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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

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Below is a list of recent items out for consultation. You can get copies from **www.ird.govt.nz/public-consultation/** or by emailing **public.consultation@ird.govt.nz**

Ref	Draft type	Title	Comment deadline
ED0192	General Determination	Depreciation Rate for kiwifruit overhead mesh shelters	28 April 2017
ED0193	General Determination	Depreciation Rate for abrasive blasting booths (including media recovery/recycling, dust extraction and ventilation systems)	28 April 2017
PUB00262	Interpretation statement	Income tax – treatment of New Zealand patents	11 April 2017

IN SUMMARY

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently. The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

BR Pub 17/03: Goods and Services Tax – traffic enforcement activities by local authorities - GST output tax on infringement fees retained - treatment of fines – GST input tax on acquisition of goods and services

This is a Public Ruling made under s 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Ruling applies in respect of ss 3A(1), 6(1)(b), 8(1), 14(1), 20(3), 20(3C) and 21–21G.

The Arrangement to which this Ruling applies

This Ruling applies to a "local authority" (as defined in s 2(1)) that is a registered person under the Act.

The Arrangement concerns local authority traffic law enforcement activities under the Land Transport Act 1998 where:

- A local authority issues infringement notices and subsequently receives infringement fees under s 141 of the Land Transport Act 1998. The infringement fees received by a local authority are paid into the Crown bank account or retained under s 141(3)–(5) of the Land Transport Act 1998. The infringement fees retained under s 141 of the Land Transport Act 1998 are a debt owing to a local authority when imposed; and
- A local authority acquires goods and services, on which tax is charged under s 8, that are applied in its traffic law enforcement activities under the Land Transport Act 1998.

The Arrangement does not include any activities that involve making an "exempt supply" as defined in s 14(1).

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- All the activities that a local authority undertakes in enforcing traffic laws in its area are part of its "taxable activity" under s 6(1)(b).
- GST under s 8(1) is not charged on any amounts of infringement fees retained by a local authority under s 141(3)–(5) of the Land Transport Act 1998.
- GST charged under s 8(1) on goods and services that the local authority acquires for use in its traffic law enforcement activities is "input tax" as defined in s 3A(1). When calculating its "output tax", under s 20(3) and (3C), a local authority may deduct the full amount of "input tax" charged on acquiring these goods and services.
- No apportionment or adjustment (in the terms of ss 20(3C) and 21–21G) to the amount of input tax deduction is required for goods and services applied to the issuing of infringement notices and the retention of the infringement fees.

The period or tax year for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 14 February 2017.

This Ruling is signed by me on 14 February 2017.

Susan Price
Director, Public Rulings

Commentary on Public Ruling BR Pub 17/03

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 17/03 ("the Ruling").

Legislative references are to the Goods and Services Tax Act 1985 (GST Act) unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

Summary

1. This Ruling and Commentary explains the GST treatment of local authorities' traffic law enforcement activities under the Land Transport Act 1998 (LTA).
2. Local authorities undertake a broad range of activities for the benefit of their communities. These activities, including traffic law enforcement, are deemed to be part of a local authority's taxable activity under s 6(1)(b).
3. The Ruling confirms that GST under s 8(1) is not charged on any amounts of infringement fees received or retained by a local authority under s 141(3)–(5) of the LTA. This conclusion is based on the infringement fee being a debt due to the local authority on imposition and not a debt due to the Crown.
4. Broadly, GST output tax is not payable on infringement fees because infringement fees are a penalty for an offence imposed under a statute. Consequently, infringement fees received as part of a local authority's traffic law enforcement activities are not consideration paid by the offender for any supply provided by the local authority.
5. The Ruling also confirms that GST charged on goods and services that a local authority acquires to use for its traffic law enforcement activities is input tax. A local authority may deduct the input tax when calculating its output tax.
6. The issuing of infringement notices and the retention of infringement fees under the LTA is a necessary and incidental part of providing traffic law enforcement services. These activities do not represent a separate use of the goods and services. There is no separate supply and no apportionment or adjustment (in terms of ss 20(3C) and 21–21G) is required when calculating input tax.

