Practitioner's viewpoint: Trustpower: the black hole problem continues

01 NOVEMBER 2016 | INCOME TAX

Click to open document in a browser

Trustpower Ltd lost its appeal over whether $17.7m of feasibility costs were deductible revenue expenditure.

The Supreme Court in Trustpower Ltd [1] *ruled that expenditure incurred between 2006 and 2008 to investigate and apply for resource consent for a number of potential power generation projects was non-deductible capital.* [2]

That decision has led to the withdrawal of the Commissioner's policy regarding the treatment of "feasibility expenditure" in Interpretation Statement 08/02. But more generally, the Supreme Court judgment highlights the unresolved problem of black hole expenditure within the New Zealand tax regime.

Although both the Commissioner and the courts have repeatedly recognised this as a problem, attempts to solve it have been piecemeal and largely unsatisfactory. One knowledgeable commentator explained how taxpayers deal with black hole expenditure in practice: [3]

© CCH

> *"This has long been a frustration for business. … Teams of tax accountants are employed to minutely scrutinise all such expenditure to see what can be justifiably pushed into the revenue account category and be deducted."*

Possibly because of Inland Revenue's awareness of this practice, investigation of black hole expenditure is common. Given the often large amounts involved, and the difficulty of achieving certainty in this difficult area, judgement calls made by taxpayers as to which side the expenditure falls often give rise to disputes. In this article Tori Sullivan, Director Tax Controversy Team, EY Law and Mark Keating, Senior Lecturer in Tax, University of Auckland, discuss the implications of the Supreme Court decision and consider possible solutions.

It is unfortunate that Trustpower is only the latest in a line of cases wrestling with this problem. In the past year, two other cases have also resulted in expenditure being both non-deductible and non-depreciable: ANZCO Foods [4] *and Queenstown Airport Corporation.*[5]

These three decisions clearly demonstrate the disincentives taxpayers face when investing in large scale capital projects. The wider impact on investment in our economy cannot be ignored and comprehensive reform is needed to provide a more commercially realistic treatment for what would otherwise be black hole expenditure.

Trustpower

Trustpower Ltd ("Trustpower") is a generator and retailer of electricity. It generates about half the electricity it sells and purchases the rest on the electricity market. As part of its wider business operations Trustpower continually assesses the feasibility of potential future generation projects along a "development pipeline process". This consisted of some 200 potential projects at any given time, with a handful of such projects being taken to the resource consent stage. The case considered the deductibility of the various professional and administrative costs incurred by Trustpower in obtaining resource consents on four of those projects.

Although the case turned on the traditional capital/revenue distinction, it was complicated by the Commissioner's policy regarding the tax treatment of "feasibility expenditure" in IS 08/02.[6]

That policy was developed by Inland Revenue in response to the High Court judgment in *Milburn* [7] . That case concerned feasibility expenditure on obtaining resource consents and licences for three of 48 different sites that were potentially suitable for development as a quarry. The company capitalised those costs once the necessary consents were obtained but treated the expenditure on revenue account if those applications failed or the project did not proceed (as there was no asset to which those costs could be capitalised and therefore depreciated).

This treatment prevented the costs on the failed applications from becoming black hole expenditure. Unfortunately, the High Court rejected that pragmatic approach, ruling that expenditure on identifiable projects to which a company has committed itself must be capitalised, even if that project is not completed.

Following *Milburn*, Inland Revenue released IS 08/02 which provided that the tax treatment of feasibility expenditure would turn on both the degree to which those costs related to specific identifiable capital projects and whether the taxpayer had decided to proceed with that project. Under IS 08/02, feasibility expenditure was deductible if it was incurred to put the taxpayer in a position to make a decision on whether to proceed with the particular project. Expenditure incurred after that point was capitalised.[8]

In effect, IS 08/02 drew a distinction between "feasibility expenditure" incurred by a taxpayer prior to making a definitive commitment to proceed with a project and expenditure incurred after that decision. This became the so-called "definitively committed" test.

Under the policy, it did not matter whether the project was successfully completed. If that project was subsequently abandoned or failed, the costs incurred after a taxpayer was definitively committed would have no corresponding asset to be capitalised to and therefore treated as black hole expenditure.

On the definitively committed test, the policy explains:[9]

© CCH

> "Identifying when a decision to proceed has been reached in any particular situation will always be a question of fact and degree, and it is necessary to weigh all the relevant factors to determine whether a commitment has been made to a project."

Applying IS 08/02, the taxpayer and the Commissioner in *Trustpower* focused on whether and when the taxpayer had made the decision to proceed with the projects. The taxpayer argued that obtaining the resource consents was merely a further step in the consideration process.

