TaxMail

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Regular commentary from our experts on topical tax issues

Issue 1

New rules for feasibility expenses and start-ups' share schemes

In case you blinked and missed it, the feasibility expenditure proposals were released on the same day as the Budget

They align the accounting and tax treatment of the expenditure

However, care needs to be taken as this is not a blanket invitation to deduct feasibility costs. The accounting treatment will be key

Snapshot

The Government is seeking feedback on two tax proposals:

— New rules for "feasibility expenditure", with deductibility to be based on the treatment of these costs under International Financial Reporting Standards ("IFRS"). Proposals to address "black hole" expenditure are also included.

— New rules for employee share schemes of start-up companies, aimed at addressing liquidity and valuation issues.

Submissions are due on 6 and 12 July 2017, respectively.

We welcome the proposed legislative clarification of the tax treatment of feasibility expenditure. This follows the recent Supreme Court decision which, in our view, went further than what both taxpayers and Inland Revenue were expecting. The proposal should redress some of the balance.

The start-ups' employee share scheme proposals are an extension of the rules being legislated more generally in the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill.

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What are the proposals?

Feasibility expenditure

A Government **consultation document** proposes making "feasibility expenditure" – defined as expenditure to determine the practicability of a proposal, prior to a commitment to develop the proposal – deductible if the costs are expensed under IFRS.

This would allow an immediate deduction if an asset is not recognised in the balance sheet (i.e. not capitalised under NZ IAS 16.7) but would exclude any feasibility expenditure that would form part of the cost of depreciable property if successful.

Where a capital project is not successful or is abandoned (i.e. impaired under NZ IAS 36) a deduction would be available for capitalised feasibility expenditure and any other capitalised costs (e.g. construction costs). The exception is where the capitalised costs relate to a building or an otherwise non-depreciable asset for tax.

Non-IFRS taxpayers will be able to apply the new rules if the IFRS standards would be met, had they been applied.

The consultation document also requests submissions on a potential de minimis threshold for immediately deducting feasibility expenditure (e.g. similar to the $10,000 de minimis for deducting legal costs) and the application date.

Employee share schemes of start-up companies

An Officials' **issues paper** seeks feedback on updated proposals to address the valuation and liquidity issues faced by employees of start-ups offering employee share schemes.

- A deferral regime that would defer both the taxing point of the share benefit and possibly the deduction for the employer until a liquidity event (such as sale of the shares or a listing under an IPO).
- Alternatively, whether the share benefit should be non-assessable to the employee and non-deductible to the employer.
- Whether the employer's deduction should be able to be cashed up at 28% (similar to under the R&D loss cash-up regime).

The issues paper canvasses a number of detailed design issues, such as the appropriate definition of a "start-up" (the suggestion is that this be limited to unlisted companies with turnover of less than $10m), whether any deferral regime should be elective or mandatory, and various other administrative issues.

Who will the changes impact?

The feasibility expenditure proposals will be relevant for all businesses looking at potential projects or acquisitions. Following the Supreme Court decision in *TrustPower v Commissioner of Inland Revenue* last year, Inland Revenue revised its published view on feasibility expenditure, indicating deductibility was limited to those costs that either do not relate to a specific project or do not materially advance a project. This has resulted in significant non-deductible ("black hole") expenditure.

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The proposals for start-up companies' share schemes are targeted at smaller businesses without share liquidity, offering share based remuneration. Officials consider that this proposal is more relevant for some sectors (e.g. technology companies) than others (e.g. companies undertaking land development/ownership, mining and construction activities may be excluded). The Government has already introduced changes to the taxation of employee share benefits more generally (these are currently in a Tax Bill before Parliament – you can read more about that **here**).

Our view

We welcome the Government's feasibility expenditure tax proposals. The Supreme Court decision in TrustPower resulted in a significant narrowing of what Inland Revenue considers is deductible for tax purposes. The proposal to align the tax treatment with accounting redresses some of that balance.

We are also pleased that the Government has sought to address the situation of capitalised costs (and not just capitalised feasibility expenses) that do not result in an asset due to a project being abandoned. The proposal here is to allow a deduction when the costs are written-off for accounting. The million dollar caveat is when the capitalised costs will give rise to a balance sheet asset that is a building (a depreciable asset for tax but at 0%) or a non-depreciable asset. Those costs will continue to be "black hole" expenditure, if abandoned or unsuccessful. This may be an area for submissions.

Business should take particular note of the request for feedback on the application date. We strongly support these changes being made retrospective to the date of the TrustPower decision.

The additional consultation on employee share scheme proposals for start-up companies reflects the difficulties of taxing share benefits which are illiquid and difficult to value. Officials' preferred solution is to defer the taxing point until there is sufficient liquidity. While this may address cash-flow, the sting in the tail is that any difference between what the employee pays for the shares, which may be nominal, and the sale/listing price will be treated as income. This is notwithstanding the normal "share taxing date" (i.e. when the shares are held substantially free of conditions) potentially being prior to the "liquidity" date, which will result in subsequent capital gains being taxed.

For the company, a deferral of deductions for the cost of the shares is also proposed. This is primarily to mitigate the revenue risk, but Officials consider that some start-ups may want to defer deductions to avoid these being lost if there is a breach of shareholding continuity when taking on new investors.

An alternative "no tax-no deduction" option is canvassed but largely discounted. Therefore, for all intents and purpose, the discussion is targeted at the deferral option. Those impacted by the new rules should take time to consider the potential trade-offs when submitting.

For further information

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