IS 08/02: DEDUCTIBILITY OF FEASIBILITY EXPENDITURE

INTRODUCTION

1. This interpretation statement contains guidelines that the Commissioner considers relevant in determining whether feasibility study expenditure is deductible under the general deductibility provisions in section DA 1 of the Income Tax Act 2007.

2. All legislative references are to the Income Tax Act 2007, unless otherwise stated.

3. This statement does not consider specific deductibility provisions that may be applicable to some types of feasibility expenditure; for example, provisions such as those found in Part D Subpart B, Part D Subpart T (petroleum mining), and Part D Subpart U (mineral mining).

4. This statement also does not consider the timing of any deduction to which a taxpayer might be entitled or Part E Subpart E (depreciation).

5. This statement is in two parts. The first part considers the application of section DA 1(1) (the general permission) to feasibility expenditure. The second part considers the application of section DA 2(1) (the capital limitation).

SUMMARY

6. In many situations it is likely that feasibility expenditure will be non-deductible on the basis that it is either incurred preliminary to or preparatory to the commencement of a business or income-earning activity or it is capital in nature.

Deductibility: General principles

7. For a deduction to be claimed it will be necessary for the feasibility expenditure to be incurred by the taxpayer:

   - in the derivation of assessable income (either from the ultimate exploitation of the product of the expenditure in a business or income-earning activity, or by sale of the product of the expenditure); and

   - as an ordinary incident of a particular business or income-earning activity.

8. The deductibility of feasibility expenditure is subject to the application of the general principles under section DA 1(1), the general deductibility provision in the Act. Thus, for feasibility expenditure to be deductible under either paragraph of section DA 1(1) there must be a sufficient relationship or nexus between the expenditure and the taxpayer’s business or income-earning activity. Any expenditure incurred before the establishment of a business or an income-earning process will not fulfil this statutory nexus because the expenditure will

have been incurred too soon. Therefore, feasibility expenditure incurred preliminary to or preparatory to the establishment of a business or income-earning activity will not be deductible.

9. The decision whether a business or income-earning activity is being carried on is always one of fact and degree. Its resolution depends on a consideration of the nature of the activities carried on and the taxpayer's intention in engaging in those activities (as set down in *Grieve v CIR* (1984) 6 NZTC 61,682). A determination of the point at which a taxpayer makes a firm commitment to go into a business or income-earning activity is critical for establishing the earliest time at which that business or income-earning activity may have commenced. Commitment alone, however, is insufficient. The profit-making structure must also have been established and current operations must have begun in order to conclude that the business or income-earning process has commenced.

10. The correct characterisation of the nature of the relevant business is vital to resolving whether there is a sufficient nexus between the expenditure and a taxpayer's business. The activities must be characteristic of that kind of business and the expenditure must be incurred as part of the ordinary business operations.

11. The profit-making structure must also be in place for a business to have commenced. However, the extent of the profit-making structure required depends on the nature of the particular business.

12. The element of commitment is also critical. To conclude that a business or an income-earning activity has commenced, it must be shown that a decision has been made to enter into that business or activity. If expenditure relates to activities undertaken in order to decide whether to enter into a particular business or income-earning activity, that expenditure will lack the required nexus and will be non-deductible.

13. For feasibility expenditure incurred after a business or an income-earning activity has commenced to be deductible, it must be incurred as an ordinary incident of the business or income-earning process. This requires that the particular activities must be undertaken as part of the income-earning process (ie, the activities must be carried out with the intention of obtaining assessable income).

Capital limitation

14. When feasibility expenditure is deductible under section DA 1(1), it is still necessary to consider whether the expenditure is denied a deduction under section DA 2(1) as being expenditure of a capital nature.

15. Whether particular feasibility expenditure is capital or revenue in nature must be determined on the facts of any particular case. The most important factors to weigh in determining whether feasibility expenditure is capital or revenue in nature are whether the expenditure:

- is recurrent or once and for all expenditure;
- is on the profit-yielding structure or the income-earning process;
- creates an identifiable asset; and
- produces an enduring benefit.

16. In relation to the other three factors, it is necessary to identify the particular nature of the taxpayer's business. When incurring feasibility expenditure of the type in question forms part of the normal business operations (ie, part of the constant demands on the enterprise), case law indicates that the feasibility expenditure is more likely to be treated as being on revenue account and deductible.

17. In relation to the enduring asset and profit-making structure factors, it is necessary to consider how far along the process the expenditure was incurred and whether a particular asset has been identified. In these circumstances whether a decision has been made to commit to a particular proposal is likely to be important.

18. Feasibility expenditure incurred principally for the purpose of placing a taxpayer in a position to make an informed decision about the acquisition of an asset (or other enduring advantage) will not generally be expenditure incurred in relation to that particular asset or advantage. However, once the decision has been made to proceed with the acquisition or development of a particular capital asset, any expenditure incurred beyond that point will relate to the acquisition of that asset and will indicate that the expenditure is more likely to be of a capital nature.

19. The same principle applies in relation to determining whether the expenditure relates to the business or profit-making structure. If the feasibility expenditure is incurred principally for evaluating one or more proposals, it is unlikely the expenditure will relate to the business structure sufficiently to indicate the expenditure is capital in nature. However, when the feasibility expenditure goes beyond simply placing a taxpayer in a position to make an informed decision, it is necessary to consider whether the expenditure relates to the profit-making structure or profit-making process.

20. Once a decision has been made to proceed with the acquisition or development of an asset, any expenditure incurred after that time will more readily be treated as being related to the underlying capital project and thereby the profit-making structure of the business, so will not be deductible. For these purposes, it is irrelevant whether the expenditure is successful. In addition, commitment in this context does not necessarily mean a taxpayer will proceed with the acquisition or development regardless of future events (eg, the availability or otherwise of suitable planning consent), only that the taxpayer has made a firm decision to proceed. Similarly, it is considered that the fact the decision to proceed, or aspects of the process, may be contingent on factors beyond the taxpayer's control will not mean that a taxpayer is not committed to pursuing a

certain course of action. Identifying when a decision to proceed has been reached in any particular situation will always be a question of fact and degree, and it is necessary to weigh all the relevant factors to determine whether a commitment has been made to a project.

LEGISLATION

21. Whether feasibility expenditure is an allowable deduction is determined under sections DA 1 and DA 2(1), which provide as follows.

DA 1 General permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or
(ii) their excluded income; or
(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or
(ii) their excluded income; or
(iii) a combination of their assessable income and excluded income.

General permission

(2) Subsection (1) is called the general permission.

DA 2 General limitations

Capital limitation

(1) 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.

22. It is the Commissioner's view that his conclusions in this statement as to the deductibility or non-deductibility of feasibility expenditure would not be altered if the same items were considered under the provisions of the 1994 Act or the 2004 Act.

WHAT IS FEASIBILITY EXPENDITURE?

23. Feasibility expenditure is neither a defined term for the purposes of the Act nor a term of art. However, it is generally used to describe expenditure incurred by a taxpayer for determining the practicability of a new proposal. A typical feasibility exercise would involve determining whether a particular course of action should be taken or certain capital assets acquired or developed. Depending on the circumstances, feasibility expenditure may include the cost of

carrying out surveys or studies (eg, engineering surveys, environmental studies, and geological and geophysical studies), conducting comparative industry and market research, engaging professionals (eg, lawyers, consultants, and financial analysts), producing samples or prototypes, and travel costs. These costs may be incurred "externally" if a third party is contracted to provide the services to the taxpayer, or "in-house" if the taxpayer's employees are paid to undertake the work. Feasibility expenses may arise at the outset of a new business venture or in the course of an existing business. In the latter case, they may be closely related to existing operations or may relate to proposals to expand the existing business or commence a new business.

24. Section DA 1(1) is the general deductibility provision in the Act, and relevantly provides that a deduction is allowed to the extent to which any expenditure or loss is incurred in deriving assessable income, or incurred in carrying on a business for the purpose of deriving assessable income. For feasibility expenditure to be deductible, therefore, it must first fall within one of these two bases of deductibility. In addition, simply satisfying section DA 1(1) may not be sufficient to ensure deductibility. A deduction may still be prohibited under a specific provision of the Act; for example, under section DA 2(1), which prohibits a deduction for expenditure of a capital nature.

25. Little New Zealand case law exists on the deductibility of feasibility expenditure. However, some overseas authorities, in particular, Australian and Canadian cases, are on point.

DEDUCTIBILITY UNDER SECTION DA 1(1)

General principles

26. The two leading New Zealand cases relevant to the interpretation of the general deductibility provision are the Court of Appeal decisions in *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271. The following general principles can be taken from the cases:

- Expenditure will be deductible only when it has the necessary relationship both with the taxpayer concerned and with the gaining or producing of the taxpayer's assessable income or with the carrying on of a business for that purpose (*Banks* at page 61,240; *Buckley & Young* at page 61,274).

- A statutory nexus must exist between the particular expenditure and the assessable income of the taxpayer claiming the deduction (*Banks* at page 61,240).

- The heart of the inquiry is the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income-earning process. That in turn requires determining the payment's true character. It then becomes a matter of degree, and so a question of fact, to determine whether a sufficient relationship exists between the expenditure and what it provided or sought to provide on the one hand, and the income-earning process on the other, for the expenditure to fall within the words of the section (*Banks* at page 61,242; *Buckley & Young* at page 61,274).

- Whether the expenditure is incurred in gaining or producing assessable income has to be judged as at the time the taxpayer became definitively committed to the expenditure for which the deduction is sought (*Banks* at page 61,241).

- The phrase "to the extent that" expressly contemplates apportionment (*Banks* at page 61,240; *Buckley & Young* at page 61,274).

- The amount of expenditure is not material. It is not a question of what a reasonable and prudent taxpayer would have expended. It is what the taxpayer has in fact paid (*Buckley & Young* at page 61,282).

Application to feasibility expenditure

27. The primary test for deductibility of expenditure under either paragraph of section DA 1(1) is that there must be a sufficient nexus between the expenditure and the taxpayer's business or income-earning activity. Feasibility expenditure is often incurred at the early stages of a new venture. This means the deductibility of such expenditure is often inextricably linked to the issue of whether and/or when a taxpayer has commenced business or commenced a new business or, in other than business cases, established an income-earning process.

28. Expenditure incurred before the establishment of a business or an income-earning process will not fulfil the statutory nexus required in terms of section DA 1(1) and will not be deductible. This is because the expenditure will have been incurred too soon. If a taxpayer has incurred feasibility expenditure *before* a business has commenced, or a new business to which the feasibility expenditure relates has commenced, or an income-earning process is established, as the case may be, a deduction will be denied.

"In business"

29. The leading New Zealand case on what constitutes being in business is *Grieve*. The Court of Appeal found that determining whether a taxpayer is in business involves a two-fold inquiry as to: (i) the nature of the activities carried on and (ii) the intention of the taxpayer in engaging in those activities. Richardson J (at page 61,691) identified several factors relevant to determining whether a taxpayer is carrying on a business, namely the:

    - nature of the activity;

    - period over which the taxpayer engages in that activity;

    - scale of operations and the volume of transactions;

    - commitment of time, money, and effort;

- pattern of the activity; and
- financial results.

30. Richardson J went on to note that it may also be helpful to consider whether the operations involved are of the same kind, and are carried on in the same way, as those that are characteristic of ordinary trade in the line of business in which the venture is conducted. However, in the end it is the *character* and *circumstances* of the *particular venture* that are crucial.

Commencement of business or income-earning activity

31. Although relevant to the issue of preliminary expenditure, the focus in *Grieve* was essentially on *whether* a business was being carried on, rather than on the issue of *when* it could be said that a business had commenced. The latter issue has been more specifically considered in other New Zealand and overseas cases, generally seen as commencing with the English case *Birmingham & District Cattle By-Products Co Ltd v IRC* (1919) 12 TC 92.

32. In *Birmingham*, Rowlatt J concluded that the taxpayer had not commenced business until the date it started to receive raw material and produce finished products. Until then all its actions were merely preparatory to the commencement of business; it was in the process of "getting ready".