The High Court ruled in favour of the taxpayer.[10] It concluded the resource consents were not stand-alone assets in their own right and the taxpayer could not have made the decision to commit to the process until after such consents were obtained. Rather, obtaining resource consents for potential projects was part of Trustpower's regular feasibility process and so was part of its ordinary business operations. All expenditure on those consents was therefore deductible. The Commissioner appealed.

The Court of Appeal overturned the High Court decision.[11] It ruled that the projects were each separate assets with their own value. As the resource consents expanded Trustpower's business structure they were on capital account.

Relying upon a traditional capital/revenue analysis, the Court of Appeal reviewed the prior case law on the treatment of resource consents (which uniformly found them to be capital assets) and then weighed the traditional tests propounded in the leading capital revenue cases, most notably *BP Australia*.[12] It concluded that, either on their own or as a step towards the larger project, the resource consents were capital assets.

In reaching that decision the Court of Appeal called into question the reasoning in IS 08/02. In particular, it considered that under normal capital/revenue criteria the expenditure on such projects should always be on capital account, regardless of whether the taxpayer has definitely committed to that project. Nevertheless, it accepted that IS 08/02 represented "a pragmatic response to the issue".[13] The taxpayer appealed that decision.[14]

The Supreme Court rejected Trustpower's appeal but on narrower grounds.[15] Although it was expected that the Supreme Court would provide some general guidance on the wider question of the capital/revenue boundary, this did not eventuate. The decision does not include that wider statement of the law, but it nevertheless provides insight into the Court's general approach.

The Supreme Court ruled that the expenditure was directed at identifiable capital projects and obtaining the consents was a "tangible step" towards completing those projects.[16] From those findings it easily concluded the expenditure was non-deductible:

> "The expenditure on obtaining resource consents in this case was directly related to specific projects that would be on capital account if they came to fruition. The projects could not proceed without resource consents. Obtaining the consents thus represented tangible progress towards their completion. The expenditure is thus on capital account and not deductible."

To support that conclusion the Court also reasoned that there was a legislative assumption, reflected in previous case law, that expenditure to obtain resource consents was on capital account. Further, the Court found that the accountancy treatment warranting immediate deductibility of those costs was "not material".[17]

Does "feasibility expenditure" exist as separate category?

For many years both taxpayers and the Commissioner have treated feasibility expenditure as a separate category of expenditure — but the Supreme Court's decision rejected that approach.

Instead, the proper test is whether the particular expenditure represented a step towards the creation of a capital asset. All costs that advance the development of a capital project are therefore capital, regardless of whether the taxpayer is committed to completing that project. Only costs that are so preliminary as not to be directed towards a specific project are still deductible.

© CCH

In practice, this is likely to lead to more feasibility costs becoming "black hole" expenditure. The Supreme Court was aware of this risk:[18]

> "At this point, we should introduce the problem of expenditure on projects which do not proceed. If such expenditure is on capital account, the taxpayer might be thought to be prejudiced. Because the project never eventuates, there is no corresponding asset or permanent advantage accruing and, therefore, nothing to depreciate. Further, because the wasted expenditure is on capital account, there is no available deduction. Such expenditure is sometimes said to have disappeared into a 'black hole'."

The court recognised the undesirability of this outcome from a policy perspective and noted the instances where Parliament had taken targeted steps to alleviate this problem; but held it did not displace the clear operation of the capital limitation where none of those concessions applied:[19]

> "The possibility that some, or all, of the expenditure may in the end turn out to be wasted does not displace the operation of the capital limitation."

The future of IS 08/02?

The Supreme Court flatly rejected the approach in IS 08/02 which focuses on a taxpayer's subjective decision over whether it had definitively committed to a project. The Supreme Court explained:[20]

> "The subjectivity which is implicit in the commitment approach would give rise to some practical problems. This is because a decision whether there was commitment would have to be made in a context in which a taxpayer:
>
> > (a) can be expected to defer commitment as long as possible to maximise the extent to which expenditure can be deducted; and
> > (b) has control of the contemporaneous records (board minutes and papers for example) which will form the basis of the later assessment whether there was a commitment."

On 18 August 2016, Inland Revenue released a Case Impact Statement advising:[21]

> "… the Commissioner will be applying the principles in the Supreme Court's decision in relation to any binding ruling applications, and in any future challenges, and so tax positions taken after the date of the judgment should take the decision into account. However, the Commissioner will not be actively reviewing previous years where taxpayers have applied the Interpretation Statement approach."

Given that conclusion, taxpayers should no longer rely upon IS 08/02.

