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WEEKLY COMMENT: FRIDAY 26 JUNE 2015

1. The judgment of the Court of Appeal in *Commissioner of Inland Revenue v Trustpower Limited* [2015] NZCA 253 was handed down on 19 June 2015. The Commissioner's appeal was allowed and the re-assessments disallowing Trustpower's deductions claimed for the 2006, 2007 and 2008 income years were confirmed. The judgment reversed the decision of Andrews J in the High Court, which I discussed in *Weekly Comment* 21 March 2014. This week I review the judgment of the Court of Appeal.

Facts of the case

2. Trustpower applied for, and obtained, resource consents relating to 4 projects that were subsequently abandoned. Trustpower sought to deduct the costs of applying for and obtaining the consents 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.

3. The four projects were part of Trustpower's development "pipeline" which contains approximately 200 projects at any time. The purpose of the pipeline is to provide Trustpower with information about the viability, feasibility and costs of building new generation capacity.

4. It was accepted by the High Court that the expenditure on the resource consents was incurred as part of Trustpower's feasibility analysis of the four projects and before it had made its build or buy decision and committed to the construction of any of them. The resource consents were also not "stand-alone assets" separate from the projects to which they related. Therefore, the High Court accepted the expenditure was "feasibility expenditure" and deductible on revenue account because it was incurred in the course of deriving income from the generation and sale of electricity.

5. The Commissioner, on the other hand, argued that:

   (a) The resource consents were separate intangible capital assets and the expenditure incurred in applying for and obtaining them was capital expenditure, to which the "capital limitation" in s. DA 2(1) of the *Income Tax Act 2007* applied (although the case was heard in terms of the *Income Tax Act 2004*); and

   (b) The resource consents were "depreciable intangible property" under the relevant provisions of subpart EE.

Relevance of financial reporting standards

6. In the High Court, Andrews J discussed, at some length, the comparative relevance of two accounting standards:

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

   (b) NZIAS 38 Intangible Assets.

7. The High Court held that, had the resource consents been stand-alone assets, they would have been intangible assets to which NZIAS 38 would have applied. However, because the High Court found that they were not stand-alone assets, the expenditure would be required to be expensed in accordance paragraph 68(a) of NZIAS 38.

8. Expenditure incurred on research or development that is recognised as an expense under paragraph 68(a) of NZIAS 38 is allowed as a deduction under s. DB 34 (previously s. DB 26).

9. The Court of Appeal dismissed the relevance of NZIAS 38 (previously Financial Reporting Standard No 13) to the determination of the tax treatment of expenditure incurred on the resource consents by simply stating at [19] that:

   "For completeness we note we are not dealing with expenditure incurred on research or development which may be deductible under s DB 26. If we had been, it would, by virtue of s DB 27, have been necessary to consider the definitions of those expressions in the Financial Reporting Standard No 13 1995 (Accounting for Research and Development Activities)."

Tax depreciation rules

10. The Court of Appeal made some useful and clarifying observations regarding the operation of the tax depreciation rules.

11. First, they noted that while s. DA 1(1) states that "a person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) … ", there is no express requirement in the provision that an amount of "depreciation loss" must be claimed as a deduction. This would appear to support the old "use or lose it" adage that depreciation loss occurs regardless of whether it is claimed, and if depreciation is claimed on a diminishing value basis, the opening tax book value diminishes regardless of whether depreciation is claimed or not. This also has implications for depreciation recovered upon disposal.

12. Secondly, the Court of Appeal clarified the meaning of the term "used or available for use". They did not accept Trustpower's submission that the resource consents were not depreciable property because they were not "used or available for use" in deriving income until Trustpower had decided to proceed with a particular project. They noted at [27] that:

    "The fact that they were not being used and would not be used unless and until Trustpower decided to use them and obtained land access did not mean that they were not "available" for use. The expression "available" simply means "capable of being used" (based on the *New Zealand Oxford Dictionary* definition of "available"). Once Trustpower decided to use them and obtained land access, they would be used. Prior to that they were available for that purpose."

13. Third, the Court of Appeal stated that it is important to distinguish between characterisation of property as depreciable and the separate question of the timing of depreciation. It is not necessary for a depreciation deduction to be available in an income year in order for property to be classified as depreciable property in that income year. They stated at [29] that:

"… the suggestion in the High Court judgment that sub-pt EE cannot apply because Trustpower had not acquired the resource consents in the three tax years is incorrect. If the consents are correctly characterised as depreciable property under s EE 6, the expenditure incurred by Trustpower in obtaining them might be carried forward and depreciated when the consents were used or available for use."

