DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 21 MARCH 2014

1. The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* ("the November Bill"), which was introduced on 22 November 2013 contains a number of proposed amendments relating to black hole expenditure. The Finance and Expenditure Committee is due to report back on the Bill by 10 June 2014.

2. This week I look at the proposed treatment of expenditure incurred for the purpose of applying for a resource consent. I also take the opportunity to discuss the case of *TrustPower Limited v The Commissioner of Inland Revenue* [2013] NZHC 2970 ("the Trustpower case"), which concerns the tax deductibility of resource consents that were both applied for and obtained. The case provides some useful insight into the tax depreciation implications and the accounting treatment.

3. The topics covered this week are:

   (a) Resource consents not obtained;

   (b) Clawback for subsequent applications or disposal of application property;

   (c) New fixed life resource consents included in Schedule 14;

   (d) Resource consents obtained: capital vs revenue;

   (e) Arguments concerning depreciation;

   (f) NZIAS 16 vs NZIAS 38.

Resource consents not obtained

4. The current s. DB 19 in the *Income Tax Act 2007* is headed "Expenses for failed or withdrawn application for resource consent". Under existing s. DB 19, *a person who applies for the grant* of a resource consent under the *Resource Management Act 1991* ("RMA") and is refused the grant or withdraws the application is allowed a deduction for expenditure:

   (a) That the person incurs in relation to the application; and

   (b) That would have been part of the cost of depreciable property, or otherwise a deduction, if the application had been granted; and

   (c) For which the person is not allowed a deduction under another provision.

5. The deduction is allocated to the income year in which the grant is refused or the application is withdrawn.

6. Clause 39 of the November Bill contains a proposal to change the heading of s. DB 19 to: "Expenses in application for resource consent". Clause 39 also contains a proposed new s. DB 19 itself, under which *a person who incurs expenditure for the purpose of applying for the grant* of a resource consent under the RMA and does not obtain the grant because the application is not lodged or is withdrawn, or because the grant is refused, is allowed a deduction for the expenditure:

   (a) That the person incurs in relation to the application or intended application; and

   (b) That would have been part of the cost of depreciable property, or otherwise a deduction, if the application or intended application had been granted; and

   (c) For which the person is not allowed a deduction under another provision.

7. The deduction in proposed replacement s. DB 19 is to be allocated to the income year in which the person decides not to lodge the application, withdraws the application, or is refused the grant.

8. The difference is that the proposed change will allow a deduction for an *intended application* that is abandoned, as opposed to an actual application. The other requirements in existing s. DB 19 are to be retained.

9. This amendment applies from the beginning of the 2014-15 income year.

Clawback for subsequent applications or disposal of application property

10. Clause 16 of the November Bill contains a proposal to insert a new s. CG 7B, which will serve to claw back deductions taken under proposed new s. DB 19 if:

    (a) Expenditure is incurred for the purpose of applying for a resource consent; and

    (b) The application is not lodged or is withdrawn or the grant is refused; and

    (c) A deduction is taken under s. DB 19 for the expenditure; and

    (d) Property, referred to as "application property", is acquired as a result of the expenditure; and

    (e) The application property is disposed of for a consideration, or is used in obtaining the grant of a resource consent.

11. In the case where the application property is disposed of for a consideration, the amount that will be clawed back is the lesser of:

    (a) The amount of the consideration that is not income under any other provision in the Income Tax Act 2007; or

    (b) The total deductions claimed under s. DB 19.

12. In the case where the application property is subsequently used in obtaining the grant of a resource consent, the amount that will be clawed back is all of the deductions claimed under s. DB 19.

13. A proposed new s. EE 57(3)(cb) will result in the expenditure that is clawed back under s, CG 7B being included in the base value of the resource consent for tax depreciation purposes.

14. The claw back rule and the inclusion of the expenditure in the base value for tax depreciation purposes apply from the beginning of the 2014-15 income year.

New fixed life resource consents included in Schedule 14

15. Resource consents granted under sections 15A or 15B of the RMA have a fixed life of between 5 and 35 years. A proposed amendment to item 10 of Schedule 14 will mean that expenditure incurred on resource consents granted under the RMA to do something that would otherwise contravene s. 15A (Restrictions on dumping waste in a marine area) or s. 15B (harmful discharged from ships or offshore installations) can be depreciated over the life of the resource consent.