33. *Birmingham* was cited by Barker J in the New Zealand Court of Appeal decision *Duff v CIR* (1982) 5 NZTC 61,131, 61,144, as being authority for the proposition that a business does not commence until the plant is ready and the owner is ready to commence dealings in the articles from which the owner is to derive profit; preparatory activities do not constitute the running of a business.

34. *Birmingham* was also confirmed by the Court of Appeal in *Calkin v CIR* (1984) 6 NZTC 61,781, where Richardson J noted the difficulty in distinguishing between transactions that are preparatory to the commencement of business and those that occur once the business has begun and concluded (at page 61,786):

> Clearly it is not sufficient that the taxpayer has made a commitment to engage in business: he must first establish a profitmaking structure and begin ordinary current business operations.

35. *Calkin* was applied in the High Court decision *Stevens & Stevens v CIR* (1989) 11 NZTC 6,001. In *Stevens & Stevens*, Gallen J also noted that it is not always easy to establish when a business commences and stated (at page 6,006):

> Preliminary investigations will clearly not be enough, nor will the expenditure of capital requirements in order to enable the business to be carried on, see *Birmingham and District Cattle By-Products Company Limited v Commrs of IR*. The business must involve trading.

36. Gallen J considered the Canadian case *Minister of National Revenue v MP Drilling Ltd* [1976] CTC 58 (discussed in paragraphs 90–92) where it was held that a business had commenced when the permanent structure, the market, and the products all existed and the efforts of the respondent were directed to bringing them together with a resultant profit to it.

37. Thus, deciding when a taxpayer ceases incurring preliminary expenditure, preparatory to the commencement of a business or an income-earning activity, and commences incurring expenditure made during the course or conduct of a business or an income-earning activity is often difficult to determine. Preliminary investigations are not enough, and neither is expenditure on capital requirements to enable the business or activity to be carried on. The income-earning process must have begun and the expenditure must be incurred as part of that process (ie, as part of the ordinary business or income-earning activities).

Cases: New Zealand

38. Very little New Zealand case law considers whether a business has commenced in the context of a claim for the deduction of feasibility expenditure. However, a few decisions are relevant to some extent in this context. These cases consider the issue of the deductibility of pre-commencement expenditure. The general principles exhibited in these cases are equally applicable in the context of feasibility expenditure.

39. In *Case L74* (1989) 11 NZTC 1,431 the taxpayers were in partnership as property developers. They bought, renovated, and sold properties. They decided to investigate buying land in the Cook Islands, building a motel, and operating it. They travelled there and found that their proposed venture was not possible. When they sought to deduct the costs of travel, the Commissioner disallowed the claim on the basis that it was expenditure preparatory to the commencement of a new business.

40. Judge Barber agreed. The Taxation Review Authority (TRA) concluded the expenditure was both preparatory to the commencement of a new business as moteliers and related to the capital structure of such a new business.

41. The Canadian *MP Drilling* case (noted in *Stevens & Stevens* and discussed in paragraphs 90–92) was also briefly considered in New Zealand in *Case M68* (1990) 12 NZTC 2,384. That decision concerned a taxpayer incorporated in 1985 as an exporter, a marketing agent, and an agricultural consultant. From 1985 to 1988, its managing director and principal shareholder was heavily involved in establishing a business for exporting certain agricultural products and services to developing countries. The taxpayer declared no income for the years ending 31 March 1986 to 31 March 1988 and sought deductions for expenditure incurred during that period. The largest components of the expenditure were travel costs and the manager's salary.

42. Bathgate DJ held that for the years ending 31 March 1986 and 31 March 1987 the taxpayer had not commenced business. In the TRA's opinion, the activities undertaken in that period were exploratory, preliminary to the undertaking of an income-earning process, and were to establish connections and build goodwill. This was the establishment of the company's business structure, before the commencement of business. The TRA stated (at page 2,391):

> Feasibility study, costs of inquiry, research and investigation, market testing and introduction expenses at the start, to build or establish a goodwill and until establishment and the undertaking of an income earning process, are generally in the nature of establishment expenses, designed to create and secure a lasting advantage, more remote from income earning, and are usually not deductible under either limb of s 104. They are capital in nature or character.

43. However, Bathgate DJ considered that the taxpayer's business had commenced in and from the 1988 income year. In that year, the taxpayer had established an overseas office and, notwithstanding that trading had not commenced and no profit had been generated, Bathgate DJ was satisfied that the income-earning process had commenced. He stated (at page 2,394):

> There was then in my opinion a close and discernible nexus between the expenditure and the income earning process, which by then had started, albeit only just started, so that the expenditure was then of revenue rather than of capital. The preliminary and preparatory work of the objector had largely ceased, an income earnings structure was then in existence, its goodwill was established and growing, and the business was carried on as had been initially intended, but had been delayed until the preliminaries had been completed and a decision made as to how and where the business would operate from. The advantages sought by the expenditure were those looked for in the nature of a trading operation, in the way of gaining or producing assessable income, rather than advantages of a preliminary and preparatory nature, of the once and for all type in establishing a structure, of the preceding years. Current business operations had begun.

44. Although this decision may at first glance seem inconsistent with cases such as *Stevens & Stevens* and *MP Drilling*, in reaching his decision Bathgate DJ noted (at page 2,395) that he had not overlooked the cases referred to by counsel for the taxpayer, including *MP Drilling*. In the TRA's opinion, the distinction between those cases and the taxpayer's case was one of fact and degree. The TRA also emphasised (at page 2,394) that a business may have commenced before a taxpayer was actually trading or earning assessable income.

45. In *Case S39* (1995) 17 NZTC 7,264 two friends incorporated the taxpayer company with the objective of developing a major media company. The majority shareholder was the company's managing director. He looked for media production opportunities for the company. Although he worked on many proposals with a view to making a profit, some of which were developed into projects, none had come to fruition during the period in question. The taxpayer company claimed various items of expenditure, the major item being management fees paid to the managing director's company for services provided by the managing director to the taxpayer. The Commissioner argued that the taxpayer's activities were preliminary and investigatory, so any expenditure was not deductible because business had not commenced and the expenditure was capital in nature.

46. Barber DJ found for the taxpayer and concluded that the type of work undertaken by the managing director for the taxpayer was not work that was preliminary to, and investigatory of, commencing business, but work that was preliminary to and investigatory of business projects. This was part of the business of media and entertainment production. Even though the work may have been entrepreneurial, speculative and prone not to result in completion or profit, it was work of the normal media and entertainment production type. The taxpayer was established to investigate and carry out or sell profitable

production opportunities in the media area. The work was part of the taxpayer's business or income-earning process.

47. Counsel for the Commissioner argued that a project must get past development proposals and feasibility studies and achieve something. Barber DJ acknowledged that it is unusual for a business not to achieve income-earning transactions. However, Barber DJ stated (at page 7,272):

> It seems to me that development proposals and feasibility studies are very much part of a media production project and were part of the income earning process of the objector even though a project needs to progress much further for fees or profit to be obtained. I do not accept Mr Willox's submission that because there were no income earning transactions, a business had never been commenced by the objector.

48. Thus, *Case S39* supports the deductibility of feasibility expenditure in limited circumstances. In that case the TRA concluded that the investigatory work undertaken by the majority shareholder on behalf of the objector was part of the normal business operations of the objector as a media production company. The feasibility expenditure was held to relate to the business of the company (ie, the investigations were part of the company's income-earning process, not the profit-making structure) and were calculated to result in income to the taxpayer.

49. However, the important distinction between *Case S39* and the other cases discussed above is that in *Case S39* the feasibility studies and investigatory work were part of the company's ordinary business operations of the company. The business of a media production company required that the company investigate production opportunities. In other words, the feasibility expenditure incurred was incurred as part of the business activity of identifying profitable projects. This can be contrasted with feasibility expenditure incurred to determine whether to go into business, which is incurred before the commencement of business and lacks sufficient nexus to satisfy the deductibility provision. The situations where feasibility expenditure will constitute an ordinary incident of the business or income-earning process, such as was the case in *Case S39*, are limited. The deductibility or otherwise of any such expenditure must be determined on the application of the statutory language to the facts in any particular case.

50. Although there are few New Zealand cases in the area of pre-commencement expenditure, those that do exist illustrate the application of the general principles discussed earlier in this statement. No special rules apply to feasibility expenditure. Thus, the cases emphasise that the deductibility or otherwise of feasibility expenditure will depend on the particular facts of the case. A sufficient nexus must exist between the expenditure and the business or income-earning activity. When the expenditure is incurred before any decision is made to enter into the business or income-earning activity, the expenditure will have been incurred too soon and will be non-deductible (*Case M68*). When a business already exists, feasibility expenditure incurred in relation to a new business will still need to satisfy these tests (*Case L74*). When feasibility expenditure is incurred as part of the ordinary income-earning process of a business, it may satisfy the requirements of section DA 1(1)(b) for deductibility (*Case S39*).

51. However, the few authorities that do exist concern relatively simple fact situations, primarily concerning pre-commencement expenditure, and do not exhibit any detailed legal analysis of applicable principles. In addition, the decisions are all TRA decisions, being the court of first instance in each case. In these circumstances, a consideration of relevant decisions from other jurisdictions is of benefit.

Cases: Australia

52. A leading Australian case in the context of feasibility expenditure is *Softwood Pulp and Paper Co Ltd v FCT* 76 ATC 4,438. In that case the taxpayer company was incorporated in 1961 to establish a new paper production industry in South Australia. This would involve building a new mill complex to process particular kinds of paper and other products. The company was owned by Australian promoters and a Canadian company that had experience in the same paper industry. The company incurred significant expenditure in relation to the proposed mill development. However, in February 1962, the Canadian company withdrew. No other promoter could be found, so the project was abandoned. The taxpayer sought a deduction for its expenditure. These expenses included overseas and local travel costs, legal and accounting expenses, the acquisition and testing of raw materials, and professional fees for the carrying out of feasibility studies by expert consultants.

53. The Supreme Court of Victoria rejected the taxpayer's claim. Menhennitt J considered the case, first, from the perspective of whether the taxpayer company was carrying on a business and, secondly, assuming it was carrying on a business, whether the expenditure was of a capital or revenue nature. On the first point, he concluded that everything the company had done was merely preparatory to the commencement of business. The key factor for the court was that at no stage had the company definitely decided to proceed with the mill. Menhennitt J, referring to *Birmingham* in support of his conclusion, stated (at page 4,451):

> The critical point is that the company had not reached a stage remotely near the carrying on of a business. Even assuming that at some stage prior to the mill turning, the company could be said to be carrying on a business, **in this case the company had not even approached the stage of making a decision about carrying on a business**. All that had happened had been that certain investigations had been made to decide whether or not the business was feasible, and whether or not it was economically viable on a competitive basis, but nothing had been done which could be said to be carrying on a business or anything associated with or incidental to the actual carrying on of a business. **Everything which was done was concerned with making a decision whether or not steps should be taken to set up a business, but no decision on even that matter had been reached**. [Emphasis added]

54. The Australian full Federal Court decision in *FCT v Ampol Exploration Ltd* 86 ATC 4,859 is usually cited in support of the deductibility of feasibility expenditure. In that case, the taxpayer carried on business as an oil exploration company, the "exploration arm" of the Ampol group of companies. In 1979, the taxpayer entered into several agreements with the Chinese Government to participate in geographical (seismic) surveys of offshore China to discover possible oil and gas fields. Participation involved no more than the possibility

of the Chinese Government granting the right to bid to undertake further seismic and exploration work.

55. An existing company within the group was used as a joint venture vehicle by the taxpayer and another company in the group. The taxpayer assigned its interest under the agreements with the Chinese Government to the joint venture company. The consideration for the assignment was to be a sum agreed on or the taxpayer's costs in connection with the surveys plus a percentage. The taxpayer claimed a deduction for its survey expenditure and the costs of consultants who interpreted the data obtained. The Commissioner disallowed the claim and the taxpayer appealed. A majority (two to one) of the full Federal Court found for the taxpayer.

