115. The shareholder and the beneficiary are not involved in carrying on the business (ie, they are not employees). As a result, the expenses they incur on the farmhouse have no nexus with deriving income. Therefore, the shareholder and beneficiary cannot claim deductions for expenses they incur on the farmhouse.

Farmhouse expenses incurred by a person not living in the farmhouse

116. Sometimes a person will incur farmhouse expenses, but may not live in that house. Such persons could include a sole trader, partner in a partnership, trustee or company. The person incurring the expenses might rent out the farmhouse, or they might provide the farmhouse as accommodation to another person (under a trust deed, as part of an employment agreement or for some other purpose). The person incurring the expenses might own the farm and lease it out, lease the farm and operate it, or own and operate the farm. An example might be where a sole trader, who owns and operates a farm, provides a second farmhouse as accommodation to their employees.
117. The following scenarios are considered in this part of the analysis:

- an employer incurs farmhouse expenses;
- a lessor incurs farmhouse expenses;
- a person incurs farmhouse expenses where they provide the farmhouse in other circumstances (eg, to a person who is neither an employee nor a lessee).

Employer incurs farmhouse expenses

118. An employer can be any entity: sole trader, partnership, trustee or company. The employer may provide the farmhouse to one or more employees. An example might be where a partnership leases a farm from a company, carries on a farming business, and provides accommodation to an employee in a farmhouse.
119. Where the occupants of a farmhouse are employees, any farmhouse expenses incurred by the employer on that farmhouse will generally be deductible. This is because expenses incurred on employees are an ordinary incident of carrying on a business and will generally have the requisite nexus with deriving business income (unless the capital limitation applies).
120. It should be noted that where expenses incurred on employees relate to a private benefit enjoyed by those employees, other regimes in the Act may also apply. Some examples include the provisions on employee remuneration under s CE 1 (eg, expenditure on account or any other benefit in money, such as reimbursement of a non-business expense), s CE 1B (accommodation provided by employers), or fringe benefit tax under subpart CX.

Lessor incurs farmhouse expenses

121. A farmhouse might be owned by a natural person in their personal capacity, in partnership with another, or as a trustee. A farmhouse might also be owned by a company. In some situations, the owner may rent out the farmhouse. When the owner rents out the farmhouse, the owner will derive rental income. An example might be where a company owns a farm and leases it to partners in a partnership that carry on the farming business and live in the farmhouse.
122. If an expense incurred by the owner on the farmhouse has the requisite nexus with the income-earning process of deriving rental income, then that expense will be deductible under the general permission. The owner will not have to apportion the expense for any private use.

Farmhouse provided in other circumstances

123. A farmhouse might be provided to a person who is neither an employee nor a lessee. This situation will usually arise where the occupant is a relative, beneficiary, shareholder or associated person. An example might be where a trustee, who owns and operates a farm, allows beneficiaries (who are not employees or otherwise involved in the farming business) to reside in a farmhouse in accordance with the trust deed. For example, such beneficiaries might be the former owners of the farm, now retired.
124. For most entities, expenses incurred by the owner, where the occupant is not an employee or lessee, will not satisfy the general permission. This is because there is no income (because the occupant is not paying rent) and the provision of the farmhouse to such a person has no connection with the farming business. In this situation the expenses will not satisfy the nexus test in the general permission.
125. However, where a company allows a shareholder, or a person associated with a shareholder, to occupy the farmhouse because of the shareholding, a dividend

arises under s CD 6. In this situation, the dividend is not deductible. However, the dividend will be assessable to the recipient.

Summary

126. The following table summarises the deductibility of farmhouse expenses in a number of different situations. The table does not include reimbursement payments made by a farming entity to the occupiers of the farmhouse for purely business related expenditure. This will usually be deductible.

