Black hole and feasibility expenditure

A Government discussion document

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Black hole and feasibility expenditure: A Government discussion document.
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CONTENTS

CHAPTER 1

Introduction

1.1 As a general principle, business expenditure whose economic value is expected to decline in value should either be immediately deductible, or, when it provides an enduring benefit, deductible over time if that benefit declines over time. When the tax system does not provide for that treatment, an economic distortion is created.

1.2 This document discusses and seeks submissions on the Government's proposals for a new treatment of feasibility expenditure and other expenditure that results in an economic cost to a taxpayer, but for which neither immediate deductions nor depreciation deductions are available ("black hole" expenditure).

1.3 There are two main proposals. In broad terms, the first proposal is that for expenditure that meets a new definition of "feasibility expenditure", businesses will be able to apply International Financial Reporting Standards (IFRS) to determine whether the expenditure is immediately deductible, or must be capitalised. The objective is to ensure that the tax treatment of "feasibility expenditure" is clearer, and to ensure that no expenditure that meets that definition will receive black hole treatment.

1.4 In addition, the second proposal is to allow taxpayers a deduction for expenditure that would have been deducted over time if the expenditure had been successful, but is denied a deduction because the expenditure did not result in a successful asset. The Government believes this would resolve a lot of black hole tax treatment.

Background

1.5 Expenditure that provides an enduring benefit is not immediately deductible because the capital limitation in the Income Tax Act 2007 denies a deduction. Some expenditure that is not deductible immediately will be deductible over time if it forms part of the cost of depreciable property, or another class of asset whose expenditure can be spread over the asset's expected life (for example, farm improvements).

1.6 Some expenditure will never be deductible, because it is not expected to result in an economic loss.

1.7 Feasibility expenditure is expenditure that is undertaken to determine the practicability of a new proposal. In some cases, the capital limitation will deny an immediate deduction. Because of the early-stage (and thus uncertain) nature of feasibility expenditure, determining whether the capital limitation applies can be difficult.

1.8 Inland Revenue has provided guidance on how to apply the legal test in its *Interpretation statement 17/01.*[1] This was issued after the Supreme Court's decision in *Trustpower Limited v Commissioner of Inland Revenue*[2] (the *Trustpower* decision), and replaced an earlier interpretation statement on feasibility expenditure. The earlier interpretation statement allowed a relatively wide variety of costs to be deducted immediately. The implication of the *Trustpower* decision is that less expenditure is immediately deductible, and it must be capitalised instead.

1.9 Requiring more of this expenditure to be capitalised increases the risk that it will ultimately become black hole expenditure. The Government considers that this economic distortion is damaging to the economy, as it is an impediment to productivity growth.

1.10 Feasibility expenditure will, perhaps more frequently than other classes of expenditure, be expected to occasionally result in black hole expenditure. This is because the expenditure may prove that a project is not viable.

1.11 In some cases where feasibility expenditure results in a project not going ahead, the expenditure does not result in a depreciable asset, whereby the feasibility expenditure is deductible over time through depreciation deductions. Instead, the expenditure in those cases can be said to have fallen into a black hole. The Government has already resolved many types of black hole expenditure under an incremental approach over the last few years (for example, software projects).

1.12 By addressing the complexity of the current state of the law, and by removing the black hole distortion, the proposals in this discussion document aim to improve economic efficiency, minimise distortion, reduce compliance and administration costs, and simplify the law where possible. The proposals are expected to result in a wider range of costs being deductible for tax purposes, to improve productivity and to remove a tax impediment to growth.

Submissions

1.13 If you would like to make a submission on the proposals in this discussion document, email it to policy.webmaster@ird.govt.nz or post it to:

Black hole and feasibility expenditure proposals
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

1.14 The closing date for submissions is **6 July 2017**.

[1] "Interpretation statement 17/01: Income tax – Deductibility of feasibility expenditure", *Tax Information Bulletin,* Vol 29, No 3 (April 2017).
[2] SC 74/2015 [2016] NZSC 91.

1.15 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Background

2.1 "Feasibility expenditure" is not a defined term in tax legislation, nor is it a term of art.

2.2 Inland Revenue's revised interpretation statement on feasibility expenditure (*Interpretation Statement 17/01: Deductibility of feasibility expenditure*) describes the term as "generally used to describe expenditure incurred by a taxpayer for determining the practicability of a new proposal". This discussion document proceeds on the basis of that description.

