The Capital/Revenue Distinction, Feasibility Expenditure and Trustpower Ltd v Commissioner of Inland Revenue

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I INTRODUCTION

In *Trustpower Ltd v Commissioner of Inland Revenue* the New Zealand Supreme Court was asked to determine the nature of feasibility expenditure incurred by Trustpower Ltd investigating the construction of two hydro dams and two wind farms and whether it was deductible.[1] The Supreme Court had to determine the distinction between capital and revenue in an area (feasibility studies) with few case authorities. The case presented the Court with its first opportunity to confirm the approach to distinguishing between capital and revenue both generally and in relation to feasibility expenditure. Although the Court did not discuss the capital/revenue distinction in general, the decision nevertheless remains important. First, the Court confirmed, by its silence on the matter, that the existing authorities on the capital/revenue distinction in general remain good law. Secondly, the Court held that feasibility expenditure is not deductible unless it falls into one of four defined categories. The definitions for these categories are not entirely clear. Therefore, the decision creates uncertainty about the deductibility of feasibility expenditure. It is also likely to increase the incidence of black hole expenditure. In light of these two policy implications, legislative reform is needed to clarify when feasibility expenditure is deductible.

II BACKGROUND: THE *TRUSTPOWER* DISPUTE

Trustpower Ltd is a retailer and generator of electricity. The company earns income from the sale of electricity to consumers. The electricity that Trustpower sells is supplied in two ways: it generates around half of its own electricity and buys the rest from other electricity generators.

At the time of the dispute, Trustpower maintained a development pipeline which involved more than 200 potential generation projects, including hydro dams and wind farms. The development pipeline allowed Trustpower to assess the economic viability of a generation project and how it should source its electricity.

Each generation project in the development pipeline was subject to a three-step feasibility analysis. The first step involved identifying potential

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1 *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91, [2017] 1 NZLR 155.

generation sites, evaluating the feasibility of each site and, if feasible, applying for resource consents to construct and operate a generation project at the site. Secondly, once the resource consents were granted, Trustpower would get designs for each generation project, call for tenders from manufacturers and construction companies, and determine how the project would be connected to the national grid. Finally, a business case would be prepared for the board's consideration.

In the 2005, 2006 and 2007 income tax years, Trustpower incurred costs of $17.7 million applying for and obtaining resource consents under the Resource Management Act 1991. The resource consents related to the construction of two hydro dams and two wind farms. These costs were incurred at the first step of Trustpower's feasibility analysis.

Trustpower sought to deduct the expenditure it incurred in applying for and obtaining the resource consents (the disputed expenditure) under s DA 1 of the Income Tax Act 2004. This turned on whether the disputed expenditure — being feasibility expenditure — was *revenue* in nature and, therefore, deductible; or *capital* in nature and, therefore, precluded from deduction by s DA 2(1).The Commissioner denied the deduction on the basis that the disputed expenditure was capital in nature.

III THE LAW

Deductions

The provisions regarding deductions are the same under the Income Tax Act 2004 and the Income Tax Act 2007. The starting point to determining whether a taxpayer is entitled to a deduction is s DA 1 (the general permission). Section DA 1(1) provides that a taxpayer is allowed a deduction for: expenditure or loss incurred by them in deriving their assessable income; or in the course of carrying on a business for the purpose of deriving their assessable income. However, s DA 1 is subject to s DA 2 (the general limitations). Under s DA 2(1), a person is denied a deduction for expenditure or loss which is capital in nature (the capital limitation). Therefore, expenditure is only deductible under the general permission if it is revenue in nature. As a result, ss DA 1 and 2(1) "[bring] into play the long-standing distinction between capital and revenue."[2]

The Commitment Approach

Prior to *Trustpower*, the commitment approach was regarded as the correct approach to determining the nature of feasibility expenditure and its

2 At [6].

deductibility.[3] The commitment approach heavily influenced the approaches taken by both parties in the *Trustpower* dispute.[4]

The commitment approach defines the capital/revenue distinction, in relation to feasibility expenditure, at the point the taxpayer commits to the acquisition or construction of a capital asset. Consequently, all expenditure incurred investigating the feasibility of a capital project is considered revenue in nature — and therefore deductible — until the taxpayer commits to undertaking the project.[5] After commitment, expenditure related to the acquisition or development of the capital project is capital in nature and, therefore, not deductible.