On 28 September 2016, Inland Revenue released the draft of a revised Interpretation Statement on the "Deductibility of Feasibility Expenditure" to replace IS 08/02. The introduction to that draft statement explains:[22]

> "The Supreme Court approach represents the current legal position, and must be applied by the Commissioner and taxpayers from the date of judgment. As such, IS 08/02 should no longer be relied on. The Commissioner will be applying the principles in the Supreme Court's decision in relation to any binding ruling applications, and in any future challenges, and so tax positions taken after the date of the judgment should take the decision into account. However, the Commissioner will not be actively reviewing previous years where taxpayers have applied the approach in IS 08/02 …"

Inland Revenue explains that the draft policy differs from its predecessor in that:

> "references to 'commitment' as a relevant factor have been removed. This has been replaced with consideration of whether there has been material advancement of (or tangible progress on) a specific capital project (or asset or other enduring benefit)."

The draft also includes two additional examples that consider the deductibility of expenditure that "is preliminary and … does not result in any tangible progress of the project or any capital asset or other enduring benefit" within the narrow exception referred to in the Supreme Court judgment.

© CCH

Implications for taxpayers

The immediate implication of *Trustpower* is uncertain. Future feasibility expenditure is now obviously governed by the reasoning of the Supreme Court (and not IS 08/02) but what happens to past or current feasibility costs? The following treatment would appear to apply:

- ***Tax positions taken before the judgment, correctly applying IS 08/02:*** Unlike other instances when Inland Revenue has won a case of wider application, it has not requested remedial action for past years (for example, by calling for a voluntary disclosure). Rather, it has confirmed that it will not actively review previous years where taxpayers have correctly applied the approach in IS 08/02. However, how the Commissioner will treat mistakenly claimed feasibility expenditure for those earlier years when it is identified as part of another audit remains unclear. For taxpayers considering acquisitions or divestment, feasibility expenditure previously deducted in accordance with IS 08/02 may represent a "hidden" tax liability that may (or may not) be uncovered during due diligence and covered by a tax indemnity agreement.
- ***Tax position taken between judgment and withdrawal of IS 08/02:*** Although taxpayers should have technically applied the Supreme Court's decision, IS 08/02 represented "the Commissioner's official opinion" until the Case Impact Statement was released on 18 August 2016. Although there is no estoppel against the Commissioner with respect to the core tax, taxpayers who relied upon the policy during that period should nevertheless be protected from the imposition of shortfall penalties and interest.[23]
- ***Tax positions taken after 18 August 2016:*** Taxpayers must now apply the Supreme Court's decision. Following release of the Case Impact Statement, IS 08/02 is no longer the Commissioner's official opinion and does not provide protection against reassessment, penalties or interest.

Trustpower itself publicly hoped Inland Revenue would not attempt to apply the decision retrospectively. It stated:[24]

> "All eyes now turn to Inland Revenue to find out what its next approach will be. While we see this decision as moving the capital-revenue boundary in Inland Revenue's favour, we hope they will continue to respect tax positions taken by taxpayers to date where they have been consistent with Inland Revenue's previous guidance."

Not surprisingly, the implications of *Trustpower* for other taxpayers have been widely criticised. Much of that criticism (considered below) focuses on the economic impact of black hole expenditure on taxpayers across a wide range of industries. As feasibility expenditure encompasses investigating new processes and services, as well as capital projects, the decision potentially impacts on a wide range of expenditure types, including wages for staff time spent on due diligence, executives' time spent on determining strategy or investigating possible expansion and new investments, and much research and development expenditure. All may now also fall into the black hole.

Unfortunately for taxpayers the outcome in *Trustpower* is not isolated. Two other recent cases have demonstrated the unsatisfactory implications of denying both a deduction and depreciation to expenditure incurred by taxpayers in the normal course of business.

ANZCO Foods

In *ANZCO Foods* the taxpayer incurred costs buying-out a restrictive land covenant to allow for more effective use of that land as part of its business.[25] ANZCO had earlier purchased a number of assets from a competitor, including meat processing plants. However, that sale included a number of restrictions on how ANZCO could use those assets. Subsequently, the parties entered into a settlement, removing those restrictions.

© CCH

ANZCO treated that settlement payment as fixed life intangible property, being "the right to use land"[26] in a manner that was previously prevented to it. The High Court upheld the Commissioner's disallowance of that depreciation. It ruled:

- ANZCO already had "the right to use the land" as its owner, and the settlement payment only lifted contractual restrictions owed to another party on that use.[27]
- Even if the removal of those contractual restrictions amounted to a right to use land, those rights ran with the land indefinitely so were neither "fixed life" nor could they be reasonably expected to decline in value. While the contractual restrictions had a fixed life, their removal was permanent.[28]

Therefore, that cost constituted black hole expenditure.

Queenstown Airport Corporation

Queenstown Airport Corporation concerned whether Queenstown Airport Corporation ("QAC") could depreciate the cost of constructing its Runway End Safety Area ("**RESA**").[29] A RESA is an area at the end of the runway intended to reduce the risk of damage to an aeroplane undershooting or overrunning the runway. The Civil Aviation Authority mandated from 2006 that all airports must have a RESA. As Queenstown Airport was built next to the Shotover river, QAC had to engineer and construct a large embankment to gain the space to satisfy the RESA requirement.

