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Dear Sir or Madam:

KPMG submission - "Black Hole and Feasibility Expenditure"

KPMG welcomes the release of the Government discussion document and supports the introduction of specific tax deductibility rules for feasibility expenditure and the associated effects of "black hole" (i.e. non-deductible) expenditure.

We note the uncertainty that the *TrustPower* Supreme Court decision has created for a wide range of taxpayers. All businesses will have some feasibility type expenses, whether or not they describe it as such. The *TrustPower* decision has impacted Inland Revenue's position on feasibility expenditure. It has released a new Interpretation Statement, *IS 17/01,* and an operational statement confirming that *TrustPower* should be applied to tax positions taken after date of the Supreme Court decision. In our view, the Court has replaced one, arguably, subjective test with another.

Application date of proposals

To remove the adverse consequences of this uncertainty, we believe any legislative clarification of the tax boundary for feasibility expenses should have retrospective effect. On our reading of the *TrustPower* decision, the Court invited Parliament to clarify the law. It seems reasonable that taxpayers who have previously taken positions, should be able to benefit from this clarity.

Feasibility expenditure

We believe the specific legislative deductibility rule for feasibility expenses should be broadly based on when an asset must be recognised for financial reporting purposes (i.e. when the expenditure must be capitalised under NZ IAS 16.7).

We do not believe an additional "feasibility expenditure" tax definition is necessary or desirable. The relevant accounting standard should give a reasonable reflex of what should be deductible for tax. In our view, the commercial tension to capitalise for financial reporting, and deduct for tax, should provide an appropriate backstop to mitigate the potential revenue risk for Government.

We are concerned with the proposed use of "commitment to developing the proposal" as the criteria for ceasing deductibility. There has previously been uncertainty over a "point of commitment" approach and disputes over when there is "commitment". It also risks confusion/conflation with the "material advancement/tangible progress" test apparently applied by the Supreme Court in *TrustPower*.

We believe an objective test, based on the accounting treatment of the expenditure, is best to mitigate any uncertainty.

If additional protection is required, however, the tax definition should be limited to expenditure to determine the "practicability of a project or proposal".

We support non-IFRS taxpayers being able to apply the same test.

We also support a *de minimis* threshold for automatically deducting feasibility expenses and recommend that $10,000 be used for consistency with other *de minimis* thresholds in the Act (e.g. for deducting legal expenses).

Black hole expenses

In relation to the "black hole" expenditure proposal, we strongly agree that all capitalised costs should be deductible when a project is abandoned (i.e. impaired and written-off for accounting). We welcome this more expansive view to addressing "black hole" expenditure issues, which to date has been limited to certain specific items of expenditure.

Buildings and non-depreciable assets

However, consideration needs to be given to capitalised expenses relating to buildings and non-depreciable assets being deductible when a project is abandoned and written-off for accounting.

We understand Officials' concern is that this would incentivise projects which are marginal as any capital gains would not be taxable if the project is successful, but a deduction would be available if unsuccessful. We note the following in response:

— This ignores the fact that a taxpayer does not undertake a project with the intention of failing. The intention is to derive revenue from the endeavour. This will be a taxable income stream, in future.

— The position that any future increases in capital value of buildings (and non-depreciable assets) will not be subject to tax is not correct. A valuation is inherently a reflection of future (taxable) cash-flows. Therefore, if the value of these assets increase, this will reflect the discounted value of those cash-flows, e.g. future rentals in the case of buildings and land. Those cash-flows will be taxable.

— If there are perceived risks with specific asset classes, or fiscal cost for particular items, it would seem easier to specifically deal with these items by exclusion rather than a general proscription. As a general comment, it would be helpful to understand the fiscal risk from including buildings (and non-depreciable property) in the proposal. The discussion document is silent on this important point, when this would appear to be a material consideration.

— We note that buildings have been excluded from the "black hole" expenditure deductibility proposals, notwithstanding they remain depreciable assets (albeit at a 0% rate). Setting aside our view that buildings (certainly, in our experience, commercial, industrial and retail buildings) do depreciate, we do not believe that taxpayers should be "penalised" twice. That is, the adverse impacts of the 2011/12 tax depreciation changes for buildings should not be exacerbated/echoed by lack of tax recognition here.

— Where an amount has been capitalised and written-off for financial reporting, within the same tax year, because the project is abandoned in that year, the item will be expensed. For buildings (or non-depreciable assets) an adjustment will need to be made in the tax calculation, per the proposal in the discussion document. In practice, we believe this adjustment will often be missed. Our suggested approach of removing the distinction would allow the rules to be simplified.

Overall project vs part of the project

There is a further complication and uncertainty with the proposed alignment with accounting. It is more likely that for financial reporting there will be an "overall project" (see the *TrustPower* facts for an example).

For tax purposes, the overall project is likely to be made up of multiple assets. Some of which would be depreciable and others which may not. For example, for a building project, as well as the building, tax depreciable commercial fit-out items might have resulted.

This raises two questions.

Firstly, the ability to depreciate when the overall project is not a depreciable project, but parts of it are. We recommend that an approach similar to the "non-residential fit-out" pool percentage of 15% is allowed as a deduction for "black hole" costs. That is, 15% of the capitalised costs should be deductible. Alternatively, taxpayers should be able to allocate costs on a fair and reasonable basis to (what would have been) depreciable assets.

Secondly, an overall project may not be abandoned in total or fully abandoned. Instead, parts may be abandoned or the project may be indefinitely mothballed. The feasibility rules need to be clear and allow appropriate deductions:

— Where parts of an overall project are abandoned, the costs of that part (or attributable to it) should be deductible; and

— Where the project is mothballed indefinitely, the impairment expense should be deductible.

Further information

Please do not hesitate to contact us, John Cantin on (04) 816 4518 or Darshana Elwela on (09) 367 5940, if you would like to discuss our submission in greater detail.

Yours sincerely

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