2.3 The Supreme Court considered the deductibility of this type of expenditure in *Trustpower Limited v Commissioner of Inland Revenue.*[3] The legal test in the *Trustpower* decision is more restrictive than Inland Revenue's original *Interpretation Statement 08/02*.[4] The revised interpretation statement reflects the *Trustpower* decision.

2.4 The original interpretation statement allowed a relatively wide scope for "preliminary" expenditure to be immediately deductible where there was no definitive commitment to proceeding with a project. The revised interpretation statement has moved away from that formulation, and interprets the test in the *Trustpower* decision as providing that expenditure may be deductible where it is of a type incurred on a recurrent basis as a normal incident of the taxpayer's business, and is so preliminary as not to be directed towards materially advancing a specific project (or capital asset or enduring benefit). That is in contrast with expenditure that is aimed at making tangible progress on a capital project, to which the capital limitation would apply.[5]

2.5 The *Trustpower* decision and the revised interpretation statement allow less expenditure to be immediately deductible for tax purposes than previously. This is because material advancement or tangible progress is likely to occur earlier than the prior interpretation of "definitive commitment".

2.6 Depending on whether the project is implemented or abandoned, the expenditure may also not receive depreciation deductions over time. Non-deductibility of capitalised costs will be appropriate provided the expenditure created (or was intended to create) an asset that was not expected to decline in value.

2.7 But where taxpayers would have received depreciation deductions had the project gone ahead (because the asset was expected to decline in value), but

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[3] The case itself was about resource consent costs, which the Commissioner of Inland Revenue maintained were not immediately deductible. The Supreme Court agreed with that interpretation, but made comments on other feasibility expenditure that are inconsistent with Inland Revenue's previous position.

[4] "Interpretation statement 08/02: Deductibility of feasibility expenditure", *Tax Information Bulletin,* Vol 20, No 6 (July 2008).

[5] The revised interpretation statement has an extensive treatment of this complex area of law and represents the Commissioner's legal interpretation. The revised interpretation statement is available at https://www.ird.govt.nz/resources/5/9/59a7819f-ec1b-4db2-a54b-3ee1caff2e00/IS+1701.pdf

did not because the project was abandoned before it met the definition of depreciable property, this expenditure is referred to as "black hole" expenditure.

2.8 The tax treatment of black hole expenditure is a policy concern that undermines economic efficiency, as explained in the next section. The Government has already resolved many types of black hole expenditure under its incremental approach over the last few years. That includes expenditure on:

- research and development;
- resource consents;
- software projects;
- patents; and
- plant variety rights.

2.9 This area of law is relatively complicated, and the Government believes that compliance and administration costs could be reduced by simplifying it. The proposals discussed here address the black hole problem and aim to simplify the law by following accounting treatment where a taxpayer has "feasibility expenditure".

The "black hole" problem

2.10 Black hole expenditure is business expenditure that is expected to result in an economic cost to a taxpayer, but is neither immediately deductible for tax purposes, nor deductible over time. It is not deductible over time because it does not form part of the cost of depreciable property for tax purposes.

2.11 Capital expenditure on assets that are not expected to decline in value (for example, land) is not black hole expenditure, despite the fact that it is not deductible immediately or over time. This is because the taxpayer does not expect to experience an economic loss when it purchases an asset that does not decline in value.

2.12 While assets that are not expected to decline in value sometimes do, it would only be appropriate to provide deductions for this expenditure if we taxed gains in asset values if they appreciated. Further, the tax system is economically neutral when it denies deductions for unexpected capital losses, provided that it also leaves untaxed unexpected capital gains, as New Zealand's tax system does.

2.13 For a project that potentially involves black hole expenditure, the economic result is that the expected pre-tax rate of return of an investment that may result in some black hole expenditure must be higher than the expected pre-tax rate of return for a project that does not include such expenditure. Another way it can reduce economic efficiency is that businesses may be incentivised to complete projects that do not make economic sense, to avoid black hole treatment for sunk capital expenditure (as after completion, a depreciable asset will have been created). In either situation, the tax system has introduced an investment distortion that lowers economic efficiency.