QAC claimed depreciation for the cost of the RESA on the basis it was a "land improvement"[30] (within the categories of "airport runway" or "hardstanding" or "roads"). In particular, QAC argued the RESA formed part of the "runway system" operated by the airport, which included not only the landing strip itself but also the safety areas used by the planes. Alternatively, QAC argued that the RESA was hardstanding or road.

Inland Revenue countered that the RESA merely constituted a type of non-depreciable land improvement. It also claimed that, even if the engineering and construction work required to create the RESA constituted "land improvements", it did not reasonably decline in value over time.

The High Court ruled against QAC on all points, finding that the RESA did not constitute depreciable property as it was not:

- "Airport runway" as planes did not take off or land on that area other than in emergencies.
- "Hardstanding" because it was not paved and aircraft would sink into its surface.
- "Road" because it was not generally used as a passageway by planes.

The Court rejected the interpretation advanced by QAC that the RESA formed part of the "runway system". Periodically, Parliament adds new categories of depreciable property to the depreciation schedules — and the Court considered whether to extend depreciation to other assets within an airport's runway system should be determined by Parliament. The Court explained:[31]

> "If a land improvement does not actually come within one of those specified depreciable land improvements it is not open to a taxpayer to contend that, by analogy with some listed items, the land improvement falls within the general purview of Schedule 13. To put the point somewhat differently, it is not the function of the Court to recognise additional new items in Schedule 13. The proper mode of extension of the Schedule 13 list is by legislation ... ".

The Court also concluded that, even if the RESA had come within the existing sch 13 categories, it would still not have qualified for depreciation as it might not reasonably be expected to decline in value while used or available for use. The Court found that despite the RESA's extensive engineering and expected 100 year useful life, provided it received standard maintenance, it would remain indefinitely except in the "rare event of an aircraft undershooting or overrunning the runway"[32] — the very contingency for which it was created. The cost therefore constituted black hole expenditure.

The problem of black hole expenditure

© CCH

There is no precise definition of black hole expenditure but the concept is both well understood and widely discussed. A practical explanation of the problem from one commentator was:[33]

> "While depreciation is worse than a full deduction in the year the expenditure is incurred it is better than nothing. 'Black hole' expenditure is the name given to expenditure that cannot be deducted in the year it is incurred because of the operation of s DA 2(1) but which does not give rise to a capital asset and hence cannot be depreciated over time. Because the expenditure does not give rise to a capital asset the outgoing is not captured in anything that can be depreciated for tax purposes. The expenditure therefore sits in no-man's land and cannot be deducted. It falls into a 'black hole' so to speak."

The concept of black hole expenditure offends the underlying policy of the Inland Revenue Acts that income tax shall be imposed on the net profit or gain of the taxpayer for the year.[34] That "net income" is calculated by including all income receipts of a business and then allowing a deduction for revenue expenses or depreciation for capital allowances. Black hole expenditure upsets that balance by refusing to recognise a portion of the genuine business costs incurred by taxpayers when calculating their annual net income. Accordingly, the taxpayer pays tax on a "net income" that is not actually enjoyed:[35]

> "As a general proposition there is tax symmetry. A revenue account receipt is taxable and revenue account costs are assessable. Conversely, capital gains are not taxable but capital losses are not deductible either. Depreciation recognised the diminution in value of capital assets over their useful working life. It also recognises that the asset will have to be replaced eventually. Black hole expenditure was and is a breach of the symmetry because it falls into a hybrid category being neither truly revenue in nature nor truly capital in nature because no asset has been generated."

Black hole expenditure imposes an unwarranted tax burden on the taxpayer. It results in a lower after-tax profit for the business and a lower return on investment for stake-holders. It causes an undesirable dead-weight cost, which is either passed on to the end customers or absorbed by the taxpayer.

This outcome is undesirable from the viewpoint of economic efficiency. New Zealand prides itself in a tax policy that adheres (as far as possible) to best practice. Earlier this year, Inland Revenue boasted how its policy design was guided by these objectives,[36] but black hole expenditure clearly breaches those objectives and is out of step with other parts of New Zealand's taxing regime.

That discussion took place with regard to the proposed relaxation of the zero-rating rules for financial services regarding capital raising costs. The proposal [37] stipulates that its aim was to further reduce undesirable outcomes arising from the denial of GST input tax credits to taxpayers providing exempt financial services to GST-registered customers. The Government recognised that refusing deduction for legitimate business costs generally results in those costs cascading through the supply chain and Inland Revenue explained its aim was "to reduce the potential for tax cascades caused by the exempt treatment of financial services, where tax must either be absorbed or passed on by the business receiving the supplies".[38] The problem of tax cascades was explained:[39]

> "Denying deductions for these costs is said to lead to tax cascades, as a taxable business must either absorb the GST cost or pass the cost onto its customers, with GST being charged on this amount again in later stages of the supply chain. … Passing on the cost of this GST may result in a tax cascade, where the unrecoverable GST is embedded in the price paid for the supply, and the supply itself is taxed."