IV THE JUDGMENTS

The Lower Courts

The High Court held that the resource consents were not assets which could be separated from the generation projects. Since Trustpower had not committed to the generation projects, the disputed expenditure was feasibility expenditure and thus deductible.[6]

The Court of Appeal reversed the High Court's decision for two main reasons. First, s DA 1 had not been satisfied. The possible future projects in Trustpower's development pipeline were "for the purpose of *extending, expanding or altering its business structure in the future*, not part of the carrying on of Trustpower's ordinary business activities".[7] Therefore, the general permission was not satisfied and Trustpower was not entitled to a deduction. Secondly, the Court nevertheless considered the nature of the disputed expenditure and held that it was capital in nature. This is because the "expenditure was incurred for the purpose of enabling Trustpower to *extend or expand* its electricity generation business".[8]

3 Peggy Lui and Craig Elliffe "The Problem with 'Black Hole' and Feasibility Expenditure: Some Suggestions for Reform" (2011) 17 NZJTLP 67 at 69.
4 *Trustpower*, above n 1, at [7].
5 Inland Revenue "IS 08/02: Deductibility of Feasibility Expenditure" (2008) 20(6) Tax Information Bulletin 12 at [20].
6 *Trustpower Ltd v Commissioner of Inland Revenue* [2013] NZHC 2970, [2014] 2 NZLR 502 at [97]. In the High Court, Andrews J approached the case by determining whether the resource consents were stand-alone capital assets, or whether they were connected to the capital project to which they related. If they were not stand alone, then since Trustpower had not committed to the projects that they related to, then the cost of obtaining them was revenue in nature. If, however, they were not stand-alone assets, it was necessary to determine the nature of the expenditure incurred in obtaining them. At [41].
7 *Commissioner of Inland Revenue v Trustpower Ltd* [2015] NZCA 253, [2015] 3 NZLR 658 at [96]–[98] (emphasis added).
8 At [87] (emphasis added).

The Supreme Court

The Supreme Court reversed the Court of Appeal's finding on s DA 1.[9] The Supreme Court held that the general permission had been satisfied because "[t]he expenditure was incurred by Trustpower in the course of carrying on its business as a generator *and* retailer of electricity".[10] Therefore, Trustpower could deduct the cost of obtaining the resource consents unless the disputed expenditure was capital in nature and therefore precluded from deduction by s DA 2(1).

However, the Court rejected the commitment approach as the correct method for determining the nature of feasibility expenditure.[11] The commitment approach did not provide a logical or principled way to determine the nature of expenditure related to the acquisition or construction of a capital asset.[12] It also allowed taxpayers to defer commitment as long as possible in order to maximise deductions.[13]

Since the Court rejected the commitment approach, it became unnecessary to consider whether the resource consents were stand-alone capital assets.[14] Presumably, this was because the commitment approach determines expenditure incurred after the point of commitment to be on capital account if the asset that the taxpayer is committed to is a capital asset. Thus, if commitment is irrelevant, then the nature of whatever the taxpayer has allegedly committed to is also irrelevant.

The Court further considered that the inclusion of resource consents in the Income Tax Act 2007's depreciation regime did not determine the nature of the resource consent expenditure. Under s EE 7(j), any property which may have its cost deducted is not "depreciable property".[15] Therefore, it was necessary to first consider whether the expenditure incurred in obtaining the resource consents could be deducted under the general permission.[16]

The Court adopted the approach of Professor John Prebble and Hamish McIntosh in determining the nature of feasibility expenditure.[17] On their view, any expenditure — feasibility or otherwise — relating to a possible capital project is capital in nature and, therefore, not deductible.[18] The rule applies regardless of whether or not the capital asset is acquired or