56. Lockhart J first considered whether the expenditure came within section 51 of the Income Tax Assessment Act 1936 (Cth), the equivalent of section DA 1(1). His Honour stated that for expenditure to fall within the first limb, the outgoings must be connected with the operations that gain or produce the assessable income. In relation to the second limb, a nexus must exist between the expenditure and the carrying on of the relevant business.

57. His Honour noted that despite the uniqueness of the situation, namely that the companies engaged in the activities had no interest from which an income-producing asset could arise, the taxpayer's role in the Chinese venture was perceived by those who controlled its affairs as a commercially sound method of carrying on its exploration business and as part of its ordinary business activities. They were seeking a profit opportunity. In addition, the circumstances that brought the deed of assignment into existence and the provisions of the deed were also held to be relevant matters for the purpose of characterising the true nature of the expenditure for the purposes of the second limb.

58. Lockhart J found, on the basis of the facts in that case, that the expenditure was necessarily incurred in the carrying on of the taxpayer's business. He stated (at page 4,870):

> The characterisation of the expenditure, and therefore of the outgoing which it represents, is to be discerned from the business activities of the taxpayer generally and its role as the prospecting arm of the Ampol group in the Chinese project in particular. The understanding between the boards of Ampol and the taxpayer, … , that **a benefit, in the form at least of some payment to the taxpayer in the nature of reward or profit, would accrue to it**, requires that the question of deductibility should be approached in a practical fashion. The whole of the relevant expenditure was incurred in the course of carrying on of the taxpayer's business of petroleum exploration. [Emphasis added]

59. Lockhart J was also satisfied that the total expenditure was deductible under the first limb of section 51(1) of the Income Tax Assessment Act 1936 (Cth). The trial judge had drawn a distinction between outgoings incurred before the execution of the deed of assignment and those incurred after, on the basis that it was not until the deed was executed that the payment to be made to the taxpayer was determined. Lockhart J disagreed. His Honour stated (at page 4,870):

> In my opinion the expenditure incurred before the deed was both incidental and relevant to gaining or producing the taxpayer's assessable income in the form of a fee, using that word in the broad sense of a payment or remuneration for the taxpayer's role in the exploration enterprise off the Chinese coast. The deduction is not denied because the particular form of payment was not finally determined in a legally binding form until 3 April 1980. It was at all relevant times the intent of Ampol and the taxpayer that **a just reward of a business character would be paid to the taxpayer**. Only the particular method to be selected to achieve this objective remained to be determined.
>
> Viewed from a practical and business point of view the deed of assignment was the method finally selected to express the object of both Ampol and the taxpayer; first, to enable Ampol to derive a fair share of any benefits which might be produced in the future from the oil production enterprise, if one emerged at all, and, second, to ensure recoupment of the taxpayer's costs if the oil fields were found to be commercially feasible together with a payment geared to a percentage of those costs, and the major share in the benefits of any such enterprise. **The total expenditure was thus connected with the gaining of the payment** from Ampolex Queensland.
> [Emphasis added]

60. Lockhart J's decision emphasises that a sufficient nexus must exist between the feasibility expenditure and the relevant business or income-earning activity, and that this will be a question of fact in any particular case. In *Ampol* the activities were unique in that they provided only a right to bid for participation in the next stage of seismic surveys and exploration. There was no interest from which an income-producing asset could arise. The clear implication from the judgment is that the expenditure might well have been held to be non-deductible, except that in the particular facts of the case the activities were carried out by the taxpayer for the gaining of assessable income (in this case in the form of a fee to be paid to the taxpayer under the deed of assignment).

61. Although concluding that the expenditure was deductible in this particular case, Lockhart J did sound a cautionary note with regard to other fact situations. He stated (at page 4,870):

> It provides no warrant for a more general proposition that outgoings of companies engaged in petroleum exploration are necessarily deductible under the second limb of subsec. 51(1) if the expenditure is related to that activity. This is a question of fact in each case. Exploration or prospecting activities (e.g. geological, geophysical or geochemical surveys and appraisal digging) are the kind of activities in which a prospecting company engages if petroleum is to be found. It is, as the title of the activity suggests, of an exploratory nature. Petroleum may or may not be found; but unless expenses of this kind are incurred it will not be found. Once a proven field has been established other expenses, for example, development drilling or activities in the course of working or establishing a petroleum field will be incurred and they savour more of a capital nature since the work is done to bring into being a proven capital asset which will be the source of income-producing activity.

62. At first glance this statement seems somewhat contradictory, as one would expect that expenditure incurred in relation to petroleum exploration by a company engaged in that activity would be deductible. However, Lockhart J's caution is explicable on general principles.

63. It is considered that Lockhart J was merely emphasising that simply because expenses are incurred in relation to an activity does not mean those expenses are necessarily deductible. It is a question of fact in each case. In terms of general principles, it must still be established that a sufficient nexus exists between the expenditure and a business or income-earning activity. When a company is

carrying on prospecting activities as a business, then exploration expenses will generally be deductible when they are necessarily incurred in the course of that business. However, it is equally possible that a company could be engaging in prospecting activities that do not constitute an income-earning activity or a business, in which case there will be no relevant nexus and the expenditure will not be deductible. This was the case in *Esso Australia Resources Ltd v FCT* 98 ATC 4,768 (discussed in paragraphs 75-84).

64. Lockhart J went on to consider whether the expenditure was of a capital nature. That part of his judgment and the judgments of the other two members of the court are considered in paragraphs 144–147.

65. Another decision of the full Federal Court that emphasises the need for a sufficient nexus between the expenditure and the taxpayer's business or income-earning activity is *Griffin Coal Mining Co Ltd v FCT* 90 ATC 4,870. In that case, the majority of the court held that no nexus existed between smelter feasibility expenditure and the taxpayer's existing business of coal mining and sale.

66. The taxpayer carried on the business of coalmining and supplied coal to the State Energy Commission of Western Australia ("SECWA"). During 1981 to 1983 the taxpayer was involved in various disputes with SECWA and the taxpayer decided to diversify its mining activities to lessen its financial dependence on SECWA. The taxpayer expressed interest in becoming involved in the construction of an aluminium smelter to which it would be prepared to supply coal at little or no profit, or even at a loss, provided it was given an equity interest in the project. However, in May 1984 it was decided that SECWA would supply the smelter's electricity. As a consequence it was no longer clear that the taxpayer would necessarily supply coal to the new smelter. Nevertheless, the taxpayer continued its involvement in the smelter project.

67. In August 1984 the taxpayer and two other companies formed a consortium and conducted a feasibility study to determine the construction and operating costs, and to assess the environmental consequences, of building an aluminium smelter. The taxpayer also undertook its own feasibility study of the project. In addition, the taxpayer engaged various consultants to advise on matters such as industrial relations, finance, environmental issues and the negotiation of a joint venture agreement. Ultimately the development did not proceed, because the two other consortium participants withdrew in June 1985.

68. The Commissioner disallowed the taxpayer a deduction for the smelter feasibility study costs.

69. The majority of the full Federal Court held that the smelter feasibility costs were not deductible under section 51 of the Income Tax Assessment Act 1936 (Cth). They were incurred by the taxpayer as part of the cost of forming a new source of income. They were not merely of a preliminary nature made under the umbrella of the conduct of the existing business. At least from May 1984 there was no longer any link between the decision to be involved in the smelter venture and the supply of coal by the taxpayer. Participation in the project was

seen as a worthwhile activity in its own right and a new separate activity of the company. The feasibility studies were not simply assessments of whether a project could be undertaken; they flowed into the selection of a site, settlement of environmental questions, and negotiation of contracts and firm commitments. The taxpayer had moved well beyond an incident occurring in the course of the business of coal extraction and sale.

70. Thus, the majority held that the smelter feasibility expenditure was not incurred as an ordinary incident of Griffin Coal's business. No nexus existed between Griffin Coal's existing business and the smelter feasibility expenditure. The latter was incurred in creating a new business structure, so was not deductible under either limb of section 51 of the Income Tax Assessment Act 1936 (Cth).

71. Other cases in this area highlight that identifying the nature or type of business or activity under consideration is fundamental to establishing when that business or activity commenced. In addition, they also confirm that a positive decision must be made to enter into that business, as was emphasised in *Softwood* (discussed in paragraphs 52 and 53).

72. In *Goodman Fielder Wattie Ltd v FCT* 91 ATC 4,438, a decision of the Australian Federal Court, the taxpayer was a company that carried on business in several divisions. In August 1981, the taxpayer contracted with the Queensland Institute of Technology ("QIT") to fund the establishment of a research and development centre for the production of monoclonal antibodies and related products suitable for commercial development. In return for funding the centre, QIT undertook to produce a range of highly specific monoclonal antibodies for commercial exploitation by the taxpayer. The centre was set up and research on a full-time basis commenced in early 1982. In November 1982 the taxpayer leased separate premises for its monoclonal antibodies division ("Mabco") to set up development and production facilities. Sales of the first monoclonal products took place in December 1982. The taxpayer claimed deductions for its contributions to the centre and expenditure incurred by Mabco on manufacturing, administration, and research and development for the 1981/82 to 1984/85 income years.

73. Hill J, applying *Softwood*, rejected the taxpayer's deductions for expenditure incurred up to November 1982. His Honour stated that critical to the resolution of the case was the characterisation of the business activity that was said to have commenced. The taxpayer claimed that the business carried on by it was to be characterised as one of researching and developing monoclonal antibody products for manufacture and sale. However, the taxpayer conceded that if the business was characterised as one of manufacturing and selling monoclonal antibody products, then that business did not commence until around November 1982. Referring to *Softwood*, Hill J noted that critical to that decision was the finding that the taxpayer had not yet committed itself to the project or made a final definitive decision to do so. In relation to the case before him his Honour concluded that the element of commitment was absent; the taxpayer was engaging in activities of a provisional kind only. The activity was that of funding a research project and could not be characterised as a business or even as an activity of gaining or producing assessable income.

74. With regard to the expenditure incurred after November 1982, the taxpayer claimed that its business included not only the manufacture and marketing of its heart worm product, but also research into, and the development of, other products. The Commissioner claimed that the expenditure was of a capital nature. This aspect of the decision is discussed in paragraphs 141–143.

75. *FCT v Brand* 95 ATC 4,633 concerned whether the voluntary prepayment of seven years' licence fees for a prawn farming project was an allowable deduction. The case turned on whether the prepayment was incurred in gaining or producing assessable income, or whether it was incurred "too soon". The Court concluded that the prepayment was an allowable deduction. Tamberlin J made several relevant comments in relation to the element of commitment to the income-producing or business activity.

76. His Honour referred to several decisions which placed an emphasis on the element of commitment, including *Goodman Fielder Wattie*. His Honour then stated (at page 4,649):

> The purpose of research expenditure or payment for a feasibility study is firstly to investigate whether a proposed or possible line of business activity is viable and secondly to decide whether to make a commitment to the activity. The third stage is the entry into such a commitment. It does not follow from a favourable research or feasibility study, for example, that any commitment or outgoing *will* be made with a view to producing assessable income. In that sense such studies may be discrete from the relevant business activity and may be "too soon" before the business activity commences to justify classification as an activity expected to produce assessable income. This stands in marked contrast to the present case.

77. The full Federal Court also considered these issues in *Esso*. The taxpayer in that case carried on the business of exploring for, producing, and selling oil and gas. Since the 1960s, the taxpayer had explored for oil and gas offshore. From the early 1970s, the taxpayer, under the direction of its ultimate parent company, also explored for coal, synfuels (primarily oil shale) and certain other minerals. On occasion the taxpayer undertook exploration and production activities as a joint venturer.

78. From 1979 to 1984, the taxpayer claimed a deduction under section 51(1) of the Income Tax Assessment Act 1936 (Cth) for expenditure in investigating the acquisition of interests in potential joint ventures for exploration. The costs incurred were general costs that were preliminary to any decision to acquire a particular tenement, or interest therein, from which mining production could take place. The Commissioner denied the deductions and the taxpayer appealed to the Federal Court. Sundberg J held that the expenditure was not deductible. His Honour decided that the taxpayer, although it carried on exploration activities in the relevant years, was not in the business of exploring for coal and oil shale because it had not engaged in exploration for reward (not having conducted the exploration for the purpose of selling or earning fees from its exploration information) nor was it committed to commercial production.