So the undesirability of non-deductible expenditure by business is recognised — and Inland Revenue officials are taking steps to further reduce those problems within the GST regime. Sadly, there are currently inadequate steps to address the equivalent problem of black hole expenditure for income tax.

Piecemeal response to black hole expenditure

© CCH

The undesirable policy outcome resulting from black hole expenditure has repeatedly been raised as a concern by the tax community over many years.[40]

The problem was examined by commentators in 2011 considering the potential implications for taxpayers incurring feasibility expenditure, using the *Trustpower* dispute (then before the High Court) as an example:[41]

> "The non-deductibility of feasibility expenditure can result in the reluctance of taxpayers to assess the viability of certain capital projects or new product development. Business expenditure on research and development in New Zealand is substantially below the level of the average of the other members of the OECD. One of the reasons for this lamentably low level of expenditure could be this tax problem."

This conclusion implied the problem of black hole expenditure falls not only upon the taxpayer and its customers but also upon the wider economy. It is reasonable to assume that black hole treatment acts as a disincentive to investment in the areas affected. Certainly, that was the view expressed by media commentators following each stage of the *Trustpower* decision. For instance, it was reported that:[42]

> "Consequently, the Chief Financial Officer of TrustPower is reported as saying that if the dispute is lost, then TrustPower's projects will be curtailed as 'it's a pretty clear signal not to take too many chances around generation development'."

More recently, NZICA (as it was then) made submissions to Inland Revenue pointing out the "perverse incentives for marginal projects" created by the problem of black hole expenditure.[43]

Although the problem has been on the Tax Policy Work Programme for more than a decade,[44] Inland Revenue has engaged in piecemeal reform as specific problems were identified and considered to warrant remediating.[45]

An example of this fire-fighting is found following the High Court decision in *Milburn*.[46] In that case, the taxpayer incurred expenditure on seeking resource consents for possible quarries. The costs of such consents were non-deductible capital but, when the quarry did not proceed, were also not depreciable. To address that obviously unsatisfactory outcome, the capital costs of obtaining certain types of consents granted under the Resource Management Act 1991 were added to the list of "depreciable intangible property" in Schedule 14, with effect from the 1997 income year.[47]

Subsequent other amendments have addressed a range of other instances of black hole expenditure on an ad hoc basis. In 2013 Inland Revenue released a Discussion Document explaining it:[48]

> "… continues this focus on supporting business growth and innovation by suggesting changes to deal with the "black hole" tax treatment … Providing tax deductibility, in appropriate circumstances, for capitalised development expenditure that is currently black hole expenditure has the potential to remove or mitigate economic distortions which may act as a disincentive to businesses undertaking R&D."

Accordingly, in 2013 deductions were permitted for certain costs of obtaining plant variety rights, company administration and failed resource consents.[49] In 2014 deductions were permitted for R&D expenditure.[50]

When introducing those changes, the Minister of Revenue acknowledged that "these amendments will remove certain distortions against investment arising from current tax settings, while reducing compliance costs and providing greater certainty for taxpayers."[51]

Taxpayer response to these measures has been lukewarm. One commentator complained:[52]

> "These two changes deal explicitly with [narrow categories of] black hole expenditure … It will be immediately apparent that although the headlines made it look as if the whole conceptual problem with black hole expenditure was benevolently dealt with by the law changes announced on budget night, that is not in fact the case. The changes address only a very small subset of what is comprised within the concept of black hole expenditure."

© CCH

More worryingly, that commentator suggested the changes were entirely self-serving and involved the Government attempting to “pick winners” by only allowing deductions for certain favoured expenses:[53]

> “The motivation from a governmental perspective for these changes is unlikely to have been a desire to improve tax symmetry. It is more likely to have been a desire to remove impediments to obtaining of patents, plant variety rights and resource consents. Those assets are ordinarily associated with positive investment activity, which is something that the government wants to encourage.”

Despite recognition of the problem, and the fanfare given to incremental steps to resolve limit examples, no wider response has been proposed. Sadly, this lack of progress compares unfavourably with the solution provided in Australia a decade ago.

Australian response to black hole expenditure

The problem of black hole expenditure is not unique to New Zealand. However, the problem is more acute here due to the lack of a capital gains tax regime that would otherwise incorporate those expenses within the cost base of the underlying asset when calculating any capital gain or loss upon eventual disposal (or abandonment) of that asset. While the benefit under such regimes may be long-deferred, it is seldom entirely lost. By contrast, the absence of an equivalent capital gains tax in New Zealand means those costs are truly wasted.