Entity/structure	Interest	Other expenses
Partnership or sole trader owns/leases and operates farm	Sole trader or partner lives in the farmhouse Apportionment is required. Determine whether the farm is a Type 1 or Type 2 farm and use appropriate method (see table at [111]). For Type 1 100% deductible.	Sole trader or partner lives in the farmhouse Apportionment is required. Determine whether the farm is a Type 1 or Type 2 farm and use appropriate method (see table at [111]).
	Farmhouse provided to employee 100% deductible.	Farmhouse provided to employee 100% deductible.
	Farmhouse rented at market value 100% deductible.	Farmhouse rented at market value 100% deductible.
	Farmhouse provided for no consideration to someone who is not an employee No expenses are deductible.	Farmhouse provided for no consideration to someone who is not an employee No expenses are deductible.
Company owns and operates farm	100% deductible where requirements of s DB 7 met.	Farmhouse provided to employee 100% deductible.
		Farmhouse provided to shareholder (not an employee) Not deductible as a dividend.
		Farmhouse rented at market value 100% deductible.
		Farmhouse provided for no consideration to someone who is not a shareholder or employee No expenses are deductible.
Trust owns and operates farm (trading trust)	Farmhouse provided to employee 100% deductible.	Farmhouse provided to employee 100% deductible.
	Farmhouse rented at market value 100% deductible.	Farmhouse rented at market value 100% deductible.
	Farmhouse provided to beneficiary who is not an employee No expenses are deductible.	Farmhouse provided to beneficiary who is not an employee No expenses are deductible.
Sole trader, partnership, company or trust owns farm, and farmhouse is leased to another entity at market value	100% deductible for the lessor.	100% deductible for the lessor. Lessee (natural person carrying on the farming business) must apportion rent and other expenses. Determine whether the farm is a Type 1 or Type 2 farm and use appropriate method.

Application date of this Interpretation Statement

127. This Interpretation Statement will apply from the start of a taxpayer's 2017-18 income year.

Examples

128. The following examples are included to assist in explaining the application of the apportionment principles and the practical approach outlined in this Interpretation Statement. Please note that the figures used in the examples illustrate the principles explained in this Interpretation Statement and do not take GST into account.

Example 1 – establishing whether farm is Type 1 or Type 2

129. Hayden is a sole trader who owns and operates a dairy farm. Hayden purchased the farm in the 1980s for \$490,000. Hayden also purchased a run off block in 2001 for \$30,000. Hayden demolished and replaced the original farmhouse with a new build in late 2016 in which he and his family live. The new farmhouse cost \$460,000. Hayden wants to know how to work out whether he is a Type 1 or Type 2 farmer.
130. The respective values of the farm and farmhouse should be used to work out whether the farm is a Type 1 or Type 2 farm. Hayden has the option of using cost but in this case the cost is unhelpful as he would be comparing the historic cost of the farm with the recent cost of the new build farmhouse.
131. The \$460,000 cost of the new farmhouse can be used as an approximation of the current market value. The farm's updated 2017 rates bill has the rateable value of the whole farm as \$4,300,000. Hayden considers that is a reasonable approximation of the market value and decides to use this figure for the threshold calculation. Although the rates bill is for 2017, the two values are sufficiently contemporaneous to use in the threshold calculation.
132. The run off block is on a separate title. However, as it is farmed together as part of the same farming enterprise it can be taken into account when calculating the farm's value. The 2017 rateable value for the run off block is \$45,000. The value of the farmhouse is \$460,000 and the rateable value of the farm (including run off block) is \$4,345,000. The farmhouse is therefore 10.6% of the value of the farm. Even allowing for the value of the curtilage, Hayden is a Type 1 farmer.

Example 2 – Type 1/Type 2 distinction

133. Gerri and Warren own and operate a small kiwifruit orchard in Te Puke. They purchased the farmhouse in 2005 for \$275,000 along with a 2 hectare block of green kiwifruit vines for \$280,000. They are Type 2 farmers.
134. In mid-2017, they decide to increase their farming operation. They purchase a nearby 2 hectare production block of gold kiwifruit vines and farm the two blocks together as part of the same farming enterprise. Gold kiwifruit vines are worth considerably more than green kiwifruit vines and they pay \$1,400,000 for the 2 hectares.
135. Gerri and Warren want to do a further threshold calculation to see if they are now Type 1 farmers. They could use the cost of the farm and farmhouse as an estimate of their respective values, but given the passage of 12 years, fluctuations in the value of kiwifruit vines and the fact they are close to the threshold they prefer to use current values. Unfortunately for Gerri and Warren, the rates notice for the farm is no use in establishing the value of the farmhouse as it merely includes a single figure for "improvements" and they cannot work out how much relates to the farmhouse.
136. Gerri and Warren decide to get a formal valuation. The farmhouse (including the curtilage) is valued at \$420,000 and the green kiwifruit block at \$445,000. The recent purchase price of \$1,400,000 for the 2 hectares of gold kiwifruit is a