14. Fourth, the Court of Appeal confirmed Trustpower's submission that s. EE 7(j), which prohibits a deduction for depreciation loss for "property for whose cost a person is allowed a deduction under a provision of this Act outside this subpart …", means that:

    (a) 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-part EE will simply not apply; and

    (b) The requirement that the revenue/capital distinction be considered before the depreciation regime is consistent with the Commissioner's acknowledgement that expenditure on consents obtained by a building developer where the consents relate to real property intended for sale will be revenue expenditure because they are, for that developer, effectively stock in trade; and

    (c) Section EE 7(j) is not limited to specific provisions (such as applying only to revenue account property), but it refers to all types of property and operates to exclude property for which a deduction is allowed under the general permission in s. DA 1.

The income/capital distinction

15. In distinguishing revenue expenditure from capital expenditure, the Court of Appeal preferred the statements made by Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* [1946] HCA 34, (1946) 72 CLR 634 (HCA) and earlier in *Sun Newspapers Ltd v Federal Commissioner of Taxation* [1938] HCA 73, (1938) 61 CLR 337 (HCA), and by Viscount Radcliffe in *The Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] UKPC 3, [1964] AC 948. The four statements are:

    ."... the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organization and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it." (Dixon J: *Hallstroms*)

    "What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process." (Dixon J: *Hallstroms*)

    "There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment." (Dixon J: *Sun Newspapers*)

"Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve ..." (Viscount Radcliffe: *Nchanga Copper Mines*)

16. These statements were seen as providing a more flexible indication of the difficult distinction than the factors considered in *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1965] UKPC 23, [1966] AC 224 (PC), known as the "BP Australia indicia", which were discussed in the High Court. The Court of Appeal stated at [65] that:

    "When the *BP Australia* factors are taken into account their individual significance will vary according to the circumstances of the particular case. In a number of cases the usefulness of some of the factors has also been questioned."

17. The Court of Appeal emphasised that:

    (a) The general principles stated by Dixon J in *Hallstroms* and Viscount Radcliffe in *Nchanga* remain the best guide for distinguishing between income and capital and may well be sufficient for that purpose without resort to the *BP Australia* factors.

    (b) The *BP Australia* indicia are just that; as Lord Pearce recognised, they are not necessarily determinative.

    (c) In the end, as all the authorities indicate, the answer will depend on a close examination of the facts of the particular case and the character of the particular payment in order to ascertain the nature and purpose or effect of the relevant expenditure.

    (d) In essence there needs to be a sufficient relationship or connection between the expenditure (or loss) and the income or capital, as the case may be. It is the object or effect of any given payment that will be determinative.

18. After stating that the general principles apply equally to the characterisation of expenditure on intangible property, the Court of Appeal applied the general principles to the facts of this case as follows:

    (a) First, the expenditure was incurred for the purpose of enabling Trustpower to extend or expand its electricity generation business: applying the test from *Hallstroms*, it related to the acquisition of the means of production by extending the business organisation.

    (b) Secondly, the resource consents gave Trustpower valuable rights when viewed in terms of the test from *Hallstroms* regarding what the expenditure was calculated to effect from a practical and business point of view, and the legal rights (which Trustpower argued were not very robust) are not determinative.

    (c) Third, the High Court finding that the resource consents were not stand-alone assets separate from the projects to which they related is irrelevant.

    (d) Fourth, the expenditure was not incurred "in carrying on" Trustpower's business or in earning the income of the existing business or in performing the income-earning operations of the business, therefore, in terms of the general permission, the requisite nexus between the incurring of the expenditure and the deriving of the income is not established.

19. The Court of Appeal decided, contrary to the High Court, that the BP Australia indicia supported the expenditure being capital in this case:

    (a) The first *BP Australia* factor — the need or occasion which called for the expenditure — was found to be of considerable importance in *Birkdale Service Station Ltd v Commissioner of Inland Revenue* [2000] NZCA 325, [2001] 1 NZLR 293 (CA). In this case, characterising the expenditure as being for the purpose of investigating the feasibility of projects did not mean it was of the same character as Trustpower's operating costs, because all of the feasibility expenditure related to possible future capital projects. Therefore, the first factor supports the conclusion that the expenditure is on capital account.

    (b) The utility of the second factor – whether payments were made from fixed or circulating capital, with the former indicating capital and the latter revenue – was questioned in the High Court. The Court of Appeal agreed with the High Court that the test focuses on the source of the funds rather than their use, and here the source is unclear. The answer to the second *BP Australia* question is, therefore, neutral.