Background

7. There has been some uncertainty as to the correct GST treatment of parking infringement fees and the Commissioner has decided to issue a Public Ruling to provide on-going clarification.
8. The Ruling applies to local authorities as defined by s 2(1). This definition has two parts: it includes local authorities within the meaning of s 5(1) of the Local Government Act 2002, and it lists other entities considered to be local authorities under the Goods and Services Tax Act.
9. For the purposes of this Ruling, a local authority is also required to be a "registered person" as defined in s 2(1).
10. The Ruling addresses the GST treatment of infringement fees arising from the issuing of infringement notices under the LTA. The LTA empowers local authorities to issue infringement notices for infringement offences. In each case, an Act, regulation or bylaw prescribes the infringement fee or penalty.
11. The Ruling also considers input tax charged on goods and services acquired by a local authority that are used or applied to its traffic law enforcement activities under the LTA. The Commissioner understands such traffic law enforcement activities include:
    - preventing the obstruction of roadways by double-parked vehicles;
    - preventing the obstruction of drivers' vision at intersections;
    - enforcing loading and clearway zones;
    - enforcing the restriction on parking at bus stops;
    - enforcing non-parking on mobility parks; and
    - enforcing the restriction on parking over access-ways.
12. These activities are "stationary vehicle offences" under the LTA. This term is defined widely by s 2(1) of the LTA and essentially includes parking in breach of any Act, regulation or bylaw.

Summary of the legislation

13. This part of the commentary summarises the relevant provisions of the LTA and the GST Act.

14. The LTA is the principal Act in the area of transport and addresses a wide variety of issues. Relevantly, for the purposes of this Ruling and commentary, the LTA allows local authority parking wardens to issue infringement notices (which give rise to infringement fees) for certain infringement offences. The LTA also specifies when infringement fees received by the local authority can be retained and when the infringement fees must be paid to the Crown.

Scheme of the Land Transport Act 1998

15. The issuing of infringement notices and retention of infringement fees under the LTA are relevant to understanding the nature of the transaction. Section 138 of the LTA sets out how a person who is alleged to have committed an "infringement offence" may be proceeded against in court or be issued with an infringement notice.

16. An "infringement offence" is defined in s 2(1) of the LTA as being:

infringement offence means—

(a) a moving vehicle offence:

(ab) a stationary vehicle offence:

(b) an overloading offence:

(ba) an offence against this Act concerning logbooks that is committed by a transport service driver:

(c) an infringement offence specified in regulations made under this Act:

(ca) a toll offence:

(d) any other offence against this Act or any other enactment that is specified as an infringement offence against this Act (other than an offence that carries a penalty of imprisonment or mandatory disqualification from holding or obtaining a driver licence)

17. Section 139 of the LTA prescribes when and how infringement notices can be issued, and s 140 of the LTA sets out the content requirements.

18. Section 141 of the LTA deals with infringement fees and, in particular, when they can be retained. Relevant to this commentary are subss (1) and (3)–(5):

- Section 141(1) of the LTA provides that the infringement fee payable for an infringement offence is the appropriate fee prescribed for the offence under the LTA.
- Section 141(3) of the LTA provides (subject to subs (4) and (5)) that all infringement fees must be paid into a Crown bank account. An exception allows the retention of a portion of fees (that the Minister of Finance from time to time approves) being the expenses incidental to their collection.
- Section 141(4) of the LTA allows the Minister of Finance to approve a retention (by an enforcement authority) of a portion of the infringement fees received from infringement offences in relation to the use of special vehicle lanes.
- Section 141(5) of the LTA provides for the retention of infringement fees received in respect of certain offences that involve parking in breach of a local authority bylaw. This subsection also allows for the retention of towage fees received and a portion of all other infringement fees received by an enforcement authority that the Minister of Finance from time to time approves.

19. Section 141 of the LTA is largely drafted in terms of an "enforcement authority" rather than a "local authority". However, the definition of an "enforcement authority" in s 2(1) of the LTA includes a "local authority" which is in turn defined by reference to a regional council or territorial authority under the Local Government Act 2002. The term "road controlling authority" is also used in the relevant sections of the LTA and, ultimately, includes local authorities.