reasonable approximation of market value for that block. The value of the farmhouse is 18.7% of the total cost of the farm. They are Type 1 farmers.

137. Soon after the farm's expansion the global price of green kiwifruit falls because of bumper crop production in Europe and China. Gerri and Warren decide to gradually replace the green kiwifruit vines with the gold variety. Any decline in value of the green kiwifruit vines (and the farm) because of the global glut is not a change in circumstances requiring a further calculation because the decline in value is temporary in nature. Nor is replacing the vines with the more lucrative gold kiwifruit vines a change in circumstances requiring a further calculation because it merely confirms that Gerri and Warren are Type 1 farmers.

Example 3 – Deductions for Type 1 farms

138. Carolyn is a sole trader who owns and operates a dairy farm in Taranaki. Carolyn does not really know how much of the farmhouse is used for business purposes. Carolyn wants to know what proportion of the farmhouse expenses she can claim as a deduction.

Type 1 or Type 2 farm?

139. First it is necessary to determine whether Carolyn operates a Type 1 or Type 2 farm. Carolyn has a modest house on a reasonable sized farm. In determining the values of the farm and farmhouse, Carolyn considers that the original cost of the farm should reasonably reflect the relative values. The cost of Carolyn's farm was \$2.5 million and the cost of the farmhouse (including the curtilage) was \$235,000. The farmhouse therefore represents 9.4% of the value of the farm. Therefore, Carolyn operates a Type 1 farm.

Farmhouse expenses

140. For expenses that relate to the farmhouse, based on the policy outlined in this Interpretation Statement, Carolyn can claim a deduction of 20% of expenses to reflect the use of the farmhouse for the farming business. She does not need to provide evidence of the business use of the farmhouse. For instance, the power bill is for electricity used by the farmhouse only. Therefore Carolyn can claim a deduction of 20% of the power bill.
141. For expenses that relate to the whole farm or are calculated with reference to the value of the farm and cannot be dissected (eg, an insurance policy that covers the entire farm), an area apportionment will often give an unrealistically low proportion relating to the farmhouse. One way of working out a realistic proportion is to calculate the value of the farmhouse as a proportion of the total value of the farm and add back any business use of the farmhouse. The value of the farmhouse is 9.4% of the total value of the farm. The business use of the farmhouse is treated as being 20%. Carolyn can therefore claim 20% of the 9.4% proportion of the amount that relates to the farmhouse. This is in addition to the amount that relates to the farm business.

Interest and rates

142. Interest and rates are 100% deductible for Type 1 farmers.

Example 4 – Type 1 farm where the business use of the farmhouse is more than 20%

143. Assume the same facts as Example 3 except Carolyn calculates that she uses more than 20% of the farmhouse for business purposes. Carolyn uses the kitchen, dining room, and laundry for farm business. Carolyn calculates, on a time and space basis, that 25% of the farmhouse is used for business purposes.

144. For expenses relating only to the farmhouse (such as the power bill), the proportion of business use of the farmhouse is 25%. Carolyn can therefore claim a deduction of 25% of the power bill to reflect the actual use of the farmhouse for the farming business.
145. Carolyn still claims 100% of the interest and rates charges that relate to the farm business and farmhouse.

