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25 November 2016

Dear Sir or Madam:

PUB00278 - Deductibility of Feasibility Expenditure

Thank you for the opportunity to submit on the draft revised Interpretation Statement ("IS") on feasibility expenditure, and the extension of time for our submission.

General comments

Our general comments are relatively brief:

- We welcome the Commissioner's confirmation that she will not be actively reviewing prior years where taxpayers have applied the so-called "commitment" approach contained in the previous IS ("IS 08/02"). This is a reasonable and pragmatic approach for prior years, given the previous, generally well settled, position.
- We are also supportive of the Commissioner's updated approach to determining the deductibility of feasibility expenditure, in light of the Supreme Court's ("SC") decision in *Trustpower Ltd v CIR [2016]* ("*Trustpower*"). We acknowledge the Commissioner must have regard to the principles in *Trustpower*. We believe the draft IS approach is consistent with that decision.

Detailed comments

We make below more detailed comments on the analysis in, and approach of, the draft IS.

Section DA 2(1) – consideration of the capital limitation

Canadian case law omission

The draft IS largely disregards the Canadian case law, considered in IS 08/12, which the Commissioner considers to be largely irrelevant following *Trustpower*. This seems reasonable given that *Trustpower* (1) supersedes the Canadian case law; (2) is directly on point for the matter at hand; and (3) was decided by New Zealand's highest court.

Role of extrinsic materials in statutory interpretation

The SC decision also raises some interesting questions on statutory interpretation and the practical application of the draft IS.

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The reference, with approval, to the Prebble and McIntosh analysis by the SC raises questions about the role and weight of extrinsic materials. In this case, an article which had no basis in either the legislative or policy development process for the matter concerned was referred to by the Courts. It would be helpful to understand the Commissioner's position on the relevance of such materials for her future interpretations.

"Material" advancement of (vs tangible progress on) a project

While the decision in *Trustpower* effectively discounted the commitment approach as stated in IS 08/02, the SC has attempted to create flexibility in two areas: in respect of initial/early stage feasibility work and costs relating to a specific capital project that are so preliminary that they do not "advance" that project.

The potential problem with this articulation is that it shifts the determination from "commitment" to "advancement".

The draft IS attempts to tackle this problem. It, in our view, takes a reasonable view that "advancement" in *Trustpower* must mean "material" advancement. However, we are concerned that "material advancement" is not a test in *Trustpower*.

Further, "material advancement" and "tangible progress" may not always be synonymous. The material advancement of a project does not necessarily mean that tangible progress is made (and vice versa), and importantly, that it can be measured.

Given the subjective nature of these terms, and potential for disputes over their meaning, it is vital that the Commissioner is clear on what the thresholds are, and this is clearly communicated to taxpayers. The examples provided in the draft IS do not provide adequate guidance.

Extension of SC analysis to "internal costs"

We agree that the reference to "external costs" in the SC decision should not be viewed as exclusive. The extension of the draft IS to include "internal costs" is a useful clarification and will help avoid future disputes with Inland Revenue.

It would also be useful for the examples in the draft IS to illustrate types of internally generated costs (other than employee costs, which we note would generally be deductible as a normal business expense) that may/may not be deductible.

Section DA 1 – consideration of the general permission

The draft IS makes no reference to the Court of Appeal's decision on the (non-) application of section DA 1 (i.e. that the general permission was not met by Trustpower) or its subsequent reversal by the SC.

In our view, this is a substantive point. It confirms that a two-step analysis is required:

- Is the expenditure referable to a business or income producing process?
- Is the expenditure capital in nature?

This is an important principle as some cases have suggested that capital expenditure can never be incurred in carrying on the business.

The section DA 1 decisions are important to the discussion on whether a business has commenced. In that regard, we note the use of "commitment" in the examples illustrating the Commissioner's view of whether there is a business. Given the difficulties with the approach in IS 08/02, the risk is that the draft IS replaces one commitment based test with another.

We prefer the following formulation of the test: "as a matter of fact, has a business commenced?" However, we have not confirmed that view by reference to the relevant case law.

The section DA 1 discussion could usefully be the subject of a standalone IS. (Alternatively, other items where this issue is relevant could be referenced in the IS. We have not prepared a list of potentially relevant statements.)