Imposition of GST under the Act

20. Section 8(1) imposes GST on the supply of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person. GST is charged on the value of that supply. The value of a supply is the "consideration" paid for the supply (ss 2(1) (definition of "consideration") and 10).

21. The term "supply" is defined very broadly in s 5(1) as including "all forms of supply". In *Databank Systems Ltd v CIR* (1987) 9 NZTC 6,213 this was interpreted as meaning "to furnish with or provide".

22. The approach of the courts is that a supply of a service requires that some kind of benefit is provided to a recipient (per Blanchard J's majority judgment in *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075 and see *Case S65* (1996) 17 NZTC 7,408).

23. For GST to apply to a payment, it must be more than just a payment to a registered person in the course or furtherance of their taxable activity. For GST to apply, the payment must also be consideration for a supply. To determine whether a payment satisfies this test, a relevant supply must be identified. Then it must be determined whether a payment is made for that identified supply (see *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093 (CA)).

24. When analysing transactions for GST purposes, the focus is on the legal rights and obligations created by the parties. The important question is whether a sufficient nexus or reciprocity exists between the supply of the goods or services and the consideration (see *CIR v NZ Refining Co Ltd* (1997) 18 NZTC 13,187 (CA), *Chatham Islands and Rotorua Regional Airport v CIR* (2010) 24 NZTC 23,979).

Analysis

25. Against this background, four main areas need to be considered in answering the issues addressed in the Ruling. These areas are:
    - the scope of a local authority's taxable activity;
    - whether GST output tax is payable on infringement fees;
    - whether GST input tax deductions are available; and
    - the extent to which GST input tax deductions have to be apportioned or adjusted if output tax is not payable on infringement fees.

Scope of a local authority's taxable activity

Services provided by local authorities and taxable activity generally

26. Local authorities provide a wide variety of services to their ratepayers and community. Undertaking services to benefit the community is consistent with the purposes of local government generally and s 10 of the Local Government Act 2002. This section specifies the purposes of a local authority include promoting the social, economic, environmental, and cultural well-being of communities.

27. In return for the local authority providing services, households and businesses are required to pay rates. Rates are generally levied to pay for many of the services that local authorities provide.

28. One service local authorities might provide is traffic law enforcement. Traffic law enforcement activities likely represent a small part of the overall services local authorities provide to benefit their communities. The broad purpose of traffic law enforcement services is to provide safe and efficient roads for ratepayers and the community. This purpose is consistent with promoting the social, economic, environmental, and cultural well-being of communities.

29. Local authorities make, administer and enforce traffic laws. Section 22AB of the LTA allows a local authority (as a road controlling authority) to make a wide variety of bylaws in relation to the roads under its control. For parking bylaws the local authority must designate the area of road affected and determine how the restrictions in the bylaw will apply. This also involves the local authority providing appropriate signage, road markings and meters as required.

30. Local authorities also undertake various administration activities such as publishing bylaws, tracing and recording payments from offenders, dealing with complaints, and responding to offenders disputing infringement notices. Under s 128D of the LTA, a local authority can also appoint parking wardens to monitor compliance and enforce traffic laws on the local authority's roads.

Specific provisions

31. Section 6(1) defines "taxable activity" as:

    (1) For the purposes of this Act, the term **taxable activity** means—

    (a) any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

    (b) without limiting the generality of paragraph (a), the activities of any public authority or any local authority.

32. Section 6(1)(b) deems all of a local authority's activities (except exempt activities) to be part of its taxable activity. Local authorities are deemed to have a taxable activity without reference to any of the requirements in s 6(1)(a) such as a "supply of goods and services" and "consideration".

33. For the sake of completeness, s 6(3)(d) provides an exception to s 6(1)(b) for any activity to the extent to which it involves making exempt supplies. It is difficult to identify any "exempt supplies" in the context of the Arrangement and this Ruling.