Example 5 – Type 2 farm with a home office

146. Anahera owns and operates a small sheep and goat farm that produces speciality cheeses that are sold at the local farmers' market. Anahera lives in the farmhouse and uses a room in the house as an office for the farm business. Anahera wants to know if she can claim any deductions for the mortgage interest she pays for her farm and farmhouse.
147. Anahera uses the cost of the whole farm and the cost of the farmhouse (including the curtilage) as a way of establishing their relative values. The purchase price of the farmhouse was \$200,000. Shortly after the purchase Anahera also made improvements to the farmhouse that cost \$100,000 in total. As a result, the total cost of the farmhouse is \$300,000. The total cost of Anahera's farm was \$700,000 (this includes the improvements made to the farmhouse). The value of the farmhouse is therefore 42.9% of the total value of the farm. Anahera therefore operates a Type 2 farm and must determine the deductibility of any farmhouse expenses under the general rules.
148. The value of the farmhouse is 42.9% of the total value of the farm. Anahera calculates her home office as being 9% of the area of the farmhouse. Therefore, Anahera can claim 9% of 42.9% of the mortgage interest. This is in addition to the mortgage interest that relates to the farm business.
149. The Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017 has inserted a new s DB 18AA in the Income Tax Act 2007 which provides another option for calculating home office deductions. From the 2017-18 income year, Anahera could choose to use this method which provides a deduction for mortgage interest, rates and rent based on the proportion of floor area used primarily in the business. An allowance for other expenses is calculated on a per-square metre basis at a rate set by the Commissioner.

Example 6 – Type 2 farm without a dedicated home office

150. Anaru owns and operates a small free-range chicken farm in partnership with his wife, Angela. Anaru and Angela live in the farmhouse. The recent cost of the farmland was \$1.5 million of which the cost of the farmhouse was \$330,000. The value of the farmhouse (including the curtilage) is 22% of the total value of the farm. The partnership therefore falls into the Type 2 farm category and must apportion any farmhouse expenses based on the actual use of the farmhouse.
151. The farmhouse does not have a home office. Instead, Anaru and Angela hold business meetings at the kitchen table and manage the farm accounts from the family computer in the dining room. In addition, Angela sometimes prepares lunches for business visitors in the farmhouse kitchen. Anaru is aware that the partnership can claim deductions for the business proportion of expenses relating to the farmhouse. Anaru wants to know what the partnership can take into account when calculating the business proportion of those expenses. In particular, Anaru wants to know how much of the telephone bill, mortgage interest and rates the partnership can claim as a deduction.
152. The partnership's telephone bill lists the toll calls made each month. Anaru and Angela can only claim a deduction for the calls made for business purposes. For

the fixed telephone charges, Anaru and Angela can claim 50% of the fixed telephone charges unless they can show that the actual business use of the telephone is greater than 50%.

153. The floor area of Anaru and Angela's house is 150m². Together, the dining room and kitchen make up 40m² in total, or 27% of the floor area of the farmhouse. Anaru calculates, on a fair and reasonable basis, that these rooms are used for the farm business for 20% of the time. This means that the business use of the farmhouse is 5.4%.
154. For the expenses that relate to the whole farm, including the farmhouse (ie, mortgage interest and rates), Anaru should also calculate the value of the farmhouse as a proportion of the total value of the farm and add back any business use of the farmhouse.
155. The value of the farmhouse is 22% of the total value of the farm. The farmhouse is used 5.4% for business purposes. Anaru can therefore claim 5.4% of 22% of the mortgage interest. This is in addition to 78% of the mortgage interest that relates to the farm business. The rates bill for the farmhouse includes charges for certain services that are charged per house. The starting point is that those service charges should be dissected and are not deductible because they relate to the private use of the farmhouse. Conversely, any service charges (such as bio-security) that relate to the business use of the farm should also be dissected and can be deducted.
156. Rates charges that relate to the whole farm or are calculated with reference to the value of the farm (ie, the general and fixed charges on the rates bill) can be calculated in the same way as mortgage interest. The value of the farmhouse is 22% of the total value of the farm. This means that 78% of the rates charges relating to the whole farm will be deductible. Additionally, the farmhouse is used 5.4% for business purposes. Anaru can therefore also claim 5.4% of 22% of the rates charges that relate to the whole farm.

