Tax update

James Coleman, Barrister, Wellington on Trustpower's journey to the Supreme Court

On 11 September 2015 the Supreme Court granted leave to Trustpower to appeal from the 19 June 2015 Court of Appeal judgment (*Commissioner of Inland Revenue v Trustpower Limited* [2015] NZCA 253). that the case concerns the tax treatment of pre-commencement expenditure.

The grounds on which the Supreme Court has granted leave are:

- Whether it was wrong for the Court of Appeal to consider the ground of reassessment set out in the Reassessment letter as being irrelevant, and
- What is the significance of the Court of Appeal saying that it proceeded on the basis of accepting the High Court's findings of fact but when in fact a large amount of the judgment is based on findings for which there is no evidence?
- What is the correct approach in determining whether the expenditure of the type at issues in the proceeding has been incurred on revenue or capital account, for the purposes of s DA 2(1) of the ITA?
- Was the Commissioner correct or at least not in error, to select the date by which the applicant had decided to apply for a resource consent as being the point at which its expenditure was sufficiently connected to the capital purpose of obtaining a resource consent to be on capital account?

The first two issues on which the Supreme Court has granted leave relate to procedural issues. With respect to the importance of the Reassessment letter the outcome will be eagerly anticipated as there is a tension between the effect of s 138G of the Tax Administration Act 1994 (TAA 1994), which confines parties to their respective Statements of Position and s 138P which superficially allows a court to make any assessment that the Commissioner could have made at the time. The law has become increasingly rigid on the s 138G point.

With respect to the second procedural issue, this issue arises directly from the *Austin, Nichols & Co Inc v Stichting Lodestar* decision, which said that the appeals are by way of rehearing and therefore the appellate court was required to review the evidence and make its own findings. In a sense this case will test what the limits are for an appellate court with respect to its rehearing of the evidence. Presumably there needs to be evidence on the record for a factual finding to be made by the appellate court.

The way that the Supreme Court has worded the second appeal point strongly implies that there were factual findings made at the Court of Appeal level, for which there was in fact no evidence either in the form of a witness having given oral evidence or in the form of a document adduced into evidence.

The third ground of appeal concerns a statutory construction and tax question: how, in terms of approach, does one go about determining whether expenditure is incurred on capital or revenue account? In this regard it is necessary to look at the facts to understand the issue. The particular expenditure in question was the expenditure incurred by Trust Power in taking preliminary steps and then applying for and obtaining various resource management act consents with respect to four possible new generation projects in the South island.

The Income Tax Act 2007 (ITA 2007) draws a distinction between revenue account expenditure and expenditure on capital account. The former is deductible when incurred as long as the necessary nexus test set out in section DA 1 of the ITA 2007 is met. The latter is not immediately deductible but normally capital expenditure is depreciable. In terms of the statutory wording s DA 1 a deduction is allowed for expenditure incurred in deriving assessable income or incurred in carrying on a business for the purpose of deriving assessable income.

Section DA 2(1) then says:

> A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the capital limitation.

The question that the Supreme Court is going to address is how one goes about determining whether the expenditure is incurred on revenue or capital account. That is, does one have to satisfy s DA 1 before checking to see whether s DA 2(1) disallows the deduction or can the court simply look at whether the amount is capital and, if it is, say that it is disallowed irrespective of whether it would have complied with s DA 1 in the first place?

Where an item is capital and the expenditure associated with it is not deductible then normally there is depreciation available. That allows the capital account expense to be claimed or allowed systematically over the course of the useful life of the asset in question. It is implicit in what I have just said that normally capital expenditure gives rise to an asset and hence the concept of depreciation makes sense.

However, there is a small category of expenditure which is neither deductible nor depreciable. Expenditure in this category relates to items which are capital in nature and hence precluded from deductibility under section DA 2(1) but which does not give rise to a capital asset and does not contribute to the capital base of a depreciable asset and is excluded from the concept of depreciation. Expenditure in this narrow band is often referred to as “black hole” expenditure. It derives this name because there is no deductibility of any sort associated with it.

The government has over time broadened the depreciation base so as to lessen the category of black hole expenditure. For example, the depreciation base has been extended to include intangible depreciable property. Items which constitute intangible depreciable property are listed in sch 14 of the ITA 2007. One of the items listed is:

> A consent granted under the Resource Management Act 1991 to do something that otherwise would contravene sections 12 to 15B of that Act (other than a consent for a reclamation), being a consent granted in or after—
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> (a) the 1996–97 tax year, if the consent relates to sections 12 to 15 of that Act; or
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> (b) the 2014–15 income year, if the consent relates to sections 15A and 15B of that Act

Trustpower sought to deduct $17,700,000 of expenditure in the three-year period 2006 through to 2008. Trustpower sought to obtain that deduction under section DA 1 of the ITA 2007 by classifying the expenditure as feasibility expenditure rather than adding the expenditure to the tax cost of the resource consents in seeking to depreciate them.