We note particularly the issue of how much reliance can be placed on old case law. This does not appear to have been challenged in *Trustpower* or elsewhere.

It could, in our view, be reasonably challenged on the basis that the older decisions are in the context of company constitutions that specified the company's activity. Further, at least for older UK cases, there is a scheduler mind-set which could be seen to have influenced the outcomes.

In the modern environment, the distinction between existing and new business activities is less relevant. Indeed, the modern environment requires a broad definition of the business as digital and other technological disruption changes the nature and mode of delivery to customers.

It seems to us that the SC decision *in Trustpower* may provide some support for this approach (see the quoted passages at paragraphs 71 and 72, quoted at paragraph 122). However, we acknowledge that the facts were that the expenditure was considered to be part of Trustpower's business.

Further, it is relatively common for a project to be carried out by a special purpose entity/subsidiary. If that is a newly incorporated/established company or vehicle, it would appear that it would always fail the section DA 1 requirement unless the company was part of a consolidated group. The Commissioner's view on this common commercial practice would be useful, for the avoidance of any doubt.

Status of the IS

Ultimately, as the SC decision demonstrates, it is not the IS but the application of the capital/revenue case law which determines the result. The risk is that taxpayers will have a false sense of security, notwithstanding the IS will not be a final statement of the law. The draft IS does not alert taxpayers to the possibility that the Courts, or indeed the Commissioner, may take a different approach.

We appreciate that the Commissioner may argue that in *Trustpower* she did not take a different approach to IS 08/02. We acknowledge that the Commissioner generally takes care to follow her statements. However, the substance of the position taken, by putting IS 08/02 at issue, was to allow a challenge to her conclusion. That, in our view, effectively amounts to the Commissioner concluding that her position in IS 08/02 was incorrect. The SC took that position in deciding the case in favour of the Commissioner.

We appreciate that this is a problem with all of the Commissioner's statements, except binding rulings (but as some cases have demonstrated, even these are not necessarily sacrosanct). It does not detract from the usefulness of the Commissioner's publication of her view. It does, however, place limitations on that usefulness. Taxpayers should be alerted to those limitations.

Relationship with revised draft Question We've Been Asked on "Deductibility of the costs of obtaining a detailed seismic assessment of a building"

Relatedly, the Commissioner is concurrently consulting on a revised draft "QB" on the deductibility of detailed seismic assessment ("DSA") costs.

In discussing the application of the capital limitation in relation to DSA costs, the comment is made in paragraph 27 of the draft QB that:

> *"While Trustpower adds to that case law,* ***the Commissioner considers that the principles from Trustpower do not assist in determining the deductibility of the DSA costs incurred in the situations identified in this item****. This is because the DSA costs are incurred in relation to an existing capital asset (that is, a building). In Trustpower, the expenditure was incurred on projects that, if they came to fruition, would result in the acquisition or development of new capital assets.* ***Those capital assets did not exist when the expenditure on the resource consents was incurred. Therefore, the following paragraphs consider the deductibility of DSA costs under the general principles*** *formulated in Hallstroms and applied and developed in Nchanga."*

[Our emphasis]

The SC approach in *TrustPower* did not apply any special capital/revenue principles. There is, therefore, nothing special about feasibility expenditure that would seem to us to require a different analysis for DSA costs.

From a position of principle, it is important that the two interpretations contain consistent arguments. KPMG will be submitting separately on the revised draft QB.

This comment raises a question for the draft IS. The source of this comment may be the Commissioner's position in the first draft of the DSA costs QB that the feasibility expenditure analysis in IS 08/02 was only applicable to new asset scenarios. That no longer appears to be the Commissioner's view in the draft IS. (See paragraph 15 which refers to the acquisition or development of a capital asset.) The Commissioner should therefore clarify her position with respect to the application of the IS to both new and existing assets.

Further information

We have not had the time to mark-up the draft IS to illustrate our comments as well as make further suggestions. (For example, we consider the reference to "relationship" in the first line of paragraph 125 should be replaced with "distinction" to better describe the issue.) If it would be helpful for us to provide such further comments, please let us know.

Please do not hesitate to contact us, John Cantin on (04) 816 4518 or Darshana Elwela on (09) 367 5940, if you would like to discuss our submission in greater detail.

Yours sincerely

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