9 *Trustpower*, above n 1, at [13(b)].
10 At [13(b)] (emphasis added).
11 At [13(e)] and [69].
12 At [69].
13 Taxpayers could defer commitment (and maximise deductions) because they have control of records, such as board minutes, which are used to determine when the taxpayer committed to the project in question. At [70(a)]–[70(b)].
14 At [13(e)].
15 At [24].
16 At [24].
17 At [13(f)]–[13(g)] and [47]. See John Prebble and Hamish McIntosh "Deducting Expenditure to Assess the Feasibility of Constructing Capital Assets: Opinions from Inland Revenue, the High Court and the Court of Appeal" (2016) 6 VUWLRP 24/2016.
18 At 6–9.

constructed.[19] This is because the nature of the expenditure is not determined by the success or failure of the particular project.[20]

However, the Court qualified its position regarding this rule.[21] It differed from the view of Prebble and McIntosh to the extent that some feasibility expenditure referable to a proposed capital project might sometimes be deductible.[22] But if the expenditure materially advanced the capital project in question, it would not be deductible.[23]

As to when feasibility expenditure is deductible, the Court made the following statements:[24]

> Expenditure which is not directed towards a specific project or which is so preliminary as not to be directed towards the advancement of such a project is likely to be seen as being on revenue account.

Early stage feasibility expenditure could be deductible since such assessments can be seen as a normal incident of business.[25] Furthermore, feasibility assessments which are so preliminary in nature that they cannot be considered as "directed to the acquisition of an asset of an enduring character" may also be deductible.[26]

Turning to the nature of the disputed expenditure, the Court applied the rule that most expenditure relating to the acquisition or construction of a capital project is capital in nature regardless of whether the project results.[27] The expenditure incurred in applying for the resource consents was capital in nature because the hydro dams and wind farms were capital projects. Therefore, the expenditure was not deductible, unless it fell into one of the categories of deductible feasibility expenditure.[28] The Court held that the cost of obtaining resource consents did not fall into any of these categories because the resource consents represented "tangible progress" towards the completion of a capital asset.[29]

V CONSEQUENCES

The Supreme Court's judgment in *Trustpower* has six main consequences. I will now discuss each consequence.

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19 *Trustpower,* above n 1, at [48].
20 *Trustpower* (CA), above n 7, at [101] (footnotes omitted).
21 *Trustpower,* above n 1, at [13(h)].
22 At [13(h)].
23 At [13(h)].
24 At [72].
25 At [72].
26 *Griffin Coal Mining Co Ltd v Federal Commissioner of Taxation* (1990) 21 ATR 819 (FCAFC) at 827 per Davies J as cited in *Trustpower,* above n 1, at [63].
27 At [47]–[48] and [71]–[72].
28 At [71].
29 At [71].

Expenditure on Resource Consents Incurred During Feasibility Studies Not Deductible

First, expenditure incurred by electricity generators for the purpose of applying for and obtaining resource consents to construct further generation capacity is capital in nature. Therefore, it is precluded from deduction by s DA 2(1). Such expenditure is not deductible even if the resource consents were obtained as part of analysing the feasibility of the generation project.

Resource consents give electricity generators legal permission to build further generation capacity. Therefore, the cost of obtaining resource consents relates to the construction of a capital asset. It is not deductible unless it falls into one of the Court's categories of deductible feasibility expenditure. Since resource consents represent tangible progress towards the construction of a capital asset, the cost of obtaining them will not be deductible.[30]

Furthermore, expenditure incurred obtaining resource consents will not be deductible under s DA 1 even if the capital project is abandoned.[31] The nature of the expenditure is not determined by the success or failure of the project. However, s DB 19 of the Income Tax Act 2007 (not enacted during the tax years in issue during the *Trustpower* dispute) now provides a deduction for the cost of successfully obtained resource consents which are time limited (and therefore depreciable) if the resource consents lapse or are surrendered. Therefore, if a capital project is abandoned, resource consents can be surrendered and a deduction will be available under s DB 19.[32]

Feasibility Expenditure Not Generally Deductible

Secondly, the Supreme Court's decision has consequences beyond the deductibility of expenditure incurred on resource consents. The Court adopted the principle that most expenditure incurred in the acquisition or construction of a capital asset is capital in nature and, therefore, not deductible, regardless of whether or not a capital asset results.[33] Since feasibility expenditure is incurred for the purpose of investigating the possibility of acquiring or constructing capital projects, most of it will not be deductible. Therefore, feasibility expenditure incurred for the purpose of assessing the viability of any capital asset will generally not be deductible under s DA 1 (the general non-deductibility of feasibility expenditure rule).