Example 7 – Farmer works part-time

157. Gus owns and operates a small alpaca farming business and also works in the city four days a week. Gus' farm is a Type 2 farm. Gus wants to know if he can claim deductions on any expenses for the home office in his farmhouse. The home office is where Gus does all the administration for his farm. Gus also wants to know if he can claim deductions for expenses relating to the spa pool and leather lounge suite in the farmhouse as these are sometimes used when business associates visit the farm.
158. Gus can claim deductions for the expenses that relate to the home office. Gus could use a similar calculation as Anaru in Example 6 to determine the proportion of private and business use of the farmhouse and farm. The fact that Gus does not work full-time on the farm does not affect the deductibility of the expenses for the use of the farmhouse in the farming business. Alternatively, from the 2017-18 income year, Gus could use the method set out in s DB 18AA of the Act.
159. The spa pool and leather lounge suite are essentially private in nature and not used as part of the farming business. Therefore, Gus cannot claim any deductions for these items.

Example 8 – Farm employees live in separate farmhouse

160. Reggie owns and operates a large deer farm and lives in the main farmhouse. Reggie's farm also has another house situated on it. Three of Reggie's employees live in that farmhouse. Reggie wants to know what expenses are deductible for the employee farmhouse.

161. Provided that none of the general limitations apply, all of the expenses incurred by Reggie on the employee farmhouse on the farm are deductible. This is because expenses incurred on employees are an ordinary incident of carrying on a business. Such expenses satisfy the nexus test in the general permission. As noted at [54], the value of this accommodation provided by Reggie is income to his employees. In addition, to the extent that Reggie also provides fringe benefits to these employees so that a liability for fringe benefit tax arises, the FBT will also be deductible. Fringe benefits provided to employees are discussed at [57] and [58].

Example 9 – Farmer leases farm from family trust

162. Tane is a sole trader who operates a dairy farm in the Waikato. Tane runs the farm from an office in the farmhouse that is dedicated to the farming business. Tane leases the farm and the farmhouse from his family trust and is obliged under the rental agreement to pay rates, insurance and other farmhouse expenses. Tane wants to know if he can claim deductions for these expenses and the rent payments made to the family trust.
163. The total cost of Tane's farm to the Trust was \$5 million and the cost of the farmhouse (including curtilage) was \$450,000. These costs reflect the relative values of the farm and farmhouse. The value of the farmhouse is therefore 9% of the total value of the farm. Tane therefore operates a Type 1 farm.
164. The principles outlined in this Interpretation Statement apply equally to this situation. The Trust can claim deductions for expenses in line with the table at [126]. Tane may claim deductions for his expenses to the extent that they have the requisite nexus with the farming business.

Farmhouse expenses

165. Based on the policy outlined in this Interpretation Statement, Tane can claim a deduction of 20% of the farmhouse expenses (such as the power bill) to reflect the use of the farmhouse for the farming business. However, Tane can claim more if he can show that the business use of the farmhouse is greater than 20%.

Farm/Farmhouse expenses

166. For expenses that relate to the whole farm (ie, rent payments and insurance premiums that cannot be dissected) or are calculated with reference to the value of the farm, an area apportionment will often give an unrealistically low proportion relating to the farmhouse. One way of working out a realistic proportion is to calculate the value of the farmhouse as a proportion of the total value the farm and add back any business use of the farmhouse.
167. The value of the farmhouse is 9% of the total value of the farm. The business use of the farmhouse is treated as being 20%. Tane can therefore claim 20% of the 9% of the rent payments and insurance premiums. This is in addition to the expenses that relate to the farm business.
168. As the farm is a Type 1 farm, Tane is also permitted to deduct 100% of the rates charges.

References

Related rulings/statements

- 'Farm lease payments – deduction for cottage', *Tax Information Bulletin* Vol 7, No 8 (February 1996): 32
- 'Farmers leasing Farm from Trust – Rental Portion Applicable to Dwellings', *Public Information Bulletin* No 89 (January 1977): 4
- 'Farmhouse interior decoration expenses – deductibility', *Tax Information Bulletin* Vol 6, No 14 (June 1995): 24
- IS 12/03: "Income tax – Deductibility of repairs and maintenance expenditure – general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68
- 'New Arrangements With Farmers — Some Further Deductions', *Public Information Bulletin* No 14 (September 1964): 6
- 'Policies We're Reviewing', *Tax Information Bulletin* Vol 4, No 8 (April 1993): 3
- 'Telephone rental deductions for businesses based at home', *Tax Information Bulletin* Vol 5, No 12 (May 1994): 2

Subject references

Deductions
Employment limitation
Farming
General permission

Private limitation

Legislative references

Income Tax Act 2007, ss CD 6, CD 20, CE 1, CE 1B
CE 5, CW 17, CX 2, CX 37, DA 1, DA 2, DA 3,
DB 6, DB 7.