However, for the avoidance of doubt, any activities involving making exempt supplies are excluded from the Arrangement.

34. Section 5(7)(a) also applies specifically to local authorities. This section provides:

    (7) For the purposes of this Act—

    (a) every local authority is deemed to supply goods and services to any person where any amount of rates is payable by that person to that local authority:

35. The effect of s 5(7)(a) is to bring local authority rates within the GST regime.

36. Sections 6(1)(b) and 5(7)(a) are recognition by Parliament that local authorities are in a unique position of undertaking an array of activities for the benefit of their communities. In return, the ratepayers of the community are required to pay rates. The broad deeming provisions indicate that local authorities' activities and the rates paid are subject to GST.

37. In summary, all of a local authority's activities that are not exempt supplies, including traffic law enforcement, are taxable activities under the Act.

Is GST output tax payable on infringement fees?

38. Infringement fees arise out of the broad traffic law enforcement activities a local authority undertakes. To understand the GST treatment of infringement fees it is necessary to appreciate how they are imposed and treated under the LTA.

Imposition of infringement fees

39. Infringement fees are imposed under statute. Section 138 of the LTA provides that if a person commits an infringement offence they may be proceeded against under the Criminal Procedure Act 2011 or be served with an infringement notice as provided in s 139 of the LTA.

40. As "enforcement authorities" under the LTA, local authorities can appoint parking wardens to issue infringement notices (ss 128D, 128E and 139 of the LTA) for certain infringement offences.

41. The term "infringement offence" is defined in s 2(1) of the LTA by reference to broad categories of offences (see [16]). In each case, further specific offences are defined by reference to other provisions. Many of the specific infringement offences are listed in the schedules to the Land Transport (Offences and Penalties) Regulations 1999 (the Schedules). Schedule 1 identifies the offence, the provision under which it arises, and the amount of the infringement fee payable in each case.

42. The Ruling applies to infringement fees imposed for stationary vehicle and special lane infringement offences.

43. Parking on a road where parking is governed by parking meters and not paying the required fee is an example of where an infringement notice might be issued by a parking warden. If the person did not pay the stipulated fee for the metered parking space, they would be committing an infringement offence under s 2(1) of the LTA, being a "stationary vehicle offence". This is further defined under the LTA to include parking in breach of a bylaw made under s 22AB(1)(m) of the LTA.

44. If a parking warden issues an infringement notice, the infringement fee payable under the Schedules depends on the length of time the car has been parked in breach of the bylaw. The Schedules provide a scale of $12 for offences less than 30 minutes to $57 for offences over 6 hours. In each case, the Schedules allow the local authority to fix a lesser amount.

45. In determining whether GST output tax is payable on infringement fees, it is necessary to determine whether infringement fees are consideration for a supply. An infringement fee can be analysed in three main ways:

    - It might be regarded as consideration paid by the offender in return for a supply of services from the local authority.
    - It might be regarded as consideration for a supply of services by the local authority to the community.
    - It might be regarded as consideration received by the local authority for a supply of services to the Crown.

Whether an infringement fee is consideration for a supply to the offender

46. Infringement offences and infringement fees are prescribed under specific statutory provisions. An infringement offence involves a breach of the LTA or another Act, regulation or bylaw. Likewise, an infringement fee is also specifically imposed by legislation, in most cases, the Schedules. Infringement fees are a penalty arising under statute for an unlawful act; they are not consideration for a supply of services.

47. The imposition of the infringement is not a supply of a service. A supply of a service to a person for the purposes of GST must be something that benefits another person in some way. Judge Willy in *Case S65* considered that a supply of a service must be for (rather than against) a person. The imposition of a fine by way of an infringement fee punishes rather than benefits the offender, so cannot be the supply of a service. Consequently, the imposition of infringement fee on the offender cannot be a service to the offender (for which the infringement fees paid to the local authority is consideration).

48. Neither can the infringement fee (nor any part of it) be consideration paid by the offender for the provision of a car-parking space. This situation might arise, for example, when a person parks their car in a metered space but does not pay the stipulated fee for the space. The person then receives an infringement notice and is required to pay an infringement fee.