2.14 In the context of feasibility expenditure, there will be black hole expenditure where there is feasibility expenditure at or beyond the "material advancement" or "tangible progress" stage (see the revised interpretation statement), if the project is subsequently abandoned, and if the feasibility expenditure was directed at a project or asset that was expected to decline in value. If expenditure was before that stage, it may be immediately deductible. If the project was completed and the expenditure capitalised to the asset, there would be depreciation deductions provided that the asset was depreciable property that was expected to decline in value.

2.15 The following diagrams illustrate, in a simplified project timeline, when black hole expenditure arises in the context of feasibility expenditure under the older "commitment" test, and the newer formulation that refers to "material advancement" or "tangible progress". The length of time during which expenditure is subject to black hole risk is greater under the "material advancement" or "tangible progress" formulation.

Figure 1: Feasibility expenditure in a project timeline – "commitment" test

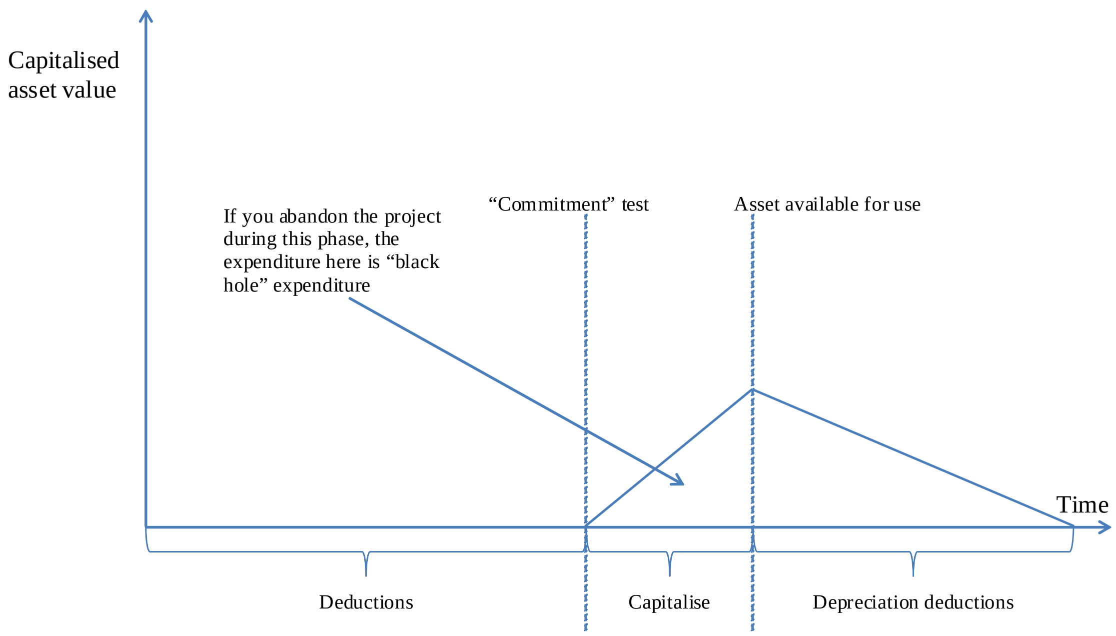
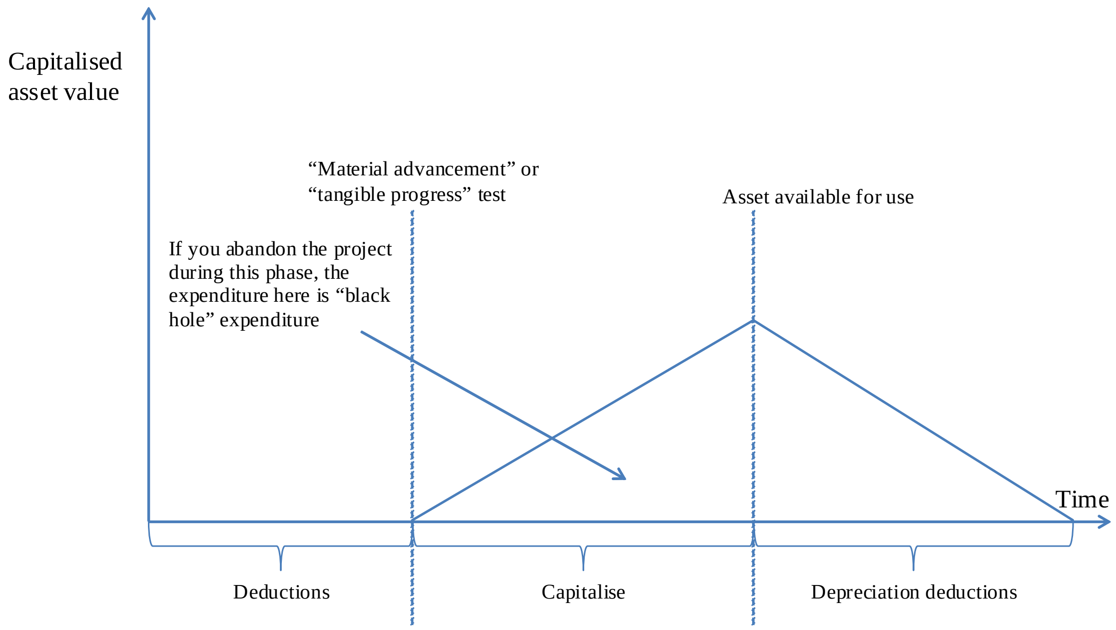