The unsatisfactory nature of black hole expenditure was addressed in Australia in 2006.[54] Section 40–880 of the Income Tax Assessment Act 1997 now provides a deduction for all kinds of black hole expenditure incurred by a business that is not otherwise deductible or depreciable under any other provision and is not included in the cost base of an asset for capital gains tax purposes. Such deduction is taken on a straight line basis for five years from the year in which the expenditure is incurred.

This provision allows for the deduction of capital expenditure types that are presently prohibited in New Zealand, including costs on establishing or reforming the business structure, capital raising costs, expenditure to make or defend against a takeover, and costs associated with the termination of business operations. It would also cover feasibility expenditure incurred on failed capital projects.

The Australian legislation provides that this black hole provision is a last resort and may be utilised only if deduction under another provision is unavailable. But it ensures those costs are spread over a five year period rather than being entirely wasted.

In 2006, Inland Revenue considered introducing a similar comprehensive regime in its Business Tax Review — but was obviously put off by the potential loss of revenue. Inland Revenue estimated that a broader reform to eliminate black hole expenditure would cost the Government between $150m to $300m annually. For instance, the Discussion Document explains:[55]

> “Another example of black hole expenditure is the cost of certain feasibility studies. Allowing such expenditure to be deducted or amortised would clearly have a fiscal cost, though it is not possible to estimate with any accuracy.”

In 2013, one commentator simply concluded:[56]

> “Businesses have long called for this concern to be addressed. … It is understood that fiscal constraints prevent New Zealand from following Australia's general solution to the problem.”

Until effective reform is introduced the precise costs will remain unknown – but will continue to be carried by taxpayers and their customers.

A case for legislative change

The decisions in *Trustpower*, *ANZCO Foods* and *Queenstown Airport Corporation* are detrimental for businesses seeking to invest or expand. They affect the power generation, agricultural processing and aviation / tourism industries — presumably all sectors of the economy the Government wants to encourage to expand. The results in these cases will undoubtedly lead to more undesirable black hole expenditure in

© CCH

each of those sectors and possibly beyond. It also calls into question wider Government policy to encourage "innovation", as promoted in Budget 2016 and the Business Growth Agenda.[57]

In the view of many commentators there are strong grounds for seeking a comprehensive legislative solution similar to that provided in Australia. For example:[58]

> "Black hole" expenditure … has been a running sore for businesses for years. Steps to remedy existing anomalies are welcome."

Another commentator explained:[59]

> "The deductibility of feasibility expenditure is an important issue for any business that incurs costs in investigating or exploring whether the acquisition or development of new assets is practical or possible. Most businesses look to grow. Growth will usually require increased production (or the equivalent). Increased production will require increased capacity achieved in one way or another. The heart of the feasibility expenditure issue is whether and to what extent the cost of evaluating options for business growth is deductible. It is an issue that affects every business aspiring to grow."

That same article concludes:

> "The court's … approach does not sit well with commercial realities. The approach reflects a restrictive view of business operations and unless readdressed by … Parliament, raises the risk of a revenue brake on business development and improvement which the country can scarcely afford."

Even the popular press have taken up the issue. Following the *Trustpower* decision the NBR wrote:[60]

> "The big infrastructure companies are going to have to start putting pressure on the Minister of Revenue to get some legislation that makes it clear."

Likewise, the New Zealand Herald wrote:[61]

> "Businesses have been left in limbo by the Supreme Court ruling in Trustpower's tax dispute."

Radio New Zealand commented:[62]

> "Lawyers and accountants are warning a landmark ruling by the Supreme Court could deter big new business projects across New Zealand from getting started. The ruling means many of the huge costs in getting resource consent for projects cannot be set off against tax, making them more expensive. … Bridget McArthur is the chairwoman of the Energy Law Association and said the Supreme Court ruling could inhibit a lot of business enterprise."

Interestingly, most commentators noted that the decision may also pose "a big problem for government" which obviously favours these infrastructure projects to proceed.[63]

> "What this decision does is potentially make a lot of costs that we thought were deductible non-deductible, and that means the cost of investigating new assets or new businesses becomes more expensive."

Conclusion

The Supreme Court has spoken and Inland Revenue must apply *Trustpower*. Due to the timing of the Supreme Court judgment some taxpayers will have already filed their 2015 income tax return while others will not. Presumably that will mean taxpayers who took their tax position based on IS 08/02 may have obtained a benefit over taxpayers who must apply the Supreme Court reasoning. That inconsistency is unwelcome.

Businesses often incur feasibility costs. It's part of being productive and innovative. Those costs should be deductible or depreciable, depending on the outcome — which was the "pragmatic approach" adopted by the taxpayer in *Milburn*.