49. In this situation, the Commissioner considers that no part of the infringement fee is being imposed or paid for the provision of a parking space. The infringement fee does not have the legal character of being imposed or paid for the provision of a car-parking space. Rather, the payment is a penalty imposed by the local authority under the LTA.

50. The conclusion that penalties are not consideration for a supply is consistent with the Commissioner's previously published material ("GST Treatment of Court Awards and Out of Court Settlements", *Tax Information Bulletin* Vol 14, No 10 (October 2002): 21 (QB 14/06), "QB 14/06: GST – hire firm security bonds", *Tax Information Bulletin* Vol 26 No 7 (August 2014): 131, and "QB 14/14: GST – late return charges (including library fines and parking overstay charges)", *Tax Information Bulletin* Vol 27, No 1 (February 2015): 40).

Whether an infringement fee is consideration for a supply to the community

51. As noted above, infringement fees are imposed under statute. The requirement to pay an infringement fee is a consequence of committing an infringement offence. The infringement fee is separate and distinct from the supply of traffic enforcement services by a local authority to its community.

52. The infringement fee is not consideration paid by the offender for the provision of traffic law enforcement services to the community by a local authority. For GST to arise there must be an element of reciprocity in the transactions between the parties (*Chatham Islands Enterprise Trust v CIR*). In *CIR v NZ Refining*, the court held that a direct link between a supply and the consideration was required and that to be consideration for a supply a payment must be made for that supply.

53. The payment of an infringement fee is a consequence of committing an offence. It is the offender's actions in committing the offence that brings about the requirement to make payment. The payment is not made by the offender in exchange for the provision of services from the local authority; nor can the offender's payment be said to be in response to and for the inducement of the supply of a services provided by the local authority (*Turakina Maori Girls College Board of Trustees v CIR* (1993) 15 NZTC 10,032).

54. Accordingly, an insufficient connection exists between the supply of traffic enforcement services by the local authority and the consideration paid by the offender.

55. In conclusion, the local authority cannot be said to provide services, to either the offender or community, for consideration paid by the offender (in the form of the infringement fees). This is consistent with the approach taken on similar facts in the UK case of *Bristol City Council v C&E Commissioners* (VAT and Duties Tribunal, Decision No 17665, 15 May 2002). Assuming the infringement fee is not consideration for a supply to the Crown, GST under s 8(1) is not charged on any amounts of "infringement fees" retained by a local authority under s 141(3)–(5) of the LTA.

Whether an infringement fee is consideration for a supply to the Crown

56. An infringement fee could still be subject to GST, if it were consideration from the Crown for a supply of services from the local authority. The central issue is whether the infringement fee is a debt owing to the Crown or local authority. If the infringement fee is a debt due to the Crown, then by allowing the local authority to retain the fee there is, arguably, a payment from the Crown to the local authority. This payment could be characterised as consideration for a supply of services. However, if the infringement fee already belongs to the local authority, it cannot also be payment from the Crown to the local authority.

57. The infringement fee is paid by the offender to the local authority. Infringement fees will usually be paid on to the Crown but in some cases the local authority may retain them. Section 141 of the LTA sets out the arrangements between the local authority and Crown for infringement fees:

> **141 Provisions relating to infringement fees**
>
> (1) The infringement fee payable in respect of an infringement offence is the appropriate infringement fee prescribed in respect of the relevant offence by or under this Act.
>
> (2) If an infringement fee is paid to an enforcement authority other than the Police, the enforcement authority must give the Commissioner the particulars of the infringement and of the payment that the Commissioner requires.
>
> (3) Subject to subsections (4) and (5), all infringement fees received under this Act by an enforcement authority or recovered under the Summary Proceedings Act 1957 must be paid into a Crown Bank Account, except that the enforcement authority may retain any portion of the fees so received that the Minister of Finance from time to time approves as being the expenses incidental to their collection.

(4) An enforcement authority that is the Agency or a local authority may retain the portion of the infringement fees received by it under this Act—

(a) that the Minister of Finance from time to time approves; and

(b) that is received in respect of an infringement offence in relation to the use of a special vehicle lane.

