Feasibility ruling: uncertainty for business

BusinessNZ is appealing to the Government to legislate to clarify a tax rule that could stifle business development and innovation.

The issue is whether expenditure to determine the feasibility of a business project is tax deductible.

The traditional view has been that feasibility expenditure is operational expenditure and is therefore deductible in the year in which the expenditure was made.

But in *Trustpower Limited v Commissioner of Inland Revenue* the Supreme Court has taken the view that feasibility expenditure previously regarded as operational is in fact capital spending and is therefore non-deductible. It has ruled that only very preliminary feasibility expenditure or expenditure not directed towards a specific project can be deductible.

This issue is important to business. Determining feasibility is part of the intelligence gathering required to make informed choices about whether to proceed with a business development. Much business development is aimed at delivering innovation in order to be more competitive. By stifling the process of determining feasibility, business innovation and competitiveness may be compromised.

The case related to Trustpower seeking resource consents for two hydro schemes and two wind farms. Trustpower was successful in obtaining the resource consents but has not progressed three of the projects, and has only partially completed one.

Trustpower sought tax deductibility for the expenditure incurred in applying for the consents, on the grounds that the terms of the resource consents granted would affect the feasibility of the projects.

The four energy projects in question were part of a pipeline of around 200 possible developments under consideration by Trustpower. Trustpower's process for advancing projects from this pipeline is:

(1) Making assessments prior to obtaining resource consents

(2) After obtaining resource consents, making engineering and geotechnical assessments, working up detailed costings, and determining the net present value of the project if completed
(3) Making a business case for Trustpower Board's decision whether or not to proceed

Trustpower views (3) as the point at which commitment to a decision to proceed with a project is made. The IRD, however, viewed the commitment point as the point at which Trustpower sought the resource consents.

The matter went to court, and the High Court ruled in favour of Trustpower. It ruled that the expenditure on resource consents was feasibility expenditure, incurred to inform the decision whether or not to build the energy projects. The High Court considered that the resource consents by themselves were not sufficient for a decision to be made to take any project through to the next stage, and the expenditure was therefore part of the feasibility process, and operational in nature.

The High Court's ruling was consistent with Canadian case law, where it has been ruled that a hydro scheme, once it becomes a reality, is a capital asset, but that feasibility investigations to find whether it should be created may be viewed as operational expenditure.

But the Appeal Court overruled the High Court, saying that the expenditure for resource consents was less for feasibility and more for the purpose of acquiring assets. Securing the consents represents progress towards the projects, it ruled. By obtaining consents, Trustpower was investing in capacity regardless of whether it was committed to proceed with the build, so the investment was capital, not operational, in nature.

The Supreme Court has now agreed with the Appeal Court, allowing that some feasibility expenditure might be deductible but not expenditure that is intended to materially advance the project. The Supreme Court said the consents gave Trustpower the option to move reasonably quickly towards construction and were already marketable (could be sold to another energy business), showing that tangible progress had already been made. The Supreme Court ruled that feasibility assessments may not be directed towards a specific project and have to be very preliminary in nature, not bringing tangible progress towards the project's development.

This ruling poses a problem for business.

If only assessments that do not represent tangible progress towards the completion of a specific project can be deductible, this will diminish the worth of feasibility assessments generally. And determining the cross over point for deductibility - where revenue expenditure morphs into capital expenditure – will further complicate the tax system, imposing compliance costs on business in the process.

The Supreme Court found that the purpose of the consents was to expand Trustpower's existing business and was therefore capital expenditure.

For business, the problem is that much feasibility expenditure is undertaken for just such a purpose and the ruling would see many businesses unable to deduct such expenditure.

This will affect businesses of all types and sizes – not just big business. Small to medium sized businesses wanting to expand operations, diversify, move premises, buy out competitors or take any number of other decisions will find their ability to research feasibility constrained.

The most likely effects of this decision will be businesses deciding to scale back feasibility undertakings, along with an increased risk of decisions based on tax outcomes instead of business growth potential.

The result of the Trustpower case is an increase in uncertainty for business.

BusinessNZ says legislative amendment is now required to clarify and ensure correct and consistent tax treatment of feasibility expenditure.

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