Figure 2: Feasibility expenditure in a project timeline – “material advancement or “tangible progress” formulation



CHAPTER 3

Applying IFRS accounting treatment

3.1 The Government proposes to alter the treatment of feasibility expenditure so that it is immediately deductible if it is expensed under International Financial Reporting Standards (IFRS). It is expected that more feasibility expenditure would be immediately deductible than currently, including any capitalised feasibility expenditure on a capital asset that is abandoned (and thus impaired for accounting purposes).

3.2 The Government also proposes that **all** previously capitalised expenditure (not just feasibility expenditure) that would ultimately be part of the cost of depreciable property (excluding buildings),[6] is immediately deductible where that depreciable property is not created because the project is abandoned.

3.3 Where expenditure that meets a new legislative definition of "feasibility expenditure" is immediately expensed in general purpose financial statements (that is, under IFRS no asset is created on the balance sheet), it would be immediately deductible for income tax purposes. Where the feasibility expenditure is capitalised under IFRS (that is, an asset is created), the feasibility expenditure would be capital expenditure for tax purposes. As will be discussed below, expenditure that would form part of the cost of an item of depreciable property would be excluded from the definition of "feasibility expenditure".

3.4 If expenditure that would be "feasibility expenditure" but for the fact that it would form part of the cost of an item of depreciable property were capitalised to any asset, that expenditure would be immediately deductible if the asset was later abandoned before completion, as part of more general relief for this sort of black hole expenditure.

Defining feasibility expenditure

3.5 A necessary condition of this proposal is that we are able to adequately circumscribe what expenditure receives this treatment. We propose to do that by introducing a definition of "feasibility expenditure".

3.6 "Feasibility expenditure" has no current tax definition, and is not defined under accounting standards. Creating an appropriate definition is the most challenging aspect of this proposal.

3.7 If "feasibility expenditure" is defined too widely, the risk is that any amendments encroach on well-settled and economically efficient existing capital/revenue tax law. If that were the case, the amendments would introduce new complexity, and potentially introduce economic distortions with no offsetting compliance or administration gains.

[6] Buildings are "depreciable property" but depreciation deductions are set at 0% under the Income Tax Act 2007.

3.8 A common understanding of feasibility expenditure is "expenditure incurred by a taxpayer for determining the practicability of a new proposal" (the working definition in Inland Revenue's revised interpretation statement). Without further restriction, this definition is not sufficiently certain from a legislative perspective. The Government suggests that the definition be further limited by restricting the expenditure to that incurred prior to a commitment to developing the proposal. In other words, the definition would in substance be: expenditure to determine the practicability of a proposal, prior to commitment to developing the proposal.

Exclusions

3.9 As an additional restriction, the Government proposes that some expenditure would be explicitly excluded as deductible on the basis that our tax system already adequately deals with its deductibility. An Australian provision[7] that addresses black hole expenditure operates on this approach, by allowing a deduction (spread over five years) for capital expenditure not otherwise deductible, but excludes expenditure that forms part of the cost of a depreciating asset or part of the cost of land, amongst other exclusions.

3.10 The exclusions in a New Zealand provision would need to be more extensive than the Australian provision. This is because the Australian capital gains tax reduces the importance of the capital/revenue distinction. In the absence of such a tax in New Zealand, it is important to ensure that we do not introduce a distortion into the system that allows capital losses to be deductible, without taxing capital gains.