© CCH

Taxpayers potentially affected by the unsatisfactory outcome in *Trustpower* and the other cases may considering holding back on economically desirable large development projects. *Trustpower* has made a bad situation worse. After so many years and many unsatisfactory disputes it is now up to Parliament to resolve the problem. Options include widening the types of assets which qualify for depreciation, or allowing either an immediate deduction or Australian-type amortisation for expenditure that is written off for accounting purposes. But it is apparent that a legislative response is required to remedy the negative implications of these recent cases.

Last reviewed on 1 November 2016

Footnotes

1 *Trustpower Ltd* v *Commissioner of Inland Revenue*[2016] NZSC 91, (2016) 27 NZTC ¶22-061.

2 Prohibited from deduction under s DA 2(1) Income Tax Act 2007.

3 James Coleman "Black Hole Expenditure" (June 2013) at http://www.jhcoleman.co.nz/articles/black_hole_expenditure/>.

4 *ANZCO Foods Ltd* v *CIR*(2016) 27 NZTC ¶22-049.

5 *Queenstown Airport Corporation Ltd* v *C of IR HC Wellington*, (2016) 27 NZTC ¶22-054.

6 See *Trustpower*, SC, at [7].

7 See *Milburn NZ Ltd* v *CIR*(2001) 20 NZTC 17,017 (HC).

8 IS 08/02, at [18].

9 IS 08/02, at [20].

10 *Trustpower Ltd* v *CIR*(2013) 26 NZTC ¶21-047.

11 *CIR* v *Trustpower Ltd*(2015) 27 NZTC ¶22-010.

12 *BP Australia Ltd* v *Federal Commissioner of Taxation*[1966] AC 224 (PC).

13 *Trustpower*, CA, at [136].

14 Leave to appeal granted in *Trustpower Ltd* v *CIR*(2016) 27 NZTC ¶22-025.

15 *Trustpower, Ltd* v *CIR*(2016) 27 NZTC ¶22-061.

16 *Trustpower*, SC, at [71].

17 *Trustpower*, SC, at [65].

18 *Trustpower*, SC, at [25].

19 *Trustpower*, SC, at [48].

20 *Trustpower*, SC, at [70].

21 See http://www.ird.govt.nz/technical-tax/case-notes/2016/cn-2016-07-27-trustpower-cir.html>.

22 See http://www.ird.govt.nz/resources/1/6/1684cbc6-2d95-4e62-848a-12bdbdf29752/pub00278.pdf

23 See Tax Administration Act 1994, at ss 120W and 141B(1D); and the discussion in Mark Keating and Kirsty Keating "*Commissioner's Official Opinion: A "Get Out of Gaol Free" Card?*" (2015) 21 NZJTLP 270.

24 See Dean Mackenzie "Trustpower bemoans tax treatment decision" *Otago Daily Times* (online ed, Otago, 27 July 2016). at: http://www.odt.co.nz/news/business/391755/trustpower-bemoans-tax-treatment-decision.

25 *ANZCO Foods Ltd* v *CIR*(2016) 27 NZTC ¶22-049 (HC).

26 Within sch 14 Income Tax Act 2007.

27 *ANZCO Foods*, at [106].

28 *ANZCO Foods*, at [109].

29 *Queenstown Airport Corporation Ltd* v *CIR*(2016) 27 NZTC (HC) ¶22-054.

30 Within sch 13 Income Tax Act 2007.

© CCH

31 *Queenstown Airport Corporation*, at [60].

32 *Queenstown Airport Corporation*, at [164].

33 James Coleman "Black Hole Expenditure" (June 2013) http://www.jhcoleman.co.nz/articles/black_hole_expenditure/.

34 See ss BC 4 and BC 5 Income Tax Act 2007.

35 James Coleman "Black Hole Expenditure" (June 2013) http://www.jhcoleman.co.nz/articles/black_hole_expenditure/.

36 See Inland Revenue "Regulatory Impact Statement – GST current issues" (11 February 2016) Tax Policy, Inland Revenue http://taxpolicy.ird.govt.nz/publications/2016-ris-archcrm-bill/gst-current-issues

37 Those reforms are included in the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill introduced on 3 May 2016.

38 IRD Regulatory Impact Statement — Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill , GST current issues, at: http://taxpolicy.ird.govt.nz/publications/2016-ris-archcrm-bill/gst-current-issues

39 Inland Revenue "Regulatory Impact Statement – GST current issues" Tax Policy, Inland Revenue (11 February 2016) http://taxpolicy.ird.govt.nz/publications/2016-ris-archcrm-bill/gst-current-issues, at [22] and [26].

40 See Casey Plunket "Feasibility and Acquisition Expenditure – thoughts inspired by Milburn NZ Ltd and Recent Legislative changes" (2001) Chapman Tripp publications; and "Black hole disappointment", Kevin Donaldson, Deloitte Tax Alert. See: http://nztaxonline.deloitte.co.nz/news/print.aspx?gid=1.