Resource consents obtained: capital vs revenue

16. The deductibility of costs for resource consents obtained was recently discussed in the Trustpower case. In that case, TrustPower applied for, and obtained, resource consents relating to 4 projects that were subsequently abandoned. TrustPower sought to deduct the costs as part of the cost of feasibility analysis of the 4 projects. The Commissioner argued that the costs were capital in nature and, therefore, could not be deducted.

17. The High Court noted that the Income Tax Act does not itself determine whether expenditure of this nature is capital or revenue. Following the Privy Council decision in *BP Australia Ltd v Commissioner of Taxation for the Commonwealth of Australia* [1965] UKPC 23, it is necessary to determine what the expenditure was "calculated to effect from a practical and business point of view".

18. The High Court discussed the "*BP Australia* indicia" to determine whether the resource consents were capital or revenue assets:

    (a) The need or occasion which called for the expenditure: because the resource consents were obtained in the course of taking developing the 4 projects, the expenditure was incurred as part of the feasibility of the projects, and this pointed to the expenditure being on revenue rather than capital account;

    (b) Whether payments were from fixed or circulating capital: the test is whether the sums were paid out of fixed or circulating capital and, therefore, the focus is on the source of the funds used in the expenditure – the test was not useful because there was little or no evidence as to the source of funds used in the expenditure;

    (c) Whether the expenditure was of a once for all or recurrent nature producing assets or advantages which were of an enduring benefit:

        (i) In relation to whether the expenditure was recurrent, the High Court accepted TrustPower's submission that most of the expenditure was not primarily directed at obtaining resource consents, but was to continually incurred to investigate and define the feasibility of various projects, and was therefore revenue in nature;

        (ii) In relation to whether an enduring benefit was produced, the High Court followed *Milburn New Zealand Ltd v CIR* (2001) 20 NZTC 17,017 (HC) where it was held that resource consents clearly provided an enduring benefit due to the period of time they were granted for;

    (d) How the payment would be treated on ordinary principles of commercial accounting: the High Court held that accounting principles would require the expenditure to be treated as revenue (refer to the discussion from paragraph 26 onwards below);

    (e) Whether the expenditure was incurred on the business structure, or as part of the process by which income was earned: the High Court accepted that consents are not

means by which TrustPower can produce income, in the absence of a commitment to proceed to construct the project concerned – therefore, the assets could not be regarded as part of TrustPower's business structure.

19. Most of the expenditure was recurrent in nature, being continually incurred to investigate and define the feasibility of the various projects. The resource consents were of value to TrustPower only as part of a bundle of rights, which were part of the feasibility studies. Accordingly, from a practical and business point of view, TrustPower's expenditure incurred in obtaining the resource consents was incurred as part of the feasibility process and was, therefore, revenue in nature.

Arguments concerning depreciation

20. The High Court considered arguments presented regarding whether the expenditure on resource consents should have been capitalised and depreciated.

21. The Commissioner's arguments were that:

(a) The definition of "property" in s. YA 1 includes, for the purpose of the tax depreciation rules in subpart EE, "consents granted on or after the 1996-97 tax year under the RMA, and therefore overrides s. 122 of the RMA (which provides that a resource consent is neither real nor personal property);

(b) The explanatory note in the Tax Bill in which inserted the provision states that the provision was introduced to "include for depreciation purposes consents under the (RMA)" due to certain consents (those listed in Schedule 14) being able to be treated as depreciable intangible property;

(c) Section EE 62(1) provides that depreciable intangible property means the property listed in Schedule 14. Section EE 62(2) sets out the criteria for property to be listed in Schedule 14. It must be intangible, and it must have a finite useful life that could be determined with a reasonable degree of certainty on the date of its acquisition. Section EE 62(3) provides that property listed in Schedule 14 is depreciable intangible property even if the criteria in s EE 62(2) are not met;

(d) The property listed in Schedule 14 includes, at clause 10 a consent granted under the RMA to do something that otherwise would contravene sections 12 to 15 of the RMA (other than a consent for a reclamation), being a consent granted in or after the 1996-97 tax year;

(e) Therefore, resource consents are prima facie capital assets, and the purposes of s. DB 19 – to provide a deduction for expenditure that would otherwise be "black hole" capital expenditure - shows that resource consents should be capitalised.