    (c) The utility of the third factor – whether the expenditure was of a once and for all nature producing assets or advantages which were of an enduring benefit to the taxpayer – has also been questioned. In *Sun Newspapers*, Dixon J concluded that recurrence is not a test. In any case, the expenditure in respect of specific resource consents, as here, was expenditure which had the purpose of providing Trustpower with an enduring benefit once the consents were obtained. Therefore, the answer to the third *BP Australia* question supports the conclusion that the expenditure is on capital account.

    (d) The Court of Appeal stated that the fourth factor – how the payment would be treated on ordinary principles of commercial accounting – is unlikely to be particularly significant or determinative, because in New Zealand, the relevant provisions of the Income Tax Act prescribe what deductions are permissible for taxation purposes irrespective of financial accounting principles. In the Court's view, the answer to the fourth *BP Australia* question is neutral.

    (e) The fifth factor – whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned – was seen by the Court of Appeal as clearly an important factor, because it reflects the distinction drawn by Dixon J in *Hallstroms* and recognised by Viscount Radcliffe in *Nchanga*. Obtaining the resource consents was a critical step or integral component of the development of four specific capital projects. Therefore, the answer to the fifth *BP Australia* question supports the conclusion that the expenditure was on capital account.

20. The Court of Appeal reviewed the case law supporting the view that expenditure incurred in investigating a new source of income will be on capital account:

    (a) In *Re Griffin Coal Mining Co Ltd v Commissioner of Taxation* [1990] FCA 343, where the expenditure related to feasibility costs for a new smelter, the Full Court of the Federal Court of Australia emphasised that the expenditure was not incurred in carrying on the business of extracting and selling coal but in acquiring an asset to be used in an expanded business of the company.

    (b) In *Esso Australia Resources Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1992] FCA 851 where the expenditure related to the evaluation of potential coal, oil shale and mineral prospects, the Full Court of the Federal Court upheld the decision of the first instance Judge that the expenditure was of a capital nature because it was "of a

preliminary nature, aimed at ascertaining whether it was commercially worthwhile to enter into mining joint ventures".

(c) In *ECC Quarries Ltd v Watkis (Inspector of Quarries)* [1977] 1 WLR 1386 (Ch) the English High Court held that while the permissions for a quarry would not themselves produce profits the subsequent operations of working and winning the minerals, which were permitted by the consents, would. Therefore, the assets of the company had radically and enduringly changed when the permissions were granted, and on common sense principles and based on consideration of the authorities, the expenditure was of a capital nature.

(d) In *Waste Management New Zealand Ltd v Commissioner of Inland Revenue* (1995) 17 NZTC 12,147 (CA) the Court of Appeal indicated that expenditure incurred investigating the feasibility of a site as a landfill for disposing of industrial waste, designing the landfill and seeking the planning consents and water rights it needed was capital.

(e) In *Case T53* (1998) 18 NZTC 8-404 Judge Barber in the New Zealand Taxation Review Authority held that legal fees incurred in a successful appeal against the refusal of resource consents required to carry on a second-hand machinery business were not deductible on revenue account because the acquisition of the resource consent was an intangible asset of the objector's business, a right of benefit and advantage that did not previously exist.

(f) In *Milburn New Zealand Ltd v Commissioner of Inland Revenue* (2001) 20 NZTC 17-017 the High Court held that expenditure incurred in obtaining resource consents for Milburn's quarries for sourcing aggregate and lime for its cement and concrete business was of a capital not revenue nature because it was a necessary part of the development of those quarries for production of materials for use in the taxpayer's business.

21. The Court of Appeal made some significant statements about feasibility expenditure:

(a) All of Trustpower's "feasibility expenditure" related to possible future capital projects. It was not incurred by Trustpower in deriving income from its existing business. It was incurred for the purpose of enlarging the business structure.

(b) For tax purposes, the question of whether expenditure incurred is sufficiently connected to a capital purpose may be appropriately determined in hindsight because taxpayers invariably file their returns after the event (the parties agreed that "feasibility" expenditure ceases to be on revenue account when a decision to acquire an asset is made).

(c) The decisions in the cases referred to above are analogous and are not distinguishable.

(d) It may be different if, for example, the taxpayer was in the business of undertaking feasibility studies and obtaining resource consents to be sold as a package to a power generation company. For such a company, income would be generated in the process of producing and selling these "shelf" consented projects.

22. Finally, the Court of Appeal stated that whether Trustpower wishes to depreciate the expenditure now under subpart EE of the Income Tax Act on the basis that, having obtained the four resource consents, they are depreciable intangible property is for Trustpower to decide.

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