3.11 In principle, any expenditure on a capital project that does not depreciate should be excluded. However, in the case of feasibility expenditure it is likely that identifying whether any resulting "capital project" depreciates is impossible given the early stage at which this expenditure is often incurred, and the likelihood that the capital project is a combination of both depreciable and non-depreciable assets. As a result, we do not propose distinguishing on this basis.

3.12 The exclusions the Government proposes are:

- Expenditure that would form part of the cost of depreciable property, if the proposal is successful. (See below for an explanation of why this would later be deductible on abandonment).
- Expenditure for which any black hole treatment has already been remedied under the Income Tax Act 2007. This would include any expenditure incurred:
  - for the purpose of applying for the grant of a resource consent (section DB 19);
  - on research or development (section DB 34);
  - for the purpose of applying for the grant of a patent or of a design registration (section DB 37);

[7] Section 40-880 of the Income Tax Assessment Act 1997.

- in devising an invention for which a patent has been granted (section DB 38);
- for the purpose of applying for the grant of plant variety rights (section DB 40BA); or
- in the development of software for use in the person's business (section DB 40B).

3.13 The list above is not intended to imply that the expenditure would necessarily meet the definition of feasibility expenditure but for the explicit inclusion, but it is possible that some of it would.

Submission point

- How could "feasibility expenditure" best be defined in legislation, taking into account the risk of including too much expenditure in such a definition?

IFRS treatment

3.14 As IFRS treatment is central to the proposals, it is necessary to understand the relevant principles. As a basis for discussion, this section quotes some of the standards.

3.15 Under IFRS, an asset must be recognised in the balance sheet when it is probable that future economic benefits will flow to the entity. Under NZ IAS 16.7:

> The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:
>
> a) It is probable that future economic benefits associated with the item flow to the entity; and
>
> b) The cost of the item can be measured reliably.

3.16 Therefore, under the proposal, if an asset is not recognised in the balance sheet, an immediate deduction would be allowed for the feasibility expenditure. In the context of feasibility expenditure, this might include expenditure on, for example, investigating new inventory management systems, or new business processes to reduce costs.

3.17 For feasibility expenditure that has been capitalised for accounting (and thus for tax), a deduction would still be available in the event that the asset is impaired, provided that the project is abandoned. This might occur in a situation where a business has feasibility expenditure that provides probable future economic benefits, and that expenditure is capitalised to an asset that is being created. If circumstances change and it is found that the asset is not worth completing (for example), under IFRS the asset would be impaired.

3.18 NZIAS 36.8 states:

> An asset is impaired when its carrying amount exceeds its recoverable amount. Paragraphs 12–14 describe some indications that an impairment loss may have occurred. If any of those indications is present, an entity is required to make a formal estimate of recoverable amount. Except as described in paragraph 10, this Standard does not require an entity to make a formal estimate of recoverable amount if no indication of an impairment loss is present.

3.19 NZIAS 36.12 states:

> In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:
>
> External sources of information
>
> (a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
>
> (b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.
>
> (c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.
>
> (d) the carrying amount of the net assets of the entity is more than its market capitalisation.
>
> Internal sources of information
>
> (e) evidence is available of obsolescence or physical damage of an asset.
>
> (f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.
>
> (g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

3.20 It is envisaged that where a taxpayer has abandoned a project, NZ IAS 36.12.f would provide an indication that the asset is impaired. In those circumstances, the taxpayer would be allowed a deduction for the previously capitalised feasibility expenditure that is impaired due to NZ IAS 36.8. There is a question of how much feasibility expenditure will fall into this category given that the definition excludes expenditure that would form part of the cost of depreciable property. However, it would include feasibility expenditure related to non-depreciable assets.

3.21 The deduction would be available in the tax year during which the amount was recognised as an expense under IFRS accounting standards. It would only be available in situations of total impairment loss.

Non-IFRS taxpayers

3.22 IFRS is used by larger companies. If a taxpayer does not apply IFRS accounting standards, they will still be allowed a deduction if the IFRS standards would be met, had they been applied.

3.23 As an example, assume a non-IFRS taxpayer has previously capitalised some feasibility expenditure. In a later income year, they abandon the project that called for the feasibility expenditure. The taxpayer would be allowed a deduction only where, had they been applying IFRS, they would have had a total impairment loss. Note that unlike for taxpayers who use IFRS, there would be no requirement that the asset is actually impaired under the taxpayer's accounting system.