When Feasibility Expenditure is Deductible

Thirdly, the Court qualified the general non-deductibility of feasibility expenditure rule by acknowledging that some feasibility expenditure *will* be deductible. Feasibility expenditure is deductible when it is:

30 At [71].
31 At [48] and [67].
32 At [30].
33 At [13(f)]–[13(g)] and [47].

(a) "so preliminary in nature that the expenditure cannot be seen as 'directed to the acquisition of an asset of an enduring character'";[34] or
(b) "associated with early stage feasibility assessments … Such assessments can be seen as a normal incident of business";[35] or
(c) "not directed towards a specific [capital] project";[36] or
(d) "so preliminary as not to be directed towards the advancement of such a project".[37]

Feasibility expenditure may also fall into specific categories of deduction prescribed by the Income Tax Act, such as resource consent expenditure under s DB 19.

In contrast, feasibility expenditure will not be deductible when it is:

(1) "incurred in respects which do, or were intended to, materially advance the capital project in question";[38] or
(2) incurred in respects which represent tangible progress towards the completion of capital projects.[39]

However, there are doubts as to how well-defined the categories of deductible feasibility expenditure are. The Court did not explain how or when each of the above propositions apply. This lack of guidance leaves uncertainty as to when feasibility expenditure is deductible.

In particular, it is unclear when a capital project is sufficiently specific such that expenditure directed to it is non-deductible for the purposes of proposition (c). The judgment does not articulate what level of specificity is required. For example, confusion arises when considering whether a generation project to be built on an unknown site is sufficiently specific.

The Commissioner, in her interpretation statement on the deductibility of feasibility expenditure, expresses the view that a project need only be identified in "general terms".[40] For instance, the building site or the number of floors need not be identified for the capital project to be specific.[41] If this interpretation is adopted, the capital/revenue boundary is defined very early in the feasibility investigation.

Confusion also arises in relation to proposition (d): how can expenditure be so preliminary so as to not advance a project? Presumably, all expenditure directed towards a project is incurred for the purpose of advancing it. It is difficult to imagine expenditure which is directed towards a specific capital project but does not advance it. However, on the face of

34 At [63].
35 At [72].
36 At [72].
37 At [72].
38 At [13(h)].
39 At [71].
40 Inland Revenue "IS 17/01: Income Tax: Deductibility of Feasibility Expenditure" (2017) 29(3) Tax Information Bulletin 15 at [179].
41 At [179].

proposition (d), the Court has recognised that such a category of expenditure exists. But the Court did not explain when it might arise. Therefore, proposition (d) is also uncertain.

It is helpful to read proposition (d) in light of the Court's earlier statement that feasibility expenditure which *materially* advances — or intends to materially advance — a capital project will not be deductible.[42] Perhaps proposition (d) should be read as permitting a deduction for feasibility expenditure which does not materially advance a specific capital project. This view is shared by the Commissioner in her interpretation statement.[43] However, such an interpretation is not clear from the judgment itself.

The uncertainty regarding the tax treatment of feasibility expenditure is likely to lead to businesses conducting feasibility studies more conservatively.[44] Conservative feasibility spending is problematic for New Zealand's economy because feasibility studies are a critical way for businesses to investigate, innovate and develop capital projects. Presently, investment in research and development in New Zealand is low compared to other Organisation for Economic Co-operation and Development countries.[45] Therefore, legislative reform is desirable to address the uncertainty regarding the tax treatment of feasibility expenditure arising out of the *Trustpower* decision.