(5) An enforcement authority that is a road controlling authority may retain—

(a) all infringement fees that it receives in respect of offences that involve—

(i) parking in breach of a bylaw of the road controlling authority on any portion of a road where parking is for the time being governed by the location of parking meters placed pursuant to a bylaw of the road controlling authority; or

(ii) parking on any other portion of a road in breach of a bylaw of the road controlling authority that prohibits parking for a period in excess of the period fixed by the bylaw where the infringement notice in respect of the offence was issued by an officer or other person appointed by the road controlling authority; and

(b) all towage fees received by it; and

(c) the portion of all other infringement fees received by it that the Minister of Finance from time to time approves.

(6) The Commissioner must from time to time, out of money appropriated by Parliament for the purpose, pay to a road controlling authority the portions of the infringement fees (other than towage fees) that the Minister of Finance from time to time approves and that the Commissioner receives in respect of other offences that involve breaches of the road controlling authority's bylaws (not being offences that are also offences against an Act or a regulation).

(7) For the purposes of subsections (4) and (5), the Minister of Finance may approve the retention of different portions for road controlling authorities or enforcement authorities and different categories of infringement offences.

58. Under s 141(3) of the LTA, the default position is that all infringement fees received are paid into the Crown bank account except for amounts retained to cover collection costs. If all infringement fees are a debt owing to the Crown, this raises the possibility that fees retained by the local authority are consideration from the Crown for the supply of services.

59. In this case, the retention of infringement fees under s 141 of the LTA is not consideration received from the Crown. Instead, where infringement fees are "retained" under s 141(3)–(5), they are a debt owing to the local authority on imposition. As the infringement fees are due directly to the local authority, they cannot also be a "payment" from the Crown to the local authority.

60. The word "retain" is defined in the Concise Oxford English Dictionary (12th ed, Oxford University Press, 2011) as:

> **Retain** v. 1 continue to have; keep possession of …

61. The word "retain" is used several times in the LTA (ss 19(3), 30ZH(1)(a) and 96(2)(e)). In each case, the use is consistent with receiving or holding something and continuing to have or keep possession of that thing. The use of the word "retain" on its own could still support the view that the local authority is merely collecting the infringement fees that it then remits to the Crown.

62. However, reading the word "retain" in the context of the scheme of the LTA supports the conclusion that the infringement fees (under s 141(3)–(5)) are derived by the local authority. Section 141 of the LTA is structured so that the starting point is the general rule in s 141(3), requiring infringement fees to be paid into the Crown bank account. However, this is subject to specific exceptions in s 141(3)–(5).

63. Under these exceptions, an enforcement authority (which includes a local authority) is entitled to retain certain payments. Section 141(3) of the LTA requires only a proportion of infringement fees received to be paid into the Crown bank account. The enforcement authority may retain such portion of the fees as the Minister of Finance from time to time approves as being expenses incidental to their collection.

64. Section 141(4) of the LTA provides the Minister of Finance can approve the retention of a portion of infringement fees arising from an offence in relation to a special vehicle lane. Section 141(5) of the LTA provides that an enforcement authority is entitled to retain all infringement fees received by it for certain stationary vehicle offences. These offences generally involve parking in breach of a bylaw of the local authority. Section 141(5)(c) also allows the Minister of Finance to approve the retention of a portion of "other" infringement fees.

65. In summary, infringement fees under s 141(3)–(5) are derived by a local authority in its own right carrying out its traffic law enforcement activities. All infringement fees that the local authority is entitled to retain under s 141 of the LTA are a debt due to the local authority when imposed. Because these infringement fees belong to the local authority in the first place, they cannot be a payment from the Crown to the local authority. Therefore, the Crown cannot be providing consideration for the supply of traffic law enforcement services from the local authority.

66. This conclusion is broadly consistent with other legislation. For instance, s 73 of the Public Finance Act 1989 provides that where a local authority prosecutes a person in court, the fine is paid to the local authority. This is subject to an amount equal to 10% being deducted and credited to the Crown bank account.