Case references

Buckley & Young Limited v CIR (1978) 3 NZTC 61,271 (CA)
Case E11 (1981) 5 NZTC 59,064
Case F47 (1983) 6 NZTC 59,801
Case G13 (1985) 7 NZTC 1,048
Case H12 (1986) 8 NZTC 168
Case J33 (1987) 9 NZTC 1,190
Case K57 (1988) 10 NZTC 465
Case L81 (1989) 11 NZTC 1,468
Case N35 (1991) 13 NZTC 3,308
Christchurch Press Company Ltd v CIR (1993) 15 NZTC 10,206 (HC)
CIR v Banks (1978) 3 NZTC 61,236 (CA)
CIR v Brierley (1990) 12 NZTC 7,184 (CA)
CIR v Haenga (1985) 7 NZTC 5,198 (CA)
Eggers v CIR (1988) 10 NZTC 5,153 (CA)
Hunter v CIR (1989) 11 NZTC 6,242 (HC)
Pacific Rendezvous Limited v CIR (1986) 8 NZTC 5,146 (CA)
Ronpibon Tin NL v FCT (1949) 78 CLR 47 (HCA)

Appendix – Legislation

Income Tax Act 2007

1. Section DA 1 relevantly provides:

DA 1 General permission

Nexus with income

- (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
 - (a) incurred by them in deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income; or
 - (b) incurred by them in the course of carrying on a business for the purpose of deriving—
 - (i) their assessable income; or
 - (ii) their excluded income; or
 - (iii) a combination of their assessable income and excluded income.

General permission

- (2) Subsection (1) is called the **general permission**.

2. Section DA 2 provides:

DA 2 General limitations

Capital limitation

- (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

Private limitation

- (2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

Exempt income limitation

- (3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

Employment limitation

- (4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.

Withholding tax limitation

- (5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the **withholding tax limitation**.

Non-residents' foreign-sourced income limitation

- (6) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the **non-residents' foreign-sourced income limitation**.

Relationship of general limitations to general permission

- (7) Each of the general limitations in this section overrides the general permission.

3. Sections DB 6 and 7 provide:

DB 6 Interest: not capital expenditure

Deduction

- (1) A person is allowed a deduction for interest incurred.

Exclusion

- (2) Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

Conduit financing arrangements [Repealed]

- (3) [Repealed]

Link with subpart DA

- (4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

DB 7 Interest: most companies need no nexus with income

Deduction

- (1) A company is allowed a deduction for interest incurred.

Exclusion: qualifying company

- (2) Subsection (1) does not apply to a qualifying company.

Exclusion: exempt income

- (3) If a company (**company A**) derives exempt income or another company (**company B**) that is part of the same wholly-owned group of companies derives exempt income, subsection (1) applies to company A only if all the exempt income is 1 or more of the following:

- (a) dividends; or
- (b) income exempted under section CW 58 (Disposal of companies' own shares); or
- (c) income exempted under section CW 60 (Stake money) and ancillary to the company's business of breeding.

Exclusion: non-resident company

- (4) If a company is a non-resident company, subsection (1) applies only to the extent to which the company incurs interest in the course of carrying on a business through a fixed establishment in New Zealand.

Exclusion: interest related to tax

- (5) Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

Consolidated groups

- (6) Section FM 12 (Expenditure when deduction would be denied to consolidated group) may apply to allow a deduction under this section to a company that is part of a consolidated group.

Relationship with subpart DG

- (6B) Subpart DG (Expenditure related to use of certain assets) overrides this section for expenditure to which that subpart relates.

Conduit financing arrangements [Repealed]

- (7) [Repealed]

Link with subpart DA

- (8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.