22. The taxpayer submitted that:

(a) Subpart EE does not apply because TrustPower did not use, or have available for use, the resource consents during the relevant tax years, therefore, the consents were not depreciable and the expenditure incurred in obtaining them was deductible under the general permission;

(b) Under s EE 7(j), property for which the cost is deductible under a general (non-depreciation) provision is not depreciable property, therefore, the resource consents cannot be depreciable property and under s 122 of the RMA, the consents would not be property; and

(c) Section DB 19 is irrelevant because the resource consents were obtained, and it cannot determine whether the expenditure is deductible.

23. The High Court accepted the taxpayer's submission that subpart EE cannot apply because TrustPower did not use the resource consents, or have them available for use, during the relevant tax years. However, even if subpart EE did apply, it could only be consents permitting activities otherwise restricted by ss 12–15 of the RMA that are "depreciable intangible property" pursuant to Schedule 14. Those consents do not include land use consents, and it is land use consents which were at issue in the Trustpower case.

24. The High Court also accepted that s. DB 19 provides no guidance as to how resource consents should be treated.

25. An associated important issue was whether the resource consents were, on a stand-alone basis, assets. The High Court found that the resource consents obtained by TrustPower were not stand-alone assets, separate from the projects to which they related. The resource consents were part and parcel of the projects. The expenditure in obtaining them must, therefore, be treated in the same manner as the projects.

NZIAS 16 vs NZIAS 38

26. The High Court discussed how the expenditure in TrustPower would be treated on ordinary principles of commercial accounting. The relevance of two accounting standards was discussed:

(a) NZIAS 16 Property, Plant and Equipment; and

(b) NZIAS 38 Intangible Assets.

27. The High Court discussed NZIAS 16 and NZIAS 38 as follows:

"[128] The title of NZIAS 16 is "Property, Plant and Equipment". Paragraph [2] provides that it is to be applied in accounting for property, plant and equipment "except when another Standard requires or permits a different accounting treatment." Paragraph [7] provides that:

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 will flow to the entity; and

    (b) The cost of the item can be measured reliably.

[129] The title of NZIAS 38 is "Intangible Assets". Paragraph [2] provides that it is to be applied in accounting for intangible assets, except (as relevant to this case) intangible assets that are within the scope of another standard. In paragraph [8], "asset" is defined as a resource:

(a) Controlled by an entity as a result of past events; and

(b) From which future economic benefits are expected to flow to the entity.

An "intangible asset" is defined as:

... an identifiable non-monetary asset without physical substance.

Paragraphs [21] and [22] of NZIAS 38 provide:

21. An intangible asset shall be recognised if, and only if:
    (a) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
    (b) The cost of the asset can be measured reliably.
22. An entity shall assess the probability of future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

Paragraph [57] ("Development Phase") of NZIAS 38 is relevant. It provides:

57. An intangible asset arising from development ... shall be recognised if, and only if, an entity can demonstrate all of the following:
    (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
    (b) Its intention to complete the intangible asset and use or sell it.
    (c) Its ability to sell the intangible asset.
    (d) How the intangible asset will generate future economic benefits. ...
    (e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
    (f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

28. The High Court then discussed the comparative relevance of the 2 standards in the circumstances. The company's auditors preferred NZIAS 16 because it was very unlikely that an intangible asset would result. The High Court's view was that if the resource consents are stand-alone assets (contrary to the judge's earlier finding that they were not), they could only be intangible assets. Therefore, in the High Court's view, NZIAS 16 did not apply.

29. The judge then considered the implications of paragraph 57 of NZIAS 38 as follows:

    "[133] The resource consents were obtained in the course of progressing projects along the development pipeline. If the consents were "assets" as defined in NZIAS 38, then they arose from a development phase. There was no evidence that, at the time the expenditure was incurred, TrustPower intended to complete the projects in respect of which the resource consents were obtained … nor any evidence that TrustPower intended to use or sell the consents, independent of the projects to which they related. … Further, in the light of TrustPower's evidence that there were always more projects in the development pipeline than it had the financial and resource capability to construct, TrustPower could not have demonstrated the availability of adequate technical, financial, or other resources to complete the projects and use the resource consents. On this basis, under NZIAS 38, the expenditure would not be recognisable as capital and would properly be treated as revenue."

Arun David, Director

DavidCo Limited