Are GST input tax deductions available?

67. Input tax is defined in s 3A. For the purposes of this Ruling and commentary, input tax means the GST local authorities pay on the goods and services they acquire for their traffic law enforcement activities.

68. A deduction is allowed for input tax paid, under s 20(3C), only to the extent that the goods or services are used for or are available for use in making taxable supplies. "Taxable supply" is defined in s 2(1) as "a supply of goods and services in New Zealand that is charged with tax under section 8".

69. The following elements need to be satisfied for there to be a "taxable supply":

- There must be a supply of a good or service.
- The good or service must be supplied in New Zealand.
- The good or service must be charged with tax under s 8.

Supply of a good or service

70. As discussed above, the Commissioner considers traffic law enforcement activities to be a part of the broad services supplied by the local authority to ratepayers and the community.

71. There is a "supply" under s 5(1) or s 5(7)(a). Section 5(7)(a) is the broad deeming provision that deems a "supply" of goods and services where a person pays rates to a local authority.

72. Even in the absence of s 5(7)(a), there is still a supply under s 5(1) as the local authority is supplying a service that benefits ratepayers and the community. Without the service, transportation in the community would be negatively affected. The enforcement of traffic laws brings about both direct and voluntary compliance with such laws. Other benefits include the efficient transportation of people and goods, the efficient operation of public transport, and the protection of people's property rights.

Good or service is supplied in New Zealand

73. A local authority carries out its traffic law enforcement activities in its respective area, and the supply of the traffic enforcement activities is performed (supplied) in New Zealand.

Good or service is charged with tax under s 8

74. Section 8(1) provides that GST is charged on the supply (but not an exempt supply) in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person.

75. Therefore, four elements must be met:

- **Supply of services:** As discussed above, a supply of traffic law enforcement services under either s 5(7)(a) or s 5(1).
- **Supply is not an exempt supply:** It is difficult to imagine any supply of traffic law enforcement services being an exempt supply under s 14(1). In any event, exempt supplies are excluded from the Arrangement in the Ruling.
- **Supply by a registered person:** Local authorities are registered persons for GST purposes and this is a requirement of the Arrangement.
- **Supply in the furtherance of a taxable activity:** All of a local authorities' activities are deemed to be a "taxable activity" under s 6(1)(b).

76. As each element is met, the goods and services used (or available for use) by a local authority for the enforcement of traffic laws qualify as goods and services used in "making taxable supplies". The requirements under the definition of "taxable supply" are met, and an input tax deduction is available under s 20(3C).

Is any apportionment or adjustment required?

77. Under s 20(3C), an input tax deduction is available only to the extent that the good or service is used or is available for use in making taxable supplies. If the good or service is to be used in making exempt or non-taxable supplies, then an apportionment of input tax will be required on acquisition to reflect that intended use. Adjustments are made subsequently, if the actual use is different to the intended use.

78. As discussed above, infringement fees retained under s 141(3)–(5) are not subject to GST. An apportionment or adjustment is not required, because the issuing of infringement notices and the consequential retention of infringement fees are merely one part of the broad traffic law enforcement services supplied and are not a supply in themselves. Infringement fees are a necessary and incidental part of the taxable supplies a local authority makes in providing traffic law enforcement services to its ratepayers and community.

79. Infringement fees are necessary because traffic law enforcement would be ineffective without the ability to impose penalties. The infringement fee is incidental to the local authority's purpose of providing safe and efficient roads, parking spaces, public transport and so on. Local authorities want motorists to comply with the law not to breach it so they can penalise them. As such, the issuing of infringement notices and the retention of infringement fees are not a separate supply from traffic law enforcement.

80. By way of an example, if a local authority receives a submission from the community requesting a residents parking area, they may choose to pass a bylaw, designate the area affected, decide on the hours of operation, and provide road markings and signage. They may also set up a system of permits or coupons for residents. It is necessary to be able to issue infringement notices to prevent non-residents parking contrary to the bylaw. The infringement fees that arise are incidental to the provision of parking spaces for residents and those with resident permits.