79. It was central to the taxpayer's contentions, before the trial judge and on appeal, that its business included exploration for coal, synfuels and minerals. The

taxpayer claimed that the nature, extent and scope of its activities and the quantum and recurrence of expenditure involved in them, including the acquisition of interests in potential mining prospects and ventures, were such that the taxpayer clearly satisfied the test of "carrying on a business". The taxpayer contended that the fact it had not at the relevant time earned assessable income from its new mining activities, commenced mining production in respect of any particular project, or committed itself to commence mining production in respect of any particular location did not mean it was not carrying on a mining business.

80. The Commissioner submitted that the evidence showed that the taxpayer had committed itself to no more than a strategy of assessing the feasibility of potential mining ventures as a possible source of income from mining or production of those mineral resources. The taxpayer had not made the transition from merely considering whether to conduct a mining business to actually conducting such a business.

81. The full Federal Court stated that the primary question was whether the expenditure was necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. Only if this question were answered in the affirmative was it necessary to consider whether the expenditure was of a capital nature.

82. When considering whether expenditure was preparatory to an activity that might at some time in the future constitute the carrying on of a new or expanded business, the Court stated that "establishing the proper characterisation of the particular business said to have been carried on is critical to resolving whether there is a sufficient nexus between the expenditure and the taxpayer's business".

83. The court accepted that it was open to the trial judge to conclude that the taxpayer was not in the business of exploration, as it "did not engage in exploration for reward". Having accepted this, the court stated that the critical issue was then whether Sundberg J erred in his approach to the requirement of the element of commitment as a criterion for deductibility under the second limb of section 51(1) of the Income Tax Assessment Act 1936 (Cth). It was on the basis of that approach that Sundberg J concluded that the appellant had not made the transition from assessing and seeking opportunities to actually carrying on a mining business.

84. The court approved Sundberg J's approach and stated that the element of commitment was an important criterion for determining deductibility as it established the requisite nexus between expenditure claimed to be deductible and the business said to be carried on. In the court's opinion, the criterion affords a practical and principled basis for ascertaining whether the nexus between the expenditure and the derivation of assessable income is too remote or too tenuous.

85. The full Federal Court accepted that the trial judge had not erred in concluding that the taxpayer had not committed itself to commercial production, with the consequence that the element of commitment to the relevant income-producing

activity in respect of which the expenditure was claimed to have been incurred was missing.

86. The taxpayer had relied on the decision in *Ampol* to support its claim for exploration expenditure. The court in *Esso* stated (at page 4,783):

> In our view the reliance placed on *Ampol* by the appellant is misconceived. It was critical to the majority's findings in favour of the taxpayer in *Ampol* that the taxpayer was engaged for reward in the exploration business. In other words, it was an exploration company which incurred the relevant expenditure with a view to turning to account for profit or reward the benefits it obtained from its exploration activities. That may be contrasted with the position in the present case. His Honour found that the appellant was not an exploration company and that it did not incur the relevant expenditure with a view to turning to account for profit or reward the benefits it obtained from its exploration activities. Rather, his Honour found … that the activities were:
>
> "... of a preliminary nature, aimed at ascertaining whether it was commercially worthwhile to enter into mining joint ventures."

Summary – Australian cases

87. The Australian cases in this area are consistent with the limited New Zealand cases discussed above. In this regard the Australian decisions deal with a wider range of factual situations and provide a more detailed analysis. The usefulness of examining Australian cases in relation to a claim for a deduction under section DA 1(1) has been established in this country for many years. See, for example, *Banks* and *Buckley & Young*. The Australian decisions are concerned with the interpretation of similar wording, and there is nothing in the New Zealand or Australian decisions to indicate that a different approach should be adopted in New Zealand.

88. In the area of feasibility expenditure, the Australian cases also indicate that the question of deductibility under the equivalent of section DA 1(1) depends on the facts of any particular case. There are no special rules in relation to feasibility expenditure and the principles applicable in relation to the general deductibility provision must be applied.

89. There must be a sufficient nexus between the expenditure and the business or income-earning activity for the expenditure to be deductible. Therefore, the business or income-earning activity must have commenced. When the expenditure relates to a new activity for an existing business, business operations must be found to have commenced in relation to that new activity (*Griffin*). The cases emphasise that there must have been a commitment made to proceed with a particular activity in order for it to be said that the income-earning activity or business has commenced (*Softwood* and *Goodman Fielder Wattie*). It is critical to establish the true character of the business or income-earning activity in order to determine whether that business or income-earning activity has commenced (*Ampol*, *Goodman Fielder Wattie*, and *Esso*).

90. When no commitment has been made to any business or income-earning activity, feasibility expenditure will not be deductible, because the business has not commenced, so there is an insufficient nexus between the expenditure and any relevant business or income-earning activity.

91. When the business or income-earning activity has commenced, there must still be *a sufficient nexus* between the expenditure and that business or income-earning activity in order for the expenditure to be deductible. Therefore, any feasibility expenditure must arise as an ordinary incident of the business or income-earning activity. In other words, the feasibility activities must be carried out as part of the ordinary current operations of the particular business or income-earning activity.

Cases: Canada

92. The Canadian case *Minister of National Revenue v MP Drilling Ltd*, referred to in *Stevens & Stevens* and *Case M68*, concerned a taxpayer company incorporated in September 1963 to carry on the business of marketing liquefied petroleum gases in the Pacific Rim. The facts showed that the successful marketing of these products involved arranging the supply with the producing oil companies, creating extraction plants, gathering gas and transporting it to seaboard by pipeline, obtaining permits for export, constructing storage facilities, and negotiating firm contracts with overseas buyers. In 1966 it was decided that the plan to market gas was not feasible and the taxpayer company moved into operational drilling. The expenses incurred from 1963 to 1966 were largely for expert analysis and feasibility studies, plus travel costs in visiting potential overseas buyers. The Minister of National Revenue argued that these expenses were not deductible because they were payments on capital account, for the purpose of creating or acquiring a business structure and preparatory to a business.

93. The Federal Court of Appeal rejected the Minister of National Revenue's arguments. It considered that the business structure per se came into existence in late September 1963, when the company commenced its business operations by continuing the marketing negotiations, supply negotiations and technical studies through its consultants, until June 1964, when it opened its own office and employed its own staff, including a full-time general manager. The permanent structure, the market, and the products all existed, and the efforts of the company were directed to bringing them together with a resultant profit to it.

94. However, it is important to note that in reaching this conclusion the court considered it "not without significance" that the Minister of National Revenue had not attempted to distinguish different types of expense. Although some of the expenditure was clearly incurred in the course of the income-earning process (eg, expenses incurred during the supply and sale contract negotiations), other expenses would not so readily fit within that category. As no particular expenses were drawn to the court's attention, however, the court concluded that all the expenditure was revenue in nature.

95. The Canadian approach to the question of when a business or an income-earning activity has commenced is similar to that taken in New Zealand and Australia. Indeed, *MP Drilling* has been cited in several New Zealand decisions.

Summary

96. For feasibility expenditure to be deductible under either paragraph of section DA 1(1) a sufficient relationship or nexus must exist between the expenditure and the taxpayer's business or income-earning activity. In relation to paragraph (a) this requires that the expenditure be incurred in deriving assessable income. In relation to paragraph (b), the expenditure must be incurred in the course of carrying on the particular business. The expenditure must be incurred as part of the ordinary business operations (*Banks* and *Buckley & Young*). Any expenditure incurred before the establishment of a business or an income-earning activity will not fulfil this statutory nexus, because the expenditure will have been incurred too soon (*Birmingham* and *Calkin*). Therefore, feasibility expenditure incurred preliminary to or preparatory to the establishment of a business or an income-earning activity will not be deductible.

97. The decision as to whether a business or an income-earning activity is being carried on is always one of fact and degree. Its resolution depends on a consideration of the nature of the activities carried on, and the intention of the taxpayer in engaging in those activities. A determination of the point at which a taxpayer makes a firm commitment to go into a business or an income-earning activity is critical for establishing the earliest time at which a business may have commenced. Commitment alone, however, is not sufficient. Therefore, there are three elements to the determination that a business has commenced.

- A taxpayer's activities must be sufficiently intense to have the characteristics of the activities of that kind of business.

- The necessary profit-making structure must have been established.

- The taxpayer must have passed the stage of merely "sounding out" whether to go into the business and have made a definite decision to do so.

98. The correct characterisation of the nature of the relevant business is, therefore, vital to resolving whether a sufficient nexus exists between the expenditure and a taxpayer's business. Without a determination of the true nature of a business, it is impossible to determine whether the activities are characteristic of that kind of business, and that, therefore, the expenditure was incurred as part of the ordinary business operations (*Goodman Fielder Wattie*, *Ampol*, *Esso*, and *Case M68*).

99. The profit-making structure must also be in place for a business to have commenced. However, the extent of the profit-making structure required depends on the nature of the particular business. On the one hand, cases such as *Birmingham* and *Softwood* indicate that when the business involves manufacturing or production from a particular site, everything done before the establishment of the necessary plant is preparatory to business. On the other hand, cases such as *MP Drilling* and *Stevens & Stevens*, which dealt with the marketing of a product, indicate that when the business structure and the product exist it is enough to be negotiating supply contracts, arranging orders, and so on.

Dixon J in *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 comments on this distinction (at page 359):

> The business structure or entity or organisation may assume any of an almost infinite variety of shapes and it may be difficult to comprehend under one description all the forms in which it may be manifested. In a trade or pursuit where little or no plant is required, it may be represented by no more than the intangible elements constituting what is commonly called goodwill, that is, widespread or general reputation, habitual patronage by clients or customers and an organised method of serving their needs. At the other extreme it may consist of a great aggregate of buildings, machinery and plant all assembled and systematised as the material means by which an organised body of men produce and distribute commodities or perform services.

100. Also critical is the element of commitment. The cases indicate that in determining whether an activity constitutes the carrying on of a business or an income-earning activity or whether it is preliminary to the carrying on or recommencement of a business or an income-earning activity, it is the element of commitment that establishes the requisite nexus between the expenditure claimed to be deductible and the business or income-earning activity said to be carried on for the purpose of gaining or producing income. If expenditure relates to activities undertaken to decide whether to enter into a particular business or income-earning activity, that expenditure will lack the required nexus, so will be non-deductible (*Softwood*, *Goodman Fielder Wattie*, *Brand*, and *Esso*).

101. When feasibility expenditure is incurred after a business or an income-earning activity has commenced, for that expenditure to be deductible it must have the requisite nexus with the business or income-earning activity, that is, be incurred as an ordinary incident of the business or income-earning activity. This requires, therefore, that the particular activities must be undertaken as part of the income-earning process, that is, be carried out with the intention of obtaining some reward from sale or exploitation (*Ampol*, *Esso*, and *Case S39*).

102. In summary, therefore, the following matters are relevant when determining whether feasibility expenditure is deductible under section DA 1(1).

- There must be a sufficient nexus between the feasibility expenditure and the business or income-earning activity.

- If the feasibility expenditure is incurred as preliminary or preparatory expenditure before the commencement of a business or an income-earning activity, there will not be a sufficient nexus and that expenditure will not be deductible.

- The decision as to whether a business or an income-earning activity has commenced is one of fact and degree. Four factors are relevant.

  – It is critical to determine the true nature of the business.

  – A commitment must have been made to enter into that business.

- The required profit-making structure for the particular business must be in place.

- The ordinary current operations of the business must have begun.

- If the business or income-earning activity has commenced then, in order to be deductible, the feasibility expenditure must have the requisite nexus with the business or income-earning activity. This means the feasibility expenditure must be incurred as part of the ordinary current operations of that business or income-earning activity (ie, the feasibility-related activities must be carried out with the intention of obtaining income from those activities).