41 Craig Elliffe and Peggy Lui "The Problem with "Black Hole" and Feasibility Expenditure: Some Suggestions for Reform" (2011) 17 NZJTLP 67.

42 Rob O'Neill "Tax black hole threatens project plans" *The Sunday Star Times* (New Zealand, 4 July 2010).

43 NZICA "Black Hole R&D Expenditure Proposals" (20 Dec 2013) www.nzica.com/Technical/Tax/Tax-submissions/~/media/NZICA/Docs/

44 See New Zealand Government "Government Tax Policy Work Programme 2009-10" (20 March 2009), at: http://taxpolicy.ird.govt.nz/sites/default/files/news/2009-03-20-tpwp-2009-10.pdf at 2

45 Professor Adrian Sawyer "Complexity of Tax Simplification: A New Zealand Perspective" (January 2016), at: http://www.researchgate.net/publication/303442604_Complexity_of_Tax_Simplification_A_New_Zealand_Perspective

46 Milburn NZ Ltd v CIR (2001) 20 NZTC 17,017.

47 This change, which was recognized as "not complete", was noted by the Supreme Court in Trustpower, SC, at [30] "Black hole R&D expenditure", (Nov 2013) http://taxpolicy.ird.govt.nz/sites/default/files/2013-dd-black-hole-r-and-d-expenditure.pdf at 1.1-1.3.

48 "Black hole R&D expenditure", (Nov 2013) http://taxpolicy.ird.govt.nz/sites/default/files/2013-dd-black-hole-r-and-d-expenditure.pdf at 1.1-1.3.

49 See Hon Peter Dunne, "Budget Tax Relief for 'black hole' expenditure", (15 May 2013), at: http://www.beehive.govt.nz/release/budget-tax-relief-%E2%80%98black-hole%E2%80%99-expenditure. See also: Inland Revenue "Black hole expenditure" (November 2013) Tax Policy, Inland Revenue http://taxpolicy.ird.govt.nz/publications/2013-commentary-arearm/black-hole-expenditure.

50 Inland Revenue "Black hole expenditure (February 2015) Tax Policy, Inland Revenue http://taxpolicy.ird.govt.nz/publications/2015-commentary-arrdrm/black-hole-expenditure.

51 Inland Revenue "Black hole expenditure" (November 2013) Tax Policy, Inland Revenue http://taxpolicy.ird.govt.nz/publications/2013-commentary-arearm/black-hole-expenditure.

52 James Coleman "Black Hole Expenditure" (June 2013), at http://www.jhcoleman.co.nz/articles/black_hole_expenditure/>.

53 James Coleman "Black Hole Expenditure" (June 2013), at http://www.jhcoleman.co.nz/articles/black_hole_expenditure/>.

© CCH

54 See Commonwealth Tax Laws Amendment (2006 Measures No. 1) Act 2006.

55 Business Tax Review, (July 2006) Inland Revenue http://taxpolicy.ird.govt.nz/sites/default/files/2006-dd-btr.pdf at [3.33].

56 Brendan Brown "The Capital-Revenue Boundary: Legislative Developments and Interpretative Issues" (2013) Chartered Accountants Australia New Zealand, at: http://www.nzica.com/~/media/NZICA/Docs/Resources%20and%20publications/2013%20Tax%20Conference/TC13%20Brendan%20Brown%20paper.ashx.

57 Ministry of Business Innovation and Employment, at: http://www.mbie.govt.nz/info-services/business/business-growth-agenda.

58 Darren White and Gina Mills "'Black Hole' expenditure: Relief at last" (2014) EY Tax Watch - Edition 3, 2014, at http://www.ey.com/NZ/en/Services/Tax/EY-Tax-Watch-edition-3-5-black-hole.

59 Vivian Chen & Geoff Clews "'Castles on a Cloud' — Deductibility of feasibility expenditure" at: http://www.taxcounsel.co.nz/Resources/Publications+papers+and+commentary/Feasibility+Expenditure.html.

60 Jenny Ruth "Trustpower case creates 'black hole expenditure'" National Business Review at: http://www.nbr.co.nz/article/trustpower-case-creates-black-hole-expenditure-jr-p-175072.

61 Hamish Fletcher "Trustpower tax ruling creates uncertainty" *The New Zealand Herald* (28 July 2016)

62 Eric Frykberg "Concern tax ruling may hurt development" (28 July 2016) Radio NZ, at http://www.radionz.co.nz/news/business/309597/concern-tax-ruling-may-hurt-development

63 Eric Frykberg "Concern tax ruling may hurt development" (28 July 2016) Radio NZ, at http://www.radionz.co.nz/news/business/309597/concern-tax-ruling-may-hurt-development

© CCH