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Our ref 160204KPMGsubDSAcosts

4 February 2016

Dear Sir/Madam

KPMG submission on Question We've Been Asked - Deductibility of seismic assessment costs

KPMG appreciates the opportunity to make a submission on the draft Question We've Been Asked ("QWBA") item on deductibility of seismic assessment costs.

General comments

We welcome the release of draft practical guidance by the Commissioner of Inland Revenue ("the Commissioner") on the deductibility of these costs. We consider it important for the Commissioner to state her views so that taxpayers can make informed decisions.

However the document leaves uncertainty about the tax treatment of initial seismic assessment costs (in contrast to the title, the QWBA only considers detailed seismic assessments). It is also unclear whether the analysis of detailed seismic assessment cost deductibility would be different when such an assessment is obtained when the building is not earthquake prone. In the latter situation, the driver may be the need to assuage tenant concerns or as a defence against tenants' demands for further earthquake strengthening. In those cases, we believe a strong argument can be made that the costs incurred relate to the maintenance of the existing income stream from the building (i.e. to support a landlord's negotiating position on new leases and lease renewals), rather than preservation of the capital asset.

Our most significant concern is the Commissioner discounting the application of her own Interpretation Statement on Feasibility Expenditure ("IS 08/02"). In particular, we find the comment in the QWBA that IS 08/02 is limited to evaluating proposals for the acquisition or development of a "new" asset and, therefore, not applicable to detailed seismic assessments to be unsupported and arbitrary. We see no reason why detailed seismic assessment costs cannot be considered under the principles stated in the feasibility expenditure statement.

We expand on these concerns and comments below.

Outline of Commissioner's draft position

The starting point in the QWBA is that detailed seismic assessments are required when a building has been identified as earthquake prone. The Commissioner identifies four possible outcomes in respect of the building as a result of a detailed seismic assessment.

The Commissioner concludes that a detailed seismic assessment is to determine the nature and scale of seismic strengthening and, possibly, an estimate of the costs with a view to deciding the best option for the building. It is therefore directed to the further preservation or otherwise of an important capital asset, rather than its day-to-day operations.

As a matter of law, this means that the cost of the assessment is a capital and therefore non-deductible cost.

Distinction between earthquake prone and not, and purpose of seismic assessments – impact on the Commissioner's analysis

The process may not be as assumed by the Commissioner.

A building owner may choose to undertake a detailed seismic assessment of their building even if an initial assessment has not identified the building as earthquake prone. (I.e. the building is above 34% of NBS so not earthquake prone). In practice, the need for a seismic assessment may include tenanta' concerns about the earthquake rating level and as a defence against demands for further strengthening work to be carried out.

In particular, some tenants will demand a building's earthquake rating to be well in excess of 34% of NBS (in some cases up to 100% of NBS or even higher) before signing up to or renewing a lease.

A detailed seismic assessment in these circumstances may be undertaken to assuage tenants' concerns around earthquake safety by emphasising the building's strengths. In other words, the purpose of the detailed assessment is not to actually identify mitigation options, but to demonstrate the building is (relatively) safe.

Context is important. Where a building owner is incurring detailed seismic assessment costs to strengthen their negotiating position on a new lease or a lease renewal with a tenant, we believe this does relate to their day-to-day operations as a landlord. In such cases, the need or occasion for the expenditure is to protect an existing revenue stream. This makes the detailed seismic assessment expenditure revenue in nature, and deductible, in our view.

The QWBA analysis needs to take account of different contexts for undertaking seismic assessments.

Initial seismic assessments need to be covered by the QWBA

Despite the QWBA's title, it does not cover the tax treatment of initial seismic assessments. In our view it would be helpful for the Commissioner to outline her view on the deductibility of initial seismic assessment costs.

We would expect that initial seismic costs would fall within the scope of feasibility expenditure. However, given the comments in paragraph 32 of the QWBA, we have concerns that initial costs would also not be deductible.

For the reasons above, and which follow, we consider that initial seismic assessment costs are also revenue and deductible costs. The QWBA should confirm this.

The Commissioner's analysis

Relationship with feasibility expenditure

We are concerned by the dismissal of the Commissioner's own statement on the deductibility of feasibility expenditure (IS 08/02). The QWBA states that IS 08/02 contemplates only expenditure incurred in evaluating one or more proposals for the acquisition or development of "new" assets.

Although we appreciate that case law confirms that a Commissioner's interpretation statement is not the law, the QWBA does not justify this gloss on the Commissioner view.