Example 1

103. Several individuals, who are employed by the marketing division of a nation-wide retail company, are considering establishing their own retail marketing consultancy business. To determine the feasibility of the business, they have purchased market industry information. They have also incurred travel and entertainment costs through travelling around the country and meeting with potential clients to ascertain the level of interest in the provision of consultancy advice. The individuals have also investigated the possibility of leasing office space and have incurred legal fees in that regard. Legal fees have also been incurred in seeking advice on the implications of the employees leaving their present employer.

104. The costs incurred to date are not deductible. The individuals have committed themselves to no more than a strategy of assessing the feasibility of a potential marketing consultancy business as a possible source of income. The individuals have not proceeded to commit themselves to any particular venture. The costs are preliminary and preparatory to the establishment of an income-producing structure. A decision to proceed with the business has not been made, the profit-making structure is not in place, and normal business operations have not commenced.

Example 2

105. The directors of an established logging and saw-milling company are considering whether the company should start the production of gardening tools, which it could supply, initially to its existing clients, but in time to a wider group. The board is unsure about the financial viability of such a course, so engages consultants to provide financial projections and information about the likely demand for such products. Several of the directors also travel around the country meeting with clients to discuss the proposed venture.

106. The consultants' report indicates insufficient regular demand for the gardening tools to warrant the company providing such products in the short term. Given this, the board abandons the idea.

107. The consultants' fees and the directors' travel costs are not deductible. These costs are preliminary and preparatory to the establishment of a new income-earning activity. They do not relate to the existing logging and saw-milling business and are not part of the current operations of that business. The fact that the company resolved not to proceed with the production of the gardening tools does not affect the character of the expenditure.

Example 3

108. Two friends who are working for a large engineering company are considering setting up an engineering business of their own. They incur expenditure in the first six months of 2007 investigating possible ways to operate a business, including obtaining advice from an accountant and a solicitor and sounding out potential clients. In July 2007, they agree they will establish the business and, having secured several clients and set up an office, they resign from their current positions. They begin to actively work on establishing their processes and databases and in September 2007 they commence work for their first clients.

109. The expenditure incurred before July 2007 is not deductible. It was preliminary and preparatory to the establishment of an income-producing activity. A firm decision to proceed with the business had not been made, the profit-making structure was not in place and normal business operations had not commenced.

110. The expenditure incurred from July 2007 is deductible, subject to the capital limitation (which is discussed next). The decision to commit to the business has been made, the profit-making structure is in place, and current operations have begun. Therefore, the business has commenced. This is the case regardless of the fact that work for a particular client does not commence until September 2007.

PROHIBITION OF DEDUCTION UNDER SECTION DA 2(1)

111. If, on the facts and circumstances of any particular case, it is determined that feasibility expenditure is deductible under either section DA 1(1)(a) or section DA 1(1)(b), it is then necessary to determine whether the deduction is prohibited by section DA 2(1) as being expenditure of a capital nature.

General principles

112. The courts have formulated principles or "tests" for determining whether an expenditure or loss is of a capital nature. The leading statement of these tests is the case of *BP Australia Ltd v FCT* [1965] 3 All ER 209, which followed the earlier judgments of Dixon J in two Australian decisions: *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337 and *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634.

113. In *Sun Newspapers Ltd v FCT*, Dixon J described the distinction between expenditure on capital account and expenditure on revenue account as corresponding (at page 359):

> with the distinction between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.

114. Dixon J identified three matters to be considered (at page 363):

> (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which the advantage 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 further use or enjoyment.

115. In *Hallstroms Pty Ltd v FCT*, Dixon J again summarised the distinction between expenditure on capital account and expenditure on revenue account (at page 647):

> 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 organisation 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.

116. His Honour indicated that determining whether expenditure was capital or revenue (at page 648):

> 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.

117. The *BP Australia* formulation was adopted in New Zealand in cases such as *CIR v LD Nathan & Co Ltd* [1972] NZLR 209, *Buckley & Young*, *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233, *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206, *CIR v Wattie* (1998) 18 NZTC 13,991, *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001, and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981. In *Wattie*, the Privy Council noted that the approach adopted in *Hallstroms* has been recognised as exemplifying the "governing approach" in New Zealand.

118. The courts have formulated various indicia for determining whether expenditure is capital or revenue. The following factors are relevant in this regard.

- The need or occasion which calls for the expenditure.
- Whether the expenditure is recurrent in nature.
- Whether the expenditure creates an identifiable asset.
- Whether the expenditure creates an advantage which is of enduring benefit to the business.

- Whether the expenditure is on the profit-making structure or on the profit-making process.

- Whether the source of the payment is from fixed or circulating capital.

- The treatment of the expenditure according to the ordinary principles of commercial accounting.

119. Many of these factors overlap and some will carry more weight in given circumstances. Therefore, while they are helpful as a starting point, it is necessary to make a final judgement of whether the expenditure is of a capital or revenue nature by analysing the facts as a whole, weighing which factors carry the most weight in light of those facts.

120. It is also important to note that while the courts have formulated these factors to help in determining the capital versus revenue question, all the cases referred to above have recognised that, although past cases can be useful in assisting with the resolution of a new case, there are dangers involved in this approach. When the distinction between capital and revenue expenditure is not clear-cut, the factors should be weighed in the context of the whole set of circumstances in that particular case.

Application to feasibility expenditure

121. As noted previously, little New Zealand case law deals expressly with feasibility expenditure. However, a few decisions have touched on the issue.

Cases: New Zealand

122. The High Court decision in *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 is the most relevant in this context. The taxpayer company, Milburn NZ Ltd ("Milburn") made and sold cement, concrete, and lime, and quarried aggregates for its concrete business. Fraser Shingle Ltd ("Fraser") was a wholly owned subsidiary of Milburn. Milburn implemented its business plan by investigating, acquiring and developing concrete businesses. Securing supplies of aggregate for its concrete plants was recognised as being important. During an expansion period, Milburn investigated 48 different sites for aggregate. The sites were generally existing quarries. At issue was Milburn's expenditure on sites in Bombay Hills and Alpha Creek near Westport, and Fraser's expenditure on an aggregate prospect on the Ngaruroro River in Hawke's Bay. All the expenditure on the three sites was for obtaining the consents or licences necessary to develop the three sites into quarries for aggregate and lime for the taxpayers' cement and concrete businesses. Milburn capitalised all expenses once the necessary consents were obtained.

123. The taxpayer companies claimed the expenditure was of a revenue nature or, alternatively, if it was capital it was part of the "cost of minerals" and deductible under section 74(2)(b) of the Income Tax Act 1976. The Commissioner considered that the expenditure by Milburn at Bombay Hills was capital in nature because it was substantial and was expenditure on establishing an asset

that was a significant and important addition to Milburn's operating structure. Alpha Creek involved the direct replacement of an existing strategic asset. Fraser's expenditure was similar in that it was incurred in investigating a resource alternative to an important existing one that was likely to be circumscribed in the future.

124. Wild J held that the expenditure was of a capital nature, regarding it as part of the cost of creating the permanent structure that produced the taxpayers' taxable income, rather than as part of the cost of earning that income. The expenditure to obtain the consents and licences was a necessary part of developing the three sites into quarries for the production of aggregate and lime for use in the taxpayers' cement and concrete businesses. His Honour concluded that the consents and licences were enduring rather than transient in nature, and were not recurrent in nature.

125. Wild J based his view on the following factors (at page 17,023):

> [a] The nature of the business of Milburn and Fraser.
> [b] The importance of Bombay and Alpha Creek to Milburn's business, and the Ngaruroro gravels to Fraser's business.
> [c] The amount of the expenditure.
> [d] Its sustained nature i.e. the length of time over which the expenditure was incurred.
> [e] The nature of the expenditure: all on obtaining of consent necessary before production could begin.
> [f] [c]-[e] when contrasted with the amount, duration and nature of expenditure on Milburn's 48 other prospects.

126. He then reached the following conclusion:

> 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. [Emphasis added]

127. The comparison drawn by the High Court provides support for the argument that 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 or development of a capital asset, it seems that expenditure is considered to be incurred on the business structure rather than the income-earning process. It is also noteworthy that Wild J compared the three sites in question with the other 48 prospects that were investigated. This suggests it is relevant to consider the frequency with which expenditure of the type under consideration is incurred in the ordinary course of the taxpayer's business. In *Milburn* it appears it was common to undertake investigatory work and to engage external consultants. However, town-planning work was carried out relatively infrequently (suggesting that recurrence of the specific type of expenditure is a factor to be considered in determining whether the expenditure is capital or revenue).

128. Wild J firmly rejected the taxpayers' argument that the classification of the expenditure depended on whether the various consents applied for were obtained or refused. Milburn's chief executive officer had earlier given evidence for the taxpayers detailing the need for an acceptable resource consent before the taxpayers would be confident of recovering an economic resource.

129. Wild J rejected the taxpayers' argument (at page 17,023):

> I am unable to accept the taxpayers' viewpoint, as advanced in evidence by Mr Williams, because it rather seeks to classify the expenditure dependant on the outcome of the various applications for consent. There is no logical nexus, and categorisation dependant upon outcome has been firmly rejected in New Zealand, Australia and England.

130. Since the outcome of the consent applications did not affect the categorisation of the expenditure, the obtaining of resource consents for only two of the three sites was not relevant. Wild J held that the expenditure on all three sites was capital in nature. The resource consent refusal for one site meant Fraser's project in that area did not continue. However, the abandonment of the project did not affect the capital nature of the expenditure incurred from the time the earlier business decision was made to proceed with the project.

131. Wild J also discussed the character of the advantage sought, in which lasting qualities, recurrence, and the need or occasion that calls for the expenditure were also considered. His Honour held (at page 17,025) that "the expenditure was substantially to obtain the consents and licences necessary to develop the three sites into quarries for aggregate and lime for the taxpayers' cement and concrete businesses". Wild J rejected the taxpayers' argument (at page 17,025):

> The other perspective, which I do not think is the correct one, is that the expenditure was nevertheless of a revenue nature, in an effort to find out whether an economic resource existed.

132. In relation to whether the payments were once and for all and intended to create an enduring asset, Wild J again rejected the taxpayers' argument that expenditure on seeking consents and licences was incurred in an effort to find out whether an economic resource existed. Wild J stated (at page 17,026):

> The third test is whether the payments were once and for all and intended to create an enduring asset. From their perspective, the taxpayers argued that expenditure on seeking consents and licences needed to be incurred from time to time, and possibly more than once in relation to a particular site. For example, Alpha Creek was an instance where successive mining licence applications had been made. **They argued that the expenditure was all part of their trying to ascertain whether there was an economic resource capable of development. I hold firmly against that argument.** I consider the correct view is that the resource consent obtained for Bombay did not need to be reapplied for, the water rights obtained did not need to be reapplied for in the short to medium term, and nor did the mining licence for Alpha Creek. Whether viewed as an integral part of the quarries to which they related (the view I prefer), or as assets in their own right, the consents and licences were enduring rather than transient in nature. [Emphasis added]

133. In rejecting the taxpayers' argument, Wild J focused on the enduring nature of the consents and licences for which the taxpayers incurred expenditure. In contrast, the taxpayers' contention was more broadly focused on the expenditure enabling them to determine, through the granting of an appropriate or an

inappropriate resource consent, whether an economic resource capable of development existed.

134. It would seem that Wild J's rejection of the taxpayers' argument, that the expenditure was incurred in order to ascertain the existence of an economic resource, was also based on his earlier findings. Wild J listed six factors (set out at paragraph 123) that indicated to him that the taxpayers "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". Since the decision to proceed had been made before applying for the consents, expenditure incurred from that point was capital in nature, and it was irrelevant to that characterisation whether the consents were ultimately granted in a manner that enabled the resources to be developed economically.

135. In *Case N55* (1991) 13 NZTC 3,434 the taxpayer was the holding company of a group of manufacturing companies. The manufacturing activities were handled by the subsidiaries. The taxpayer supplied the subsidiaries with accounting, management, and clerical services for which it charged management fees. During the relevant income years, the taxpayer undertook the development of a four-wheel drive vehicle on the basis that had the venture proceeded a subsidiary would manufacture the vehicle. The project was eventually abandoned. The taxpayer sought to deduct the development expenditure. It argued that the expenses were recurrent in nature and not once and for all and were part of its ongoing product development activities. No enduring benefit was brought into existence. The expenditure was not preliminary before commencement of a business because only product diversification was being sought, not a new business.