Black Hole Expenditure

Fourthly, increasing the amount of non-deductible feasibility expenditure will also increase the amount of black hole expenditure. Black hole expenditure refers to expenditure which is capital in nature — and, therefore, not immediately deductible — but does not produce a depreciable asset and therefore cannot be depreciated.[46] The expenditure is said to disappear into a tax black hole.[47]

The *general non-deducibility of feasibility expenditure* rule will increase the amount of black hole expenditure: under the rule, most feasibility expenditure is capital in nature — and, therefore, not deductible. The Court also made it clear that the rule applies regardless of whether or not a capital asset results.[48] Where no capital asset results, feasibility expenditure will not generally be deductible because it is capital in nature (unless it is early stage or if there is a provision in the Income Tax Act 2007 allowing a specific category of deduction) and it will also not be depreciable. Thus, the expenditure will fall into the tax black hole.

42 At [13(h)].
43 At [126].
44 Especially since feasibility expenditure can be substantial in sum, as demonstrated in the *Trustpower* dispute.
45 Lui and Elliffe, above n 3, at 68.
46 At 67.
47 At 67.
48 *Trustpower,* above n 1, at [48].

Black hole expenditure creates a distortionary effect on New Zealand businesses. Taxpayers are denied a deduction on the basis that expenditure goes towards the completion of a capital asset which is producing benefits. But, in reality, the capital asset does not exist. Therefore, the risks and costs of conducting feasibility studies increase. This distortionary effect strengthens the tax incentive to conduct feasibility studies conservatively, and discourages investment in innovation generally. Again, legislative reform is needed to remedy the black hole issue. Widening the tax black hole in relation to feasibility expenditure is contrary to provisions in the Income Tax Act 2007 that permit deductions for certain expenditure typically considered capital in nature, but which do not result in a depreciable asset.[49] For example, the Act permits deductions for certain expenditure incurred on research and development (ss DB 33–35) as well as expenditure incurred on unsuccessful software developments (s DB 40B). Discouraging feasibility expenditure by increasing the incidence of black hole expenditure is also contrary to the Government's Business Growth Agenda "Building Innovation" work stream which seeks to encourage business innovation in New Zealand.[50]

Confirmation of Existing Authorities

Fifthly, the Supreme Court confirmed that the existing law on the capital/revenue distinction is good law. The Supreme Court acknowledged that the High Court and Court of Appeal had reviewed the "leading cases" on the capital/revenue distinction,[51] in particular *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia*.[52] While the Supreme Court did not discuss *BP Australia*, it did not reject any of the leading cases or expressly identify which other cases it considered to be leading. Therefore, it has left the principles in the leading cases intact. The existing authorities continue to form part of New Zealand's income tax law. And the Supreme Court, by its silence, has affirmed the existing law.

No Statement Regarding How to Approach Capital/Revenue Distinction

Finally, the Supreme Court did not discuss how the capital/revenue distinction should be approached in general. It did not identify which cases it considered to be leading, nor did it discuss how they should be applied. Presumably, this is because the Court adopted, and established, the principle that most expenditure related to the acquisition or construction of a capital asset is capital in nature and, therefore, not deductible — and this was seen as sufficient to resolve the *Trustpower* dispute.

49 Lui and Elliffe, above n 3, at 72.
50 *Business Growth Agenda: Towards 2025 - Building Innovation* (Ministry of Business, Innovation & Employment, October 2015) at 1.
51 *Trustpower*, above n 1, at [37] and [40].
52 *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 (PC).

VI CONCLUSION

In the *Trustpower* dispute, the Supreme Court had an opportunity to provide certainty to the capital/revenue distinction in general and in relation to feasibility expenditure. The decision was a missed opportunity. Nevertheless, the decision remains an important one. First, it confirms that the body of case law typically regarded as the leading authorities on the capital/revenue distinction are authoritative in New Zealand. Secondly, the Court confirmed the approach to determine the capital/revenue distinction with respect to feasibility expenditure. However, there remains uncertainty about the definitions of the categories of deductible feasibility expenditure. Moreover, the general non-deductibility of feasibility expenditure will create more black hole expenditure. These two issues are likely to disincentivise investment in new capital projects. Therefore, legislative reform is needed following *Trustpower* to clarify the rules relating to the deductibility of feasibility expenditure.