3.24 The deduction would be available in the tax year during which the amount would have been recognised as an expense under IFRS accounting standards.

De minimis

3.25 Under a de minimis rule, expenditure could perhaps be deductible provided that expenditure:

- meets the general permission;
- is within the definition of "feasibility expenditure"; and
- is below a particular de minimis threshold.

3.26 Non-IFRS-taxpayers would need only to assess whether expenditure provided "probable future benefits" (NZ IAS 16.7) to determine whether the expenditure should be capitalised or expensed at the early stage. The criteria for impairment in this situation are cited in NZ IAS 36.12. In these circumstances, a de minimis to save compliance costs may not be necessary.

3.27 If a de minimis applied, the only requirements in that situation would be that the general permission was met, and the expenditure met the definition of "feasibility expenditure", and was below the de minimis threshold.

3.28 The de minimis threshold for legal and research and development expenditure in sections DB 62 and DB 34 respectively is $10,000. If a de minimis threshold is required for this proposal, matching it with the threshold in sections DB 62 and DB 34 may be appropriate.

Submission points

- Is it appropriate to require non-IFRS taxpayers to be familiar with IFRS for the purposes of deductions for black hole expenditure?
- Should a de minimis apply? At what level of expenditure?

Expenditure on an abandoned asset

3.29 A deduction would be allowed when a person incurred expenditure that would form part of the cost of an item of depreciable property if:

- the item would have been depreciable property if it had been completed;
- the item is abandoned before it is available for use; and
- the person recognises the expenditure as a loss under NZ IAS 36.8, which governs impairment of assets, or the person had not previously recognised the expenditure as the cost of an asset under NZ IAS 16.7.

3.30 For current purposes, provided that there is expenditure that would have formed part of the cost of an item of depreciable property, a deduction will be available in two cases. The first is if there is an impairment loss recognised due to NZ IAS 36.8 and the item is abandoned before it is available for use. The second is when the expenditure was never previously capitalised under IFRS, but it would have formed part of the cost of depreciable property (and so was excluded from the definition of "feasibility expenditure").

3.31 This means that expenditure that would otherwise be "feasibility expenditure" but for the fact that it would form part of the cost of an item of depreciable property will be deductible if the asset is later abandoned. But the proposal is wider, in that any expenditure would be deductible if it would have formed part of the cost of an item of depreciable property that is abandoned before it is available for use, provided the expenditure is not capitalised under IFRS.

3.32 The deduction would be available in the tax year during which the amount was recognised as a loss under NZ IAS 36.8.

3.33 The amount of the deduction would be for the full amount of the expenditure, with the proviso that the expenditure was not allowed a deduction under any other section of the Income Tax Act 2007.

All expenditure on depreciable property covered

3.34 This proposal would cover any feasibility expenditure that would form part of the cost of an item of depreciable property, but would also cover a wide variety of other costs that are capitalised to an asset that is abandoned. An example of this would be a partially-built boat that is abandoned before it is available for use. Under this proposal, the construction costs of the boat would be immediately deductible, instead of being neither deductible immediately nor over time.

Submission point

- Is the accounting treatment sufficiently clear that a taxpayer would be able to apply the proposal above in a wide variety of circumstances?

Clawback

3.35 If a taxpayer subsequently reverses its decision to impair the asset, the taxpayer would have to return as income any amount previously deducted under the proposal.

Non-IFRS taxpayers

3.36 As with the first proposal, if a taxpayer does not apply IFRS accounting standards, they will still be allowed a deduction if the IFRS standards would be met, had they been applied.

3.37 As an example, assume a non-IFRS taxpayer has expenditure incurred in constructing a boat. In a later income year, they abandon the boat before it is available for use. The taxpayer would be allowed a deduction only where, had they been applying IFRS, they would have had a total impairment loss of the capitalised expenditure. Note that the requirement that the item is abandoned before it is available for use would still remain.

Application date

3.38 There are a number of possible dates for application for the main proposals. Some taxpayers have expressed the view that any change should apply from the date of the *Trustpower* decision.

Submission point

- Is there any particular reason why any change to the law should not be prospective (that is, applying from the date of enactment)?