136. The Commissioner submitted that the expenditure was not consistent with the taxpayer's business, so was non-deductible under a previous equivalent of section DA 1(1). Barber DJ rejected the Commissioner's submission, finding that the expenditure was consistent and must be regarded as necessarily incurred in carrying on the taxpayer's business.

137. Barber DJ then went on to consider the capital–revenue distinction and concluded that the expenditure was capital. The TRA found that the expenditure was of a once and for all nature, incurred with a view to bringing into existence an asset or advantage for the enduring benefit of the business. The expenditure was not an ordinary expenditure in the regular conduct of the business and was related to the business structure, rather than the business process. Acknowledging that product development–type expenditure may be ongoing in some businesses, the TRA found that in this case it was related to the capital base for a new manufacturing process. In addition, Barber DJ stated that the expenditure could also be regarded as preparatory to the commencement of ordinary business operations in relation to a separate production line and system, so was capital on that basis.

138. Of note are Barber DJ's obiter comments in relation to product development expenditure (at page 3,440):

> In some situations there must be a fine line between deductible production or marketing expenditure and non-deductible capital product development expenditure. For instance, expenditure on altering or upgrading the packaging of an existing product would seem to be a fairly normal expense of manufacturing, distributing, and marketing the product rather than an outlay towards the capital structure for manufacturing, distributing, and marketing the product. I observe that labels such as "product development expenditure" may be misleading and the test is always the character of the particular expenditure.

139. The issue in *Case P3* (1992) 14 NZTC 4,017 was whether certain expenditure by a manufacturer of safety helmets qualified for an export market development expenditure tax credit. This came down to whether the expenditure was capital or revenue in nature. The expenditure essentially comprised the salary cost of the taxpayer's design engineer who modified existing helmet designs and built samples in order to secure overseas orders. The Commissioner argued that the deduction available for export development expenditure did not extend to include research and sample raw material costs. In his view, the deduction did not extend to the cost of developing a product that may be of enduring benefit to the taxpayer.

140. Barber DJ referred to his earlier decision in *Case N55* and the passages from that decision indicating that in some situations product development expenditure could be revenue in nature. In *Case P3* Barber DJ concluded that the expenditure was a reasonable and normal trading or revenue expenditure. The TRA found that altering helmets was part of the ordinary incidents of the business. It was an ongoing, recurrent business activity for the taxpayer. This situation could be contrasted with the development of a one-off prototype undertaken by the taxpayer in *Case N55*.

141. The New Zealand authorities in this area, although limited, do indicate that to be expenditure of a revenue nature, the feasibility expenditure must be incurred as part of the ordinary current operations of the business. In much the same way as the enquiry under section DA 1(1), the expenditure must be incurred as an ordinary incident of the income-earning process in order to avoid the capital prohibition in section DA 2(1).

Cases: Australia

142. Several of the Australian authorities discussed above in relation to section DA 1(1) also consider whether the expenditure was capital in nature.

143. In *Softwood Pulp and Paper Co Ltd v FCT*, (refer to paragraphs 52and 53) Menhennitt J, having reached the view that the expenditure under consideration was preliminary to the commencement of business and therefore non-deductible on that basis, went on to conclude that even if he was wrong in that regard, the expenditure was of a capital nature. His Honour cited with approval the comments of Dixon J in *Sun Newspapers* (set out in paragraphs 111–112).

144. Menhennitt J then posed the question whether if any of the amounts fell within either of the first two limbs of section 51, they were nevertheless of a capital nature. His Honour concluded that the expenditure went beyond simply investigating the possibility of undertaking a new business activity and extended

into the establishing of the profit-making structure, that is, options acquired over land, arrangements made for the supply of water, electricity, timber, etc. In these circumstances, even if the expenditure had satisfied either of the first two limbs of section 51, the expenditure would have been held to be capital.

145. The facts in *Softwood* can be contrasted with those in *FCT v Ampol Exploration Ltd* 86 ATC 4,859. In *Ampol*, the expenditure was held to relate to the company's ordinary business activities. The expenditure could not lead to the establishment of an asset and was not incurred for the purpose of creating or enlarging the business structure.

146. In *Ampol*, Lockhart J, in the majority, concluded that the expenditure was deductible under both limbs of the equivalent of section DA 1(1) (discussed in paragraphs 54–64). His Honour then went on to consider the "more difficult question" as to whether the expenditure was in fact of a capital nature. Lockhart J concluded that the payments in question were of a revenue nature, being part of the outgoings of the taxpayer in the course of carrying on its ordinary business activities. It was not expenditure incurred for the purpose of creating or enlarging a business structure or profit-yielding or income-producing asset.

147. In his Honour's opinion, an examination of the authorities established that there was no presumption that prospecting or exploration costs were prima facie of a capital nature. The authorities confirmed first, the danger of seeking to extract principles of general application in this branch of the law, and second, the correctness of the frequently repeated statement that whether expenditure is capital or not must be a question of fact in each case.

148. Burchett J agreed with Lockhart J that the expenditure was of a revenue nature. His Honour concluded that the relevant business of the taxpayer was the discovery and exploitation of oil, to which the seismic survey expenses were incidental. Their purpose was not to enlarge the framework within which that activity was carried on, rather they formed part of the activity.

149. The important factor in the majority's decision in *Ampol* is that the exploration activities, for which the expenditure was incurred, were part of the company's ordinary current operations. They were not adding to the business structure or undertaken with a view to obtaining an enduring asset. The activities were part of the company's income-earning process, that is, the process by which the company earned its rewards. On this basis, therefore, the expenditure was of a revenue nature.

150. The decision in *Goodman Fielder Wattie* highlights that determining the true nature of the relevant business, identified in the discussion on deductibility of expenditure under section DA 1(1), is also critical in the capital versus revenue context.

151. In *Goodman Fielder Wattie* Hill J had concluded that the expenditure incurred before November 1982 was incurred before the commencement of the business (discussed in paragraphs 72–74). With regard to the expenditure incurred after

November 1982, the taxpayer claimed that it was carrying on a business that included not only the manufacture and marketing of its heartworm product, but also research into and the development of other products. The Commissioner claimed that the expenditure was of a capital nature.

152. Hill J considered the decisions in *Sun Newspapers*, *Ampol*, and *Hallstroms*, and stated (at pages 4,449–4,450):

> The judgment in the *Sun Newspapers* case makes it clear that it is necessary to consider carefully the nature of the business which is carried on, so as to be able to distinguish between recurrent expenditure, that is to say "expenditure which is made to meet a continuous demand" (per Rowlatt J in *Ounsworth v Vickers Ltd* [1915] 3 KB 267 at 273) and that expenditure which is made once and for all. A pharmaceutical company, the business of which includes continuing research and development as part of the continuous or constant demand for expenditure in its business, does not each time that expenditure is incurred make an outlay of capital or of a capital nature. Its business, when properly analysed, includes its research and development, at least in the ordinary case. No doubt, there are matters of degree involved, and in a particular case the research and development may be concentrated on a product so far removed from the day to day products of the taxpayer, that the expenditure cannot be properly seen as part of its working expenditure.
>
> Counsel for the applicant relied heavily upon the decision of the Full Court of this court in *FC of T v Ampol Exploration Ltd* 86 ATC 4859; (1986) 13 FCR 545. In that case, it was held that the taxpayer, the exploration arm of the Ampol Group, was carrying on a business of exploring for petroleum and the expenditure it incurred in its China venture was held to have been necessarily incurred in the carrying on of that business and as not being of a capital nature. …
>
> By analogy it was said that where a company such as the applicant here is engaged in an activity where research and development forms part of its activity, part of the constant demand upon the enterprise, then expenditure on research and development is on revenue account.
>
> Research and development expenditure does differ somewhat from the exploration expenditure involved in the *Ampol* case. In general terms, one difference that is of significance is that the expenditure in *Ampol* was not expenditure directed towards the obtaining of rights of an enduring kind. On the peculiar facts of that case, the expenditure was directed merely at obtaining the right to negotiate, that not being a right of a proprietary kind. Research and development may, in a particular case, be directed towards obtaining patentable rights which can be seen as of an enduring kind and may, for that reason, be of a capital nature. It was not suggested here by counsel for the Commissioner that the applicant's expenditure was directed towards the obtaining of patent rights nor was this even put to any witness.

153. His Honour noted that the cases make it clear that whether property rights are ultimately obtained is not determinative. Acknowledging Dixon J's statements in *Hallstroms* as to what is required, his Honour concluded (at page 4,450):

> There is, in my opinion, much to be said for the view that the whole of the expenditure in issue in the present case, except perhaps so much of it as concerned the salary of Dr Watson, in the time he was involved in the patent dispute, was expenditure on revenue account rather than on capital account. A company engaged in an enterprise involving new technology such as the applicant, where the nature of its activity requires as part of its business ongoing research into product development incurs expenditure which is recurrent, expenditure which is part of the regular cost of its trading operations. That expenditure is, to adopt the words of Dixon J in *Sun Newspapers*, part of the process by which the organisation (being an organisation where research is part of its business activity) operates to obtain regular returns by means of regular outlays.

154. Thus, as in *Ampol*, in *Goodman Fielder Wattie* the expenditure was held to be recurrent expenditure that was incurred as part of the company's ordinary

business activities of the company. The expenditure was not directed towards obtaining any rights of an enduring kind.

155. Thus the decisions in Australia in relation to the application of the equivalent to section DA 2(1) again emphasise the need to identify the nature of the particular business or income-earning activity and to identify whether the expenditure is incurred as part of the income-earning process of that business or activity or to create or expand the business structure. Similar considerations to those discussed in relation to deductibility under section DA 1(1) above, also apply to any denial of a deduction under section DA 2(1). The decisions in *Ampol* and *Goodman Fielder Wattie* highlight that when the expenditure relates to the income-earning process, that is, it is incurred as an ordinary incident of the business, the expenditure is more likely to be of a revenue nature. However, when the expenditure relates to the obtaining of an advantage of an enduring benefit, for example, a capital asset or another accretion to the business or profit-making structure, the expenditure will generally be of a capital nature.

Cases: Canada

156. *Bowater Power Co Ltd v Minister of National Revenue* [1971] CTC 818, a decision of the Canadian Federal Court (Trial Division), is also often cited as one of the leading cases supporting the deductibility of feasibility expenditure.

157. In *Bowater* the taxpayer company carried on the business of generating and selling electrical power and energy. During its 1959 and 1960 taxation years, the taxpayer claimed a deduction for expenditure for survey costs and engineering studies relating to developing additional power and the location of physical plant for its power station. It claimed the deduction on the basis that such expenditure was an ordinary operating expense incurred for the purpose of gaining or producing income from its business. The manager of the taxpayer gave evidence that the company was continually looking into the feasibility of installing thermal power. It was also continually looking at its existing facilities to see how to increase capacity and considering new sources of generation to meet increasing customer demand.

158. The costs claimed related to two specific feasibility studies undertaken for the taxpayer. The first involved a report on the feasibility of building a new power station on a lake adjacent to the company’s existing supplies of water for its current hydro-power stations. The report covered the availability of construction materials at the site, the geography and geology of the area, the hydrology and water flows. The report concluded that it was not economically feasible to undertake the project because of the high cost per horsepower produced. The second report identified how the company could better utilise one of its existing watersheds, particularly as regards its hydro potential. The report concluded that it was economically feasible to proceed with the recommendations and the taxpayer went so far as to arrange finance. However, the project did not proceed. This was because a provincial government project to develop a hydro-powerstation in the area started and the government offered to sell power from that plant to the taxpayer at a cheaper rate than the rate at which the taxpayer could produce power if it improved its own site.

159. The Federal Court found for the taxpayer. Noel ACJ referred to *BP Australia* and *Hallstroms* and concluded that the matter must be viewed from a practical and business point of view. His Honour considered that having regard to the facts and the circumstances of the work conducted by the taxpayer the expenditures were part of the company's current operations. His Honour accepted evidence that the business of the taxpayer was developing and marketing electricity and that this required a continuous evaluation and appraisal of both its power resources and its method of operation. Noel ACJ concluded that the expenditures were made to effect an increase in the volume and efficiency of the taxpayer's business, so were for the purpose of gaining income.

