

Tax Tips Alert

June 2017



Proposed changes to the deductibility of feasibility and black hole expenditure

On 25 May, as part of the Government's 2017 Budget, the Ministers of Finance and Revenue proposed significant amendments to the deductibility of feasibility expenditure and black hole expenditure. Details of these proposals are included in the Government's discussion document, [Black hole and feasibility expenditure](#) (the Discussion Document).

In this Tax Tips Alert, we discuss the key features of the proposed amendments.

Feasibility expenditure

Background

The proposals in relation to the tax treatment of feasibility expenditure have been made following the Supreme Court's decision in *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91 in July 2017, and Inland Revenue's finalised interpretation statement, *IS 17/01: Income tax - deductibility of feasibility expenditure*, released in February 2017 in the light of that decision.¹

In broad terms, in *Trustpower*, the Supreme Court rejected the approach previously taken by Inland Revenue that feasibility costs should be deductible up until the point a capital project was committed to (often referred to as the **commitment test**). Rather, the Supreme Court held that, where feasibility expenditure is incurred as an ordinary and recurring incident of a taxpayer's business, it will only be deductible when:

- it is not directed towards a specific capital project, or
- if directed towards a specific project, it is so preliminary that it does not materially advance that project.

Trustpower therefore placed a significant restriction on the circumstances in which taxpayers could deduct feasibility expenditure.

The Discussion Document proposes legislative amendments to reverse this course and increase the availability of deductions for taxpayers incurring feasibility expenditure on the grounds that the current treatment could be an impediment to productivity growth and therefore damaging to the New Zealand economy.

New definition of "feasibility expenditure"

The term 'feasibility expenditure' is not a defined term in New Zealand's tax legislation, nor in relevant accounting standards.

The Discussion Document does not include a specific proposal for a definition of this term. Rather, the Discussion Document states that the legislative definition should in substance capture expenditure that is incurred:

"to determine the practicability of a proposal, prior to commitment to developing the proposal"

Feasibility expenditure to be immediately deductible in certain circumstances

The Discussion Document proposes that feasibility expenditure should be immediately deductible where such expenditure:

- is expensed for financial reporting purposes under IFRS (or would be expensed under IFRS if the taxpayer used IFRS to prepare financial statements); and
- **would not** form part of the cost of depreciable property if the relevant project was completed.

That is to say, feasibility expenditure that is capitalised under IFRS, or **would** form part of the cost of depreciable property, will not be immediately deductible.

Interestingly, while the Discussion document notes that in principal any expenditure on a capital project that does not depreciate should be excluded from the definition of feasibility expenditure, it does not propose to distinguish between expenditure on the basis of whether it results in a depreciable or a non-depreciable asset. This is on the basis that, prior to committing to carry out a project, it is likely too difficult to determine whether the project will give rise to an asset that will depreciate in value.

For non-IFRS taxpayers, a deduction would still be available if the expenditure would have been expensed if the IFRS standards had been applied.

¹ We wrote about the *Trustpower* decision and IS 17/01 in our [August 2016 Tax Tips Alert](#), and our [February 2017 Tax Tips](#), respectively.

Black hole expenditure

The proposals would also introduce a new deduction for certain 'black hole' expenditure where expenditure is incurred in relation to an asset that would be depreciable if completed, but where that asset is abandoned before it is completed and available for use. Under current law, this expenditure would not be deductible on the basis that it is capital in nature, and would not give rise to depreciation deductions on the basis that the relevant asset is never available for use.

Specifically, the Discussion Document proposes to allow taxpayers a deduction in respect of expenditure that would form part of the cost of an item of depreciable property where:

- the item is abandoned before it is available for use; and
- the expenditure is recognised as a loss in relation to an impaired asset under accounting standard NZ IAS 36 (or would be so recognised if the taxpayer applied this standard for the purposes of preparing its accounts).

This deduction would be allowed at the time the loss is (or would be) recognised under NZ IAS 36.

Deduction not limited to feasibility expenditure

Significantly, the proposal in relation to black hole expenditure is not limited to feasibility expenditure that is not otherwise deducted under the proposed new rule in relation to feasibility expenditure. Rather, the rule would apply to all expenditure incurred that would form part of the cost of an item of depreciable property (subject to certain exclusions discussed below).