In a sense, therefore Trustpower played Russian roulette claiming that deductibility was "all or nothing": see [6] of the judgment. The trouble with Russian roulette is that it is dangerous. The "all or nothing" approach turned out to be a dangerous gamble for Trustpower.

The support for the proposition that initial investigations to determine whether to proceed with a project is revenue in nature is, however, weak. It derives principally from the Commissioner's own 2008 interpretation statement IES 08/02: Deductibility of Feasibility Expenditure. In support of the views reached in that document, the Commissioner points to *Milburn Ltd v Commissioner of Inland Revenue* (2001) 20 NZTC 17,017 where Justice Wilde said, at [32], that:

> These six factors, certainly in combination, indicate to me that the taxpayers, having investigated or evaluated the three sites, had made business decisions to expend money in developing the sites for commercial production. The first step, or one of the first steps, to that end was to apply for the necessary consents.

From such comments the Commissioner gleaned the following principle (IES 08/02, above, at [127]):

> …in the capital versus revenue context in relation to an existing business, a distinction may be drawn between amounts expended on initial investigations to determine possible prospects and amounts expended once a decision to proceed with any prospect in particular has been made. Once a decision has been made to proceed with the acquisition of development of a capital asset, it seems that expenditure is considered to be incurred on the business structure rather than the income earning process.

The Commissioner's interpretive statement has little case law to back it. The New Zealand cases it lists are concerned with pre-commencement costs. Rather more support is gleaned from the Australian cases listed. The position reached by the Commissioner in her interpretation statement is generous to taxpayers. Oddly it appears that in her submission to the Supreme Court the Commissioner wanted the Court not to look at or review her position on whether feasibility expenditure was revenue or capital but to confine itself to whether the expenditure here fell within the concept of feasibility expenditure or not. Submissions like that are particularly unattractive to a court. They are a little bit like submissions to the effect that a court has no jurisdiction. They go down like a lead balloon.

The Court of Appeal approached the issue in an entirely orthodox manner. It noted that s DA 1 contains the general permission to the effect that a deduction is allowed for expenditure, to the extent it is incurred in deriving assessable income or in the course of carrying on business for the purpose of deriving assessable income. They also noted that a depreciation loss may also be deducted under the general permission. The court also noted the effect of the general limitation contained in s DA 2 of the ITA 2007. The general limitation prohibits a deduction for expenditure that is capital in nature.

There is a question in this case as to from where one starts the analysis, and that is what the Supreme Court will review. Does one start from the view point of deciding whether the expenditure is revenue in nature or from the perspective of deciding whether it is in relation to a capital asset? The Court of Appeal considered that the correct starting point was whether the expenditure was deductible under s DA 1 or not (at [31]).

To get to that point, however, the Court of Appeal needed a statutory basis for doing so. It found it in s EE 7. That section says that a deprecation deduction cannot be taken if there is a deduction available elsewhere, which in this case would be under s DA 1.

Thus, despite the fact that there is a pretty strong case for depreciation, the capital revenue issue needed to be addressed. Trust Power had its sights on an immediate deduction of the full $17,700,000. Accordingly, it rejected any contention that there may be depreciable intangible property here. In particular it argued, at [26], that the resource consents were not used nor were they available for use. They clearly were not used, but an eyebrow is raised at the proposition that they were not available for use. The Court of Appeal did indeed raise such an eyebrow at [27] and rejected the contention that resource consents were not available for use.

At [31] the Court of Appeal said that:

> …if a person is allowed a deduction 'under a provision of this Act outside this subpart' then the property involved will not be 'depreciable property'. In other words, if Trustpower is allowed a deduction for the expenditure under s DA 1 (the general permission) because it was incurred on revenue account, sub-pt EE relating to "Depreciation" will not be applicable. In our view Mr Harley is therefore right to submit that the issue whether Trustpower's expenditure should be characterised as on revenue or capital account needs to be determined first because if it is on revenue account and deductible under the general permission the provisions of sub-pt EE will simply not apply.

The Court of Appeal’s approach to whether the expenditure was on revenue account was, however, in reality an analysis of whether the expenditure was capital in nature, with the implied assumption that if it was then it was not on revenue account. There is plenty of scope for an argument to the effect that what was expended here was the ordinary business expenditure of deciding whether to buy one’s “widgets” or make one’s “widgets”. It is submitted that expenditure of that sort is not capital but revenue in nature. Such costs are not even properly called feasibility costs. They are something else entirely.