160. Noel ACJ concluded that the costs of the feasibility studies were deductible as part of the current operations of the business. This finding is consistent with the New Zealand requirement of a nexus between the expenditure and the taxpayer's carrying on of a business. This finding is also consistent with the capital–revenue test from *BP Australia*, which considers whether payments are expended on a taxpayer's business structure or are part of the income-earning process.

161. Noel ACJ also recognised that a hydroelectric development is a capital asset once it becomes a business or commercial reality. If a taxpayer is merely considering whether or not to create a capital asset, the expenditure may be revenue in nature. However, once the development of the asset becomes a reality, the expenditure incurred is capital in nature. The stage at which a development becomes a business or commercial reality may be seen as equating to the stage at which a decision or commitment is made to create an asset. Noel ACJ stated (at paragraph 73):

> While the hydroelectric development, once it becomes a business or commercial realty [sic] is a capital asset of the business giving rise to it, whatever reasonable means were taken to find out whether it should be created or not may still result from the current operations of the business as part of the every day concern of its officers in conducting the operations of the company in a business-like way.

162. Although Noel ACJ acknowledged the capital nature of hydroelectric developments that have become a business or commercial reality, he concluded that the expenditure Bowater incurred on the two feasibility studies was deductible. This was based on a judgement as to whether the development had become a business or commercial reality. Consideration of this factor is consistent with the approach taken in New Zealand and Australia of determining whether a decision or commitment has been made to create an asset, and how far along a taxpayer is in the process of developing a capital asset.

163. However, the fact that ultimately the project did not go ahead also appears to have influenced Noel ACJ in his finding that the expenditure was deductible. The success or failure of a project is not a factor that is present in New Zealand or Australian law. Noel ACJ recognised that a capital cost allowance (equivalent to New Zealand depreciation) is not permitted if the project fails or is aborted, and the expenditure is not deductible if it is not incurred in the ordinary course of a taxpayer's business. He referred to such expenditure as

"nothings" (at paragraph 14), but considered that the expenditure incurred by *Bowater* was revenue in nature (at paragraph 71):

> The costs here of the engineering studies conducted to examine the potential of appellant's drainage area or to determine the feasibility of constructing power developments at certain sites in Newfoundland were also incurred in my view or laid out while the business of the appellant was operating and was part of the cost of this business. Had it lead to the building of plants, business profits would have resulted. Should these expenses be less current expenses because instead of being laid out in the process of inducing the buying public to buy the goods or with a view to introducing particular products to the market, they were laid out for the purpose of determining whether a depreciable asset should be constructed from which business gains could be collected and would then have been added to the value of this capital asset which would have been subject to capital cost allowances? I do not think so. The law with regard to the deduction of what might be called border-line expenses or "nothings" has moved considerably ahead in the last few years, as can be seen from the above decisions [see *Algoma Central Railway v MNR* [1967] CTC 130 , upheld on appeal [1968] CTC 161; and *Canada Starch Co Ltd v MNR* [1968] CTC 466].

164. Noel ACJ also noted that if the expenditure had led to the building of plants, business profits would have resulted, and it is considered that a capital cost allowance would have been permitted. By considering the effect of categorising the expenditure as capital in nature (for which no allowance would be permitted because the project failed) as well as the effect of *not* categorising the expenditure as revenue in nature, Noel ACJ appears to be considering the effect of "nothings" or "black hole" expenditure. He subsequently notes the law's progression with regard to the deduction of expenses that are ordinarily neither depreciable nor deductible.

165. A similar approach was taken in *Kruger Pulp & Paper Ltd v Minister of National Revenue* [1975] CTC 2,323.

166. A desire to prevent "black hole" non-deductible expenditure was more marked in the Canadian case *Gartry v R* 94 DTC 1947. In that case the taxpayer agreed to purchase a retired navy boat for use in his proposed fishing business. However, the boat sank before title formally passed to him. In determining whether the expenses were on revenue or capital account (and if they were on capital account, whether a deduction for a terminal loss was permitted), Bowman TCCJ stated:

> In analyzing this question one cannot ignore the anomalous result that a denial of deductibility on any basis would entail. Either the expenditures resulted in the appellant's obtaining an asset or they did not. If they did, and if the asset so acquired was depreciable property, it must follow that the provisions of subsection 20(16) were available to the appellant to permit the deduction of a terminal loss when the boat sank. If they did not result in the acquisition of an asset for the enduring benefit of the business they cannot, in light of the decisions in *Algoma Central Railway (supra)*, and in *Bowater Power Co. Ltd. v. M.N.R.*, 71 DTC 5469, be regarded as capital in nature. The Crown's position would relegate the appellant to the worst of both possible worlds. It says, in effect, to Mr. Gartry "You were spending money on a capital asset, a boat, and if those expenses had matured into full ownership before the boat sank you would have been able to claim a terminal loss. As it happens, the boat sank before title was transferred to you and you obtained nothing. **But they are still capital expenditures and so you can deduct nothing."**
>
> This position is inconsistent with ordinary fairness, common sense and commercial reality. The disposition which in my view accords most closely to the facts and the authorities as I understand them is that the expenses should be treated as on revenue account or, to the extent

> that any are on capital account, as the cost of acquiring depreciable property which, when disposed of, are the subject of a claim for a terminal loss under subsection 20(16). Since either conclusion leads to deductibility it is not necessary that I determine specifically into which category they fall. [Emphasis added]

167. Therefore, *Gartry*'s application of the principle that expenditure is revenue in nature if an asset is not obtained is consistent with *Bowater*.

168. *Wacky Wheatley's TV & Stereo Ltd v Minister of National Revenue* [1987] 2 CTC 2,311 involved three corporations in the business of retail marketing electronic equipment. They contemplated expansion into Australia, so several corporate representatives travelled to Australia to assess the market potential. They determined that expansion would not be profitable, but sought to claim the travel costs as deductible expenditure.

169. The Tax Court of Canada agreed with the taxpayer, concluding that the expenses were incurred for the purpose of producing income and they were not on account of capital. The court found that the business structure already existed and the costs were expended to ascertain the feasibility of extending those existing operations. The court stated (at page 2,315):

> If the Australian opportunity had proved viable and actual plans for entry into the Australian market had been made by the appellants, any expenditures incurred to facilitate the actual expansion would arguably be on capital account. The expenditures in question were not, however, of such a nature. These expenses were anterior to any business decision to enter the Australian market and it is my opinion that they were clearly incurred as part of the current expenses of the appellants' operations.
>
> Clear support for this conclusion is found in the case of *Bowater Power Co Ltd v* MNR …
>
> In the present case, the evidence shows that expansion into new markets was an on-going concern of the appellants. It is my opinion that the expenditures in question resulted from the current operations of each of the appellants "as part of the every day concern of its officers in conducting the operations of the company in a business-like way".

170. The principles applied in these cases are consistent with the New Zealand and Australian authorities discussed above. The courts considered whether the expenditure was incurred as part of the profit-making process or on the profit-making structure. It was also acknowledged that the evaluation by a business of a proposed course of action can be done as part of the income-earning process of that business, so expenditure incurred at the evaluation stage may be on revenue account notwithstanding that the proposal being evaluated, if implemented, would give rise to capital expenditure. On the particular facts of *Bowater* Noel ACJ was satisfied that the business of developing and marketing electricity required continuous evaluation and appraisal, so concluded that the expenditure was part of the current operation and deductible. A similar conclusion was reached in relation to the particular facts of *Wacky Wheatley's*. This is consistent with the decisions reached on the facts in *Ampol* and *Goodman Fielder Wattie*.

171. However, it is considered that a divergence in approach may be seen in the application of the principles to particular facts in the Canadian decisions. The Canadian courts appear more willing to conclude that if expenditure is *not* of a

capital nature, for example if a commitment to any particular proposed course of action has not been made, then that expenditure *will be* part of the current operations of the business and thus satisfy the equivalent of the nexus test under the equivalent of section DA 1(1).

172. It is arguable that the approach of the Canadian courts in this regard is more liberal than that taken by the Australian and New Zealand courts. An approach that considers the success or failure of expenditure as relevant in determining the deductibility of the expenditure has consistently been rejected in New Zealand and Australia. A line of authority maintains that when determining whether expenditure is deductible it is irrelevant whether an outlay is successful (eg, *Lothian Chemical Co Ltd v Rogers* (1926) 11 TC 508 and *John Fairfax & Sons Ltd v FCT* (1959) 101 CLR 30). These cases establish that once a commitment has been made to purchase or develop a capital asset, subsequent expenditure incurred will be capital in nature irrespective of whether the asset is in fact acquired or developed. This follows from the deductibility or otherwise of a particular item of expenditure being determined when the expense is incurred (*Banks* at page 61,241), as opposed to at some other time (eg, the end of the income year in which it was incurred). In addition the enduring benefit test focuses on whether the expense was incurred *with a view to* (as opposed to definitively) bringing into existence an asset or advantage of enduring benefit. This line of authority has been approved and applied in New Zealand.

173. Thus, while the Canadian courts apply the same principles to the determination of the nature of particular expenditure, the fact the Canadian courts consider the success or failure of the expenditure as relevant means the conclusions reached by those courts on particular fact situations may differ from those that would be reached by a New Zealand court.

Summary

174. Whether particular feasibility expenditure is capital or revenue in nature must be determined on the facts of any particular case.

175. The cases indicate that four of the capital / revenue indicators are the most relevant to determining whether feasibility-type expenditure is capital or revenue in nature. These are whether the expenditure:

- is recurrent or once and for all expenditure;
- is on the profit-yielding structure or the income-earning process;
- creates an identifiable asset; and
- produces an enduring benefit.

176. In relation to whether the expenditure is recurrent or once and for all expenditure, it is critical to identify the particular nature of the taxpayer's business. When feasibility expenditure of the type in question forms part of the normal business operations (ie, part of the constant demands on the enterprise)

the cases indicate that the feasibility expenditure will more likely be treated as being on revenue account and deductible (as in *Ampol* and *Goodman Fielder Wattie*). This can also be seen from *Milburn* where expenditure was regularly incurred on the preliminary stages of investigating potential new sources of aggregate (and was accepted to be revenue) but expenditure on obtaining resource consents occurred relatively infrequently (and was held to be capital).

177. The courts have taken into account how far along in the process the expenditure was incurred (to determine whether it is part of the proft-making structure) and whether a particular asset has been identified. If the expenditure is incurred principally for evaluating one or more proposals it is unlikely the expenditure will relate to the business structure sufficiently to indicate the expenditure is capital in nature. However, when the feasibility expenditure goes beyond simply placing a taxpayer in a position to make an informed decision, it will be necessary to consider whether the expenditure relates to the profit-making structure or profit-making process such as in *Softwood*. In that case, the expenditure went beyond simply investigating the possibility of undertaking a new business activity and extended into establishing the profit-making structure (eg, options acquired over land and arrangements made for the supply of water, electricity, and timber). In these circumstances whether a decision has been made to commit to a particular proposal is likely to be important. Evidence of such a decision could include records such as board minutes, contracts with third parties, and other documentation showing that a decision had been made.

178. The same principle applies in determining whether the expenditure produces an enduring benefit (the third *BP Australia* factor). The incurring of expenditure principally for placing a taxpayer in a position to make an informed decision about the acquisition of an asset (or other enduring advantage) will not generally be expenditure incurred in relation to that particular asset or advantage. However, once the decision has been made to proceed with the acquisition or development of a particular capital asset, any expenditure incurred beyond that point will relate to the acquisition of that asset and will indicate that the expenditure is more likely to be explicitly related to effecting an enduring advantage of a capital nature. In *Milburn* the taxpayers decided to proceed with the development of an asset in the case of the three sites under review, in contrast to the other 48 sites investigated by them. Expenditure incurred in relation to those three sites was held to be of a capital nature.