Clawback

Where a taxpayer claims a deduction in relation to an asset impaired under NZ IAS 36, and this impairment is subsequently reversed, the taxpayer will be required to return as income the amount previously deducted.

Exclusions from new proposed rules

The Discussion Document notes that in a number of circumstances the Income Tax Act 2007 (the Act) already provides a deduction for black hole expenditure (for example, for black hole expenditure incurred in relation to a resource consent application under s DB 19, and for expenditure incurred in relation to research and development under s DB 41).

The Discussion Document proposes that the rules in relation to feasibility expenditure and black hole expenditure should not apply to black hole expenditure for which the Act already provides a deduction.

Significantly, the proposal in relation to black hole expenditure is not limited to feasibility expenditure that is not otherwise deducted under the proposed new rule in relation to feasibility expenditure.



Implementation issues

Effective date

The Discussion Document does not specify whether any changes would be retrospective or only applied prospectively. However, the Discussion Document specifically requests submissions on whether there is any reason why any change to the law should not be prospective.

Inland Revenue's stated position with respect to the application of the *Trustpower* decision is that it will apply the Supreme Court judgment in relation to tax positions taken after the date of that decision, and in binding ruling applications and future challenges, made or occurring after this date. However, Inland Revenue stated that it would not actively review previous years where taxpayers have applied the commitment test, consistently with Inland Revenue's approach prior to the *Trustpower* decision. We are aware that Inland Revenue has been continuing to review the application of the commitment test to tax positions taken prior to the Supreme Court decision.

De minimis threshold

The Discussion Document considers the possibility of a de minimis threshold below which feasibility expenditure incurred in deriving assessable income (or in the course of carrying on a business for the purpose of deriving assessable income) would be deductible, irrespective of whether it was expensed under IFRS, or would form part of the cost of depreciable property.

The Discussion Document suggests that this threshold might be set at \$10,000, being the threshold that applies to similar de minimis rules in relation to legal expenditure and research and development expenditure.


Our comment

We are pleased to see the Government's commitment in resolving the issues around feasibility and black hole expenditure and we are broadly supportive of the proposed changes. We agree that the current treatment of feasibility expenditure is harmful to the New Zealand economy. Trustpower effectively increased the potential amount of black hole expenditure by, in many cases, pulling back the date when expenditure can be deducted as feasibility expenditure. This increase in potential black hole expenditure further exacerbates the distortionary effect as the amount at stake is larger and is therefore a more significant factor in a business's investment decisions.

In the post-Trustpower world, it is possible a business may decide to continue with a project that it otherwise would not on the basis that it is able to get depreciation deductions rather than incurring costs to explore another project and risk incurring black hole expenditure that may ultimately not be deductible or depreciable (ie if no depreciable asset is created). This kind of behaviour lowers economic efficiency as arguably businesses are making suboptimal decisions as a result of tax.

In our view, any change that would reduce such distortions is positive. In particular, we are pleased to see the proposals go beyond feasibility expenditure and allow for an immediate deduction where a capital project is unsuccessful. However, we consider that the proposals should apply retrospectively to the date of the Trustpower decision as it would be unfair for businesses that are currently incurring feasibility expenditure to be 'worse off' than businesses that delay incurring such expenditure until the proposals are enacted. Since there is a general consensus that the current treatment is unsatisfactory from a New Zealand Inc. perspective it makes sense that the proposals should eliminate as much as possible the impact of the Trustpower decision.

Finally, we are supportive of the proposed de minimis threshold as a means of reducing compliance costs for taxpayers that incur relatively little feasibility expenditure, particularly in circumstances where taxpayers that do not use IFRS to prepare financial statements. A de minimis would remove the need for such taxpayers to become familiar with these standards in order to apply the proposed new rules.



We consider that the proposals should apply retrospectively to the date of the Trustpower decision as it would be unfair for businesses that are currently incurring feasibility expenditure to be 'worse off' than businesses that delay incurring such expenditure until the proposals are enacted.

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