Paragraph 23 of IS 08/02 analyses what constitutes feasibility expenditure:

> *"Feasibility expenditure is neither a defined term for the purposes of the Act nor a term of art. However, it is generally used to describe expenditure incurred by a taxpayer for determining the practicability of a new proposal. A typical feasibility exercise would involve determining whether a particular course of action should be taken or certain capital assets acquired or developed…"*
>
> [Emphasis added]

This definition specifically refers to determining whether a particular course of action should be taken. It is not limited to determining whether a new capital asset should be acquired or developed. Further, even the reference to capital assets is not limited to new assets. On the contrary, the development of a capital asset implies the existence of an asset. The feasibility expenditure statement is therefore clearly not limited to new assets. The Commissioner has mis-interpreted her own statement.

(We have focussed on "development" of an asset as that is how the Commissioner characterises the actual seismic work. See further below.)

The inconsistency between the QWBA and the feasibility expenditure statement is also apparent from the analysis of the factors in *BP Australia* in IS 08/02. In particular, when analysing whether an expense is feasibility expenditure applying the enduring benefit test, the Commissioner noted the following in IS 08/02 at paragraph 172:

> *"In addition the enduring benefit test focuses on whether the expense was incurred with a view to (as opposed to definitively) bringing into existence an asset or advantage of enduring benefit. This line of authority has been approved and applied in New Zealand."*

And at paragraph 178:

> *"The incurring of expenditure principally for placing a taxpayer in a position to make an informed decision about the acquisition of an asset (or other enduring advantage) will not generally be expenditure incurred in relation to that particular asset or advantage."*

And at paragraph 182:

> *182. Therefore, it is considered that the following matters will be relevant in determining whether feasibility expenditure will be denied a deduction under s DA 2(1).*
>
> - *...*
> - *The categorisation of the expenditure is not affected by the ultimate success or failure in acquiring or developing a capital asset, or in obtaining an advantage of enduring benefit, or in establishing a profit-making structure. The existence or recognition of contingencies, which may affect the eventual outcome, does not alter the categorisation of expenditure once a commitment or decision has been made to proceed.*

[Emphasis added]

It is clear that IS 08/02 considers that expenditure to put a taxpayer in a position to make an informed decision about an "enduring advantage / advantage of enduring benefit" (as well as developing a capital asset) will generally be feasibility expenditure. Determining the options for an existing building (i.e. whether to strengthen, sell, demolish or take no action based on a detailed seismic assessment) is aimed at generating an "enduring advantage / benefit".

Further, the QWBA seems to assume that the earthquake prone status of the building will be definitively known. However, there will be cases where the detailed assessment will confirm that the building is not in fact earthquake prone. In that case, no action of a capital or other nature would be required. The QWBA does not consider this possible outcome.

We understand that the Commissioner may consider herself constrained by the Court of Appeal decision in *CIR v Trustpower (2015)*. Distinguishing the feasibility expenditure interpretation statement helps in that regard. However, this is inconsistent with her statements that IS 08/02 should still apply until the appeal to that decision is decided.

Analysis of expenditure of this nature therefore fits within the scope of IS 08/02 and should be re-cast in that light. Consistent with continuing to apply the principles of IS 08/02, detailed seismic assessments enable a taxpayer to make an informed decision about potential courses of action in relation to an existing asset (i.e. how best to secure an enduring advantage or to develop that asset if the Commissioner's characterisation of seismic expenditure is accepted).

At the time the detailed seismic assessment is performed there may be no commitment to any particular course of action. Taking into account that no action may be required as a result of the assessment, and applying the principles in IS 08/02, means there is a strong argument that detailed seismic assessment costs are correctly considered as deductible feasibility expenditure.

Case law on repairs and maintenance expenditure

Alternatively, if the Commissioner maintains her view that the feasibility expenditure analysis is not applicable, then consideration should be given to the body of case law relating to expenditure on repairs and maintenance.

This has established a two-step process for evaluating expenditure incurred in maintaining or preserving capital assets.[1] The fact that the Commissioner states in the QWBA that detailed seismic assessments are directed to the preservation of (or, synonymously, the maintenance of) a capital asset means that such an analysis is relevant.

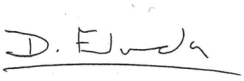
If regard is given to the extent of the work done, and the effect on the identifiable asset of seismic assessment expenditure (the impact will be nil as it is to put the taxpayer in position to make a decision about different options or perhaps to do nothing at all), the conclusion must be that the expenditure is not capital in nature.

With the release of the QWBA it is also timely to note that we continue to have concerns with Inland Revenue's blanket no deduction approach on the issue of actual seismic expenditure. We would be pleased to discuss this further.

Further information

Please do not hesitate to contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940, if you have any questions or if you would like to discuss our submission further.

Yours sincerely



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[1] *Auckland Gas Co Ltd v CIR (2000) 19 NZTC 15,702*