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Regular commentary from our experts on topical tax issues

Issue 1

Feasibility expenditure – new approach to deductibility

A boundary shift for feasibility expenditure has been confirmed in light of the *Trustpower* decision

The scaling back of deductibility increases the scope for "black hole" expenditure

Consultation on the draft IS is an opportunity to raise practical concerns and uncertainties with the new approach

Snapshot

Inland Revenue has released a new draft Interpretation Statement (IS), *IS 16/XX: Income tax – deductibility of feasibility expenditure*, in light of the recent Supreme Court decision in *Trustpower Ltd v CIR* [2016] NZSC 91. It updates and replaces *IS 08/02: Deductibility of Feasibility Expenditure*.

Overall, we consider the deductibility of feasibility expenditure has not been scaled back as significantly as anticipated. The draft IS confirms that the *Trustpower* decision must be applied by both the Commissioner and the taxpayer from the date of the judgment. Therefore, IS 08/02 can no longer be relied upon for tax positions taken from that date.

We welcome confirmation that the Commissioner will not seek to review previous positions taken, which apply the approach in IS 08/02. Consultation on the draft IS closes on 9 November 2016.

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What's changed?

Trustpower decision – the background to the revised IS

- The Supreme Court held that the capital/revenue boundary is not controlled by the "commitment" approach in IS 08/02. It considered that approach is impractical to apply.
- Instead, expenditure on a capital project is necessarily capital in nature (see *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 (HC)). It is irrelevant whether a capital asset is ultimately produced.
- The Court did not prescribe the boundary for when such expenditure ceases to be deductible. It did state that expenditure on initial stages of feasibility work for a capital project may be deductible as a normal incident of business. It also confirmed that expenditure which is not directed towards a specific project may be on revenue account.

Inland Revenue's new approach to deductibility of feasibility expenditure

The draft IS confirms expenditure is likely to be deductible if it is part of the ordinary course of the taxpayer's business and does not add to the business structure or contribute to obtaining an enduring benefit.

Importantly, it also confirms that whether or not feasibility expenditure results in a capital asset is irrelevant to determining deductibility.

The draft IS sets out a new approach to determining the deductibility of early stage feasibility expenditure. Such expenditure will be deductible in two cases:

- If the expenditure is not directed towards a specific capital project/asset; or
- If a specific capital project/asset has been identified, the expenditure is so preliminary that it is not directed towards "materially advancing" that project/asset.

This means that early stage feasibility expenditure is divided into expenditure for a specific capital asset or project and that which is not. Specific expenditure is in turn divided into preliminary and that which materially advances the project (with the latter being non-deductible).

Examples are given in the draft IS to illustrate the new approach. In Example 8, a national restaurant chain, which continually looks to build new restaurants, seeks to identify a new site in Wellington. To assist with this, it hires a contractor to survey traffic flows in different areas. That expenditure is deductible as it is preliminary and does not result in any tangible progress towards the project.

Our view

The draft IS shifts the boundary for deductibility of feasibility expenditure from when a taxpayer is "committed" to a capital project/asset to whether the expenditure materially advances a specific capital project/asset. Given the *Trustpower* decision, this new approach is necessarily more restrictive than the old approach. However, we welcome the fact that Inland Revenue has taken a more expansive view of the comments made by the Supreme Court than initially expected.

The new approach is likely to be more objective but also more "grey" than the previous "commitment" approach. There is some uncertainty regarding how it will apply to different scenarios, notwithstanding the various examples contained in the draft IS.

Helpfully, the draft IS also addresses an uncertainty raised by a comment in the *Trustpower* decision regarding internal versus external costs. It confirms that whether a study is carried out internally or commissioned from a third party will not affect the deductibility of the relevant costs.

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The fact that the new approach is more restrictive means that there is now more scope for "black hole" expenditure to arise. The outcomes are as follows:

Asset/Project specific expenditure	Asset/Project	Deductibility
Successful	Depreciable asset	Deductible as depreciation or as preliminary expenditure
	Non-depreciable asset	Deductible only if satisfies draft IS as preliminary expenditure
Unsuccessful	(if successful would have resulted in): Depreciable asset	Deductible only if satisfies draft IS as preliminary expenditure or specific rules: e.g., resource consents, unsuccessful software, apply.
	Non-depreciable asset	Deductible only if satisfies draft IS as preliminary expenditure

This highlights the continuing need to review the boundary for black hole expenditure. If the expenditure is successful, the income produced is taxable. It seems logical that the expenditure to derive that income should be deductible. The Government should share in the pain as it shares in the benefits. However, the capital gains boundary remains an on-going constraint to addressing black hole expenditure comprehensively. It remains to be seen whether a legislative response to clarify the feasibility deductibility boundary will be forthcoming following the *Trustpower* decision.

We note that, in determining whether feasibility expenditure is deductible, it is still important to consider the specific facts and circumstances at hand.

Submissions on the draft IS are due by 9 November 2016. This is an opportunity to raise with Inland Revenue practical concerns or uncertainties regarding how the new approach will work.

For further information

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