179. Once a decision has been made to proceed with the acquisition or development of a structural asset or an enduring advantage, any expenditure incurred after that time will more readily be treated as being related to the underlying capital project (and thereby the profit-making structure of the business), and will not be deductible. For these purposes, the position in New Zealand and Australia is that it is irrelevant whether the expenditure is successful. This position differs from that in Canada, where the outcome of the project is taken into account (see the earlier discussion of *Bowater*). However, the New Zealand courts do ask when a decision or commitment has been made to create an asset, which may be seen as a similar inquiry to the Canadian test of whether the development has become a business or commercial reality. In addition, commitment in this context does not necessarily mean that a taxpayer will proceed with the

acquisition or development regardless of future events, (eg, the availability or otherwise of suitable planning consent), only that the taxpayer has made a firm decision to proceed. Similarly, it is considered that the fact the decision to proceed, or aspects of the process, may be explicitly contingent on any stated events, results or factors beyond the taxpayer's control will not mean a taxpayer has not made the relevant commitment (such as in *Milburn* where Fraser failed to obtain planning permission for its proposed aggregate extraction).

180. If a taxpayer chooses not to continue with the acquisition or development of an asset, despite having earlier made a firm decision to proceed, this does not affect any earlier finding that the expenditure incurred is capital in nature. When the creation of an asset fails to eventuate, the expenditure incurred cannot be re-characterised as revenue in nature. As stated by Wild J in *Milburn* (at page 17,025), "[t]he correct approach is to look at the expenditure at the time it was incurred". The failure to create a capital asset, despite the taxpayer's earlier commitment, would also mean no depreciation allowance could be deducted. Rather, the expenditure incurred from when the decision to proceed was made to when the course of action was abandoned would constitute "black hole" expenditure. This differs from the Canadian approach of generally treating expenditure as revenue in nature and deductible, if a capital asset fails to eventuate (see the earlier discussion of *Bowater*).

181. Identifying when a decision to proceed has been reached in any particular situation will always be a question of fact and degree and it is necessary to weigh all the relevant factors to determine whether a commitment has been made to a project.

182. Therefore, it is considered that the following matters will be relevant in determining whether feasibility expenditure will be denied a deduction under section DA 2(1).

- The incurring of feasibility expenditure of the type under consideration forms part of the normal business operations (ie, part of the constant demands on the enterprise). In this regard, it is critical to identify the true nature of the business or income-earning process. Cases suggest that in the absence of this factor being satisfied, expenditure will generally not be deductible.

- A commitment or decision has been made to proceed with the acquisition or development of a capital asset. Any expenditure incurred from that time will generally no longer be feasibility expenditure. That expenditure will be considered to relate to that capital asset, enduring benefit or profit-making structure, so will be treated as capital in nature and a deduction will be prohibited.

- The categorisation of the expenditure is not affected by the ultimate success or failure in acquiring or developing a capital asset, or in obtaining an advantage of enduring benefit, or in establishing a profit-making structure. The existence or recognition of contingencies, which may affect the eventual outcome, does not alter the categorisation of expenditure once a commitment or decision has been made to proceed.

- The point at which a firm decision to proceed with the acquisition or development of an asset in any particular situation is a question of fact and degree.

183. It is useful to elaborate on the above bullet points. Genuine feasibility study expenditure is incurred when a taxpayer is exploring whether the acquisition or development of a capital asset is practical or possible. To obtain a deduction for such expenditure, the first requirement is that the expenditure must be incurred in the course of the taxpayer's normal business operations. *Milburn* and *Ampol* are examples where expenditure was incurred as part of each taxpayer's ordinary business operations. If this nexus requirement is not satisfied, the expenditure incurred is not deductible. For example, expenditure incurred in the course of operations that are outside a taxpayer's normal business operations cannot meet the nexus requirement.

184. Although a deduction is prima facie available when the nexus requirement is satisfied, expenditure of a capital nature is not deductible. This means consideration must be given to whether the expenditure incurred is capital or revenue in nature. As such, in the context of the type of expenditure incurred in this type of case, a timeline begins from when a taxpayer is exploring whether the development or acquisition of an asset is feasible (the expenditure on which is deductible if the nexus requirement is met) to when a taxpayer develops or acquires the asset. The capital asset that may ultimately be acquired or developed will be part of the taxpayer's profit-making structure and is not part of the income-earning process. Generally, expenditure on the development of such an asset is also capital in nature. It is a question of fact and degree as to *when* the expenditure incurred alters from relating to the exploration of whether the development or acquisition of an asset is practical or possible, and whether it should be developed or acquired, to when the expenditure relates to the development or acquisition of a sufficiently identified capital asset. At this latter stage, the capital nature of the expenditure means its deductibility is prohibited. *Milburn* provides an example of such a timeline, where expenditure incurred on the exploration of prospective quarry sites was deductible only up to a particular stage. Once the particular stage was passed, the expenditure incurred was capital in nature and non-deductible.

185. As stated in the second bullet point of paragraph 182, the point at which the expenditure alters from revenue to capital in nature is when a commitment, or decision, has been made to proceed with the acquisition or development of a capital asset. At one end of the spectrum, commitment can be viewed narrowly as a binding and almost irrevocable decision to acquire or develop an asset. This level of commitment may be satisfied by the approval given by a taxpayer's board to the acquisition or development of an asset. At the other end of the spectrum, commitment may be broadly viewed as a provisional and revocable decision that allows a taxpayer to continually reassess whether to continue with a project.

186. It is considered that in the current context, commitment does *not* require a legal or other form of binding decision that is final and irrevocable. In *Milburn*, the taxpayers made business decisions to develop the quarry sites, and Wild J held that the disputed expenditure was capital in nature. Yet Fraser's commitment to developing its prospective quarry site could not have been binding, as it effectively revoked its commitment when it failed to obtain a resource consent.

187. Rather, commitment requires a decision *to proceed*, in contrast to a taxpayer continuing to weigh up whether *or not* to proceed. A commitment can still be made despite recognising that whether the development or acquisition ultimately goes ahead may be contingent on particular factors. For example, the taxpayers in *Milburn* had committed to developing the quarry sites, but the obtaining of appropriate resource consents was a known contingency. Other contingencies that may be recognised are the need for technical refinement to occur and the obtaining of the final construction cost. Such matters would not necessarily mean a commitment or decision to proceed with the acquisition or development of a capital asset had not been made, if the facts and/or circumstances otherwise showed that the taxpayer was actively proceeding, rather than continuing to gather information on which to decide whether to proceed.

188. A commitment or decision to proceed can also be made despite the later development of a contingency (or deal breaker) that was not recognised at the time of commitment. For example, the legal requirements for building foundations may change after the commitment was made to construct a building. It is also noted that the point of commitment has been described in the Canadian case of *Bowater* as the point at which the project or development becomes "a business or commercial reality".

189. A taxpayer will have made a commitment or a decision to proceed with the acquisition or development of a capital asset, when preliminary work has been completed with indications that the development or acquisition of an asset is technically and financially viable, and the facts indicate that the development or acquisition is proceeding. This will be the case notwithstanding that there may be no explicit documentary evidence that a formal decision to proceed has been made.

190. The following points are also relevant in determining whether a taxpayer has made a commitment or a decision to acquire or develop a capital asset.

- Recognition that the project or development may ultimately fail, for example, if resource consent is not obtained, is not relevant in this context if the taxpayer is proceeding to develop the asset identified and is intending to seek such consent.

- The relevant asset needs only to be identified with sufficient particularity; the exact details do not need to be known. For example, if a taxpayer makes a commitment or decision to construct an office building, the later finalisation of whether to construct eight or nine storeys does not change the earlier commitment or decision.

- If a commitment or decision has been made, it will not matter if a taxpayer has not identified the development's exact cost or the net profit possible from the development. A commitment or a decision to build an asset is no less a decision to proceed merely because the exact costs cannot be accurately forecast at the time the commitment or decision is made.

- The project's or development's ultimate success or failure is not a relevant factor to consider in determining whether a taxpayer has made a commitment or a decision to proceed (based on New Zealand and Australian case law, in contrast to Canadian case law).

- Giving approval to a development or project in stages will not necessarily prevent there having been a commitment or a decision to proceed with a development that is capital in nature. A staged development may be used for various reasons, including accountability, reporting, or financial or budgetary capping. Once there is no longer a question of whether to proceed (ie, a commitment or a decision to proceed has been made), a taxpayer's use of a staged development does not alter the commitment or decision that has been made to proceed.

191. Where expenditure on capital account leads to the acquisition of more than one asset, the expenditure should be spread across the assets acquired. The apportionment of the expenditure should be made on a basis that is appropriate in the circumstances.

Example 4

192. A company owns and operates a specialised property business throughout New Zealand. The company investigates potential sites all over the country, identifies property developments considered to be economically feasible, and sells this information to potential developers. The investigation of potential sites usually involves an employee visiting the area, requesting information from the local authority about the property, obtaining a valuation and, in some cases, instructing architects to provide preliminary drawings to show how the property might best be developed. When it is perceived that there may be difficulties in obtaining planning consent or meeting resource management requirements in relation to the particular type of development, the company often instructs specialist planning consultants to provide preliminary advice. Information obtained is compiled into a report on the potential site and this report is offered to interested parties for a fee.

193. The costs incurred to date are deductible. They are incurred as part of the company's normal and recurrent business operations. The costs incurred are an ordinary incident of carrying on the business of providing feasibility reports on potential property developments for reward. In addition, the expenditure is not directed to obtaining an enduring advantage.

Example 5

194. A company undertakes continual investigations into potential quarry sites as part of its normal business operations. When one or more sites are identified as feasible, the relevant information is provided to the company's board of directors. The board considers the information and determines which sites the company will proceed to develop.

195. The expenditure of the company in undertaking its investigations into potential quarry sites is deductible. The expenditure is an ordinary incident of the company's business and is for the purpose of gaining some reward from any site ultimately developed. The costs have been incurred in weighing up whether to proceed with a particular site and before any decision has been made to proceed with the acquisition or development of any particular site. The costs relate to providing the information the board needs to make an informed decision about whether to develop any particular site. However, once the board has decided to proceed with any particular site, any future costs incurred in relation to that particular site will be capitalised.

Example 6

196. A competitor company also regularly seeks out new quarry sites (including sites that it could develop itself and existing quarries that it could purchase). In the 2007 income year, it investigated 20 potential sites for development and undertook geological surveys to determine the best sites for development. Engineering reports were commissioned on the top five sites and the results were presented to the board of directors. The board gave approval to develop two of the sites.

197. Further tests were undertaken and reports were commissioned to determine the most appropriate extraction location and depth at each site. A large earthquake occurred at one of the sites and the company abandoned work on it as it was no longer suitable for extraction.

198. Work continued on the second site, although the company was aware the water table levels might affect the depth at which material could be extracted, including a remote possibility that the levels would be too high to make the site a viable commercial proposition.

199. The expenditure incurred on the 18 sites that were not selected for development is on revenue account. The expenditure is of a type incurred frequently by the company in the course of its business and the company was still weighing up whether to proceed with the development of the sites.

200. Expenditure incurred after the board gave approval to develop the two sites is on capital account. The company had decided to proceed with the development of capital assets. This is the case notwithstanding that one of the sites was never successfully completed (because of the earthquake damage) and notwithstanding that the development of the second site was contingent on water levels not being too high.

201. Also in the 2007 income year, the company wished to purchase two existing quarries. It considered 20 quarries from which it hoped to find two to purchase. Ten of the quarries were situated in New Zealand and the remaining 10 were in Australia. Fifteen of the quarry owners were selling the quarries as stand-alone assets, while the remaining five were offering 100% of the shares in a subsidiary company that owned the quarries as their sole asset.

202. The company procured engineering reports on each of the sites to determine which would be suitable for its purposes. On the basis of the engineering reports non-binding bids were placed on three sites and two quarries were ultimately purchased.

203. Expenditure on the engineering reports is deductible. This is the case regardless of whether the quarries were situated inside or outside of New Zealand and whether the quarries were purchased as a stand-alone asset or by way of shares in an asset-owning company.