



6 July 2017

Black hole and feasibility expenditure proposals
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Black hole and feasibility expenditure – a Government discussion document

Introduction and general comments

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the *Black hole and feasibility expenditure* Government discussion document (discussion document). The Law Society supports the proposal to seek to achieve greater certainty through legislation in respect of the tax treatment of so-called "feasibility expenditure", and to address anomalous instances of "black hole" expenditure such as expenditure on depreciable property that does not reach the stage of being used or available for use.
2. The Law Society comments on aspects of the discussion document, with a view to ensuring that any legislative amendments result in clear and cohesive law.

Proposed definition of "feasibility expenditure"

3. The discussion document proposes a new, specific deductibility rule for feasibility expenditure that is based on the IFRS treatment of such expenditure. For the purposes of that rule, the discussion document suggests that the term "feasibility expenditure" be defined along the lines of "expenditure to determine the practicability of a proposal, prior to commitment to developing the proposal".
4. The Law Society notes that the proposed definition is a combination of:
 - the approach to deductibility taken in the former interpretation statement on feasibility expenditure (IS 08/02), which placed a high degree of importance on when the expenditure was incurred relative to a decision to commit to or proceed with the acquisition or development of an asset; and
 - the approach taken in the more recent interpretation statement (IS 17/01), which placed more emphasis on what the particular expenditure was directed towards (i.e., whether it was directed towards materially advancing a specific project or asset).

5. The Law Society submits that including both a time-based element and a purpose-based element into the definition would make the definition more uncertain and potentially narrower than is intended. For example, that definition would appear to exclude some expenditure that would be deductible under the approach set out in Interpretation Statement: IS 17/01 *Income Tax – Deductibility of Feasibility Expenditure*.
6. A "commitment to developing the proposal" could occur quite early in a particular process, even though the proposal may still be subject to a number of contingencies and/or may be materially altered as it is further investigated. In this regard, Figures 1 and 2 in the discussion document are simplistic and do not capture the iterative process that occurs in practice, where "commitment" can occur in stages and implementation and evaluation often happens contemporaneously through the middle part of a project life cycle.
7. The Supreme Court in *Trustpower Limited v Commissioner of Inland Revenue* [2016] NZSC 91 also pointed out difficulties with the concept of "commitment" in this context:

[68] In *Milburn*, the practicality of the taxpayers establishing the proposed quarries was conditional on the obtaining of resource and other consents on satisfactory terms. So any commitment to proceed on the part of the taxpayers was necessarily conditional. More generally it might be thought that development decisions seldom, if ever, involve a commitment to proceed irrespective of the way events pan out or changes in circumstance. So the commitment approach could not be practicably applied on the basis that unconditional commitment is required [...]. But once conditionality is allowed for, as it must be, the concept of commitment becomes indeterminate.

8. Therefore, the Law Society submits that further consideration be given to the definition of "feasibility expenditure" and in particular whether a time-based "commitment" element is necessary or desirable.

Application of general deductibility provisions

9. It is not clear from the discussion document whether the proposed new rule would be a code for the tax treatment of "feasibility expenditure", such that a taxpayer would be prevented from claiming a deduction under the general deductibility provisions for expenditure that fell within the definition of "feasibility expenditure", but which was not expensed under IFRS. The Law Society submits that a taxpayer should be entitled to claim a deduction under the general deductibility provisions if those provisions would allow one, which is consistent with the way that most of the existing specific deductibility rules operate.
10. If the new rule is intended to operate as a code then it will be even more important to consider the scope and application of the rule (and uncertainty of interpretation) and officials (and Parliament) will need to consider carefully the desirability and appropriateness of enacting a rule that would deny deductions for expenditure that is currently deductible.

Requirement for complete abandonment

11. It appears from the discussion document that in the case of expenditure that is not immediately deductible (either because it is "feasibility expenditure" that is capitalised under IFRS or because it would form part of the cost of a depreciable asset), a deduction will only be available outside the depreciation regime if the item is abandoned (see paragraph 3.17 for feasibility expenditure and paragraph 3.29 for expenditure that would form part of the cost of depreciable property).
12. The Law Society submits that, especially in the case of "feasibility expenditure", further consideration should be given to whether complete abandonment should be required. Depending how an item is accounted for under IFRS it may be that there is an impairment (i.e., writing down in the accounts) but not a total abandonment. This may reflect the fact that the project in question is modified or downsized, but continues, such that some (but not all) of the expenditure remains capitalised. If complete abandonment, or a full impairment, is necessary it is likely that there will be some arbitrary and unintended outcomes.

Application date

13. The discussion document invites submissions on whether there are any reasons why any change to the law should not be prospective (i.e., apply from the date of enactment), noting that some taxpayers have expressed a view that any change should apply from the date of the *Trustpower* decision. The discussion document does not, however, discuss the merits or otherwise of various application dates or indicate the Government's current views.
14. The application date issue is not straightforward. The Supreme Court's decision in *Trustpower* was inconsistent with Inland Revenue's published guidance on the issue. Since the decision many taxpayers will have taken tax positions in returns filed after that time that reflect the law as outlined by the Supreme Court and the new Interpretation Statement. Now that the discussion document has been released the proposals outlined in it may also be taken into account by taxpayers when taking tax positions. The decision regarding an appropriate application date needs to treat taxpayers in different positions as fairly as possible.
15. The Law Society submits that any new rule should apply in respect of an income year, rather than a particular date, and that on balance the 2016/2017 income year seems the most practical given that most affected taxpayers will not yet have filed tax returns for that income year. To give some practical guidance to taxpayers, if the legislation is to have some retrospective application then the Law Society submits that an announcement should be made as soon as possible in a form that taxpayers may rely on with some degree of confidence when filing tax returns prior to the law being enacted (noting that of course it will be for Parliament to ultimately decide).

Conclusion

16. This submission was prepared with the assistance of the Law Society's Tax Law Committee. If you wish to discuss this further, please contact the committee's convenor, Neil Russ, via the committee secretary, Jo Holland at jo.holland@lawsociety.org.nz, (04) 463 2967.

Yours faithfully

A handwritten signature in black ink, appearing to be 'K. Beck', written in a cursive style.

Kathryn Beck
President