81. Therefore, when goods and services are acquired for traffic law enforcement activities and applied to the issuing of infringement notices (and the consequential retention of infringement fees), there will be no separate use and no requirement to apportion input tax or make any adjustments post-acquisition.

Examples

82. The following examples help to explain how the law applies to particular situations. The GST consequences of each example are a result of the particular facts. Any additions or variations to the facts may give rise to different GST consequences.

Example 1: GST on infringement fees

83. Ray parks his car on a street in a council-metered parking bay. Parking costs $2 an hour, and Ray puts $4 in the meter for 2 hours of parking. Ray is 20 minutes late returning to his car. A council parking warden has issued an infringement notice and left it under the car's windscreen wiper. The infringement notice is for a $12 infringement fee for parking in a metered parking bay in breach of a bylaw. The council will retain the amount under s 141(5) of the LTA.

84. No GST is required to be charged on the infringement fee. It is a penalty arising under the LTA. The payment of the $12 penalty is a consequence of Ray's acting contrary to local bylaws and the penalty is prescribed under the Schedules. The $12 is not consideration for a supply of services.

Example 2: Availability of input tax deductions

85. Brambleton Council purchases 20 new handheld ticketing machines. The ticketing machines are purchased at a cost of $460 each (inclusive of GST). The local authority uses the ticketing machines when enforcing traffic laws in its area. Each council parking warden receives a ticketing machine that they use for issuing on-the-spot infringement notices.

86. Brambleton Council, as a registered person, is able to claim an input tax deduction of $60 per machine when calculating its output tax. The ticketing machines have been acquired for use (and are subsequently used) in traffic law enforcement activities.

87. No apportionment or adjustment to the input tax deduction is required. There is no separate supply. Infringement fees are the result of an offender breaching the terms of an Act, regulation or bylaw. The penalty itself arises under (and is prescribed in) statute and is not part of a service provided to the public. The act of issuing the infringement fee is a necessary and incidental part of the traffic law enforcement activities. The ability to enforce the traffic laws facilitates the effective provision of the council's traffic law enforcement services. Therefore, the ticketing machines are used in making taxable supplies being the provision of the council services.

References

Subject references

GST, infringement fee, infringement offence, local authority, penalties

Legislative references

Criminal Procedure Act 2011

Goods and Services Tax Act 1985 – ss 2(1) (definitions of "local authority", "registered person", "taxable activity", "taxable supply", "consideration"), 3A, 5(1) and (7)(a), 6(1)(b), 8, 10, 14(1), 20(3) and (3C), 21–21G

Land Transport Act 1998 – ss 2(1) (definitions of "enforcement authority", "infringement offence", "stationary vehicle offence", "road controlling authority"), 19(3), 22AB, 30ZH(1)(a), 96(2)(e), 128D, 128E, 138–141

Land Transport (Offences and Penalties) Regulations 1999 – schedules 1, 1A, 1B

Local Government Act 2002 – ss 5(1) (definition of "local authority"), 10

Public Finance Act 1989 – s 7

Case references

Case S65 (1996) 17 NZTC 7,408

Chatham Islands Enterprise Trust v CIR (1999) 19 NZTC 15,075

CIR v Databank Systems Ltd (1989) 11 NZTC 6,093 (CA)

CIR v NZ Refining Co Ltd (1997) 18 NZTC 13,187 (CA)

Databank Systems Ltd v CIR (1987) 9 NZTC 6,213

Rotorua Regional Airport v CIR (2010) 24 NZTC 23,979

Turakina Maori Girls College Board of Trustees v CIR (1993) 15 NZTC 10,032

Other references

Concise Oxford Dictionary (12th ed, Oxford University Press, 2011)

"GST Treatment of Court Awards and Out of Court Settlements", *Tax Information Bulletin* Vol 14, No 10 (October 2002): 21 (QB 14/06)

"QB 14/06: GST – hire firm security bonds" *Tax Information Bulletin* Vol 26 No 7 (August 2014): 131

"QB 14/14: GST – late return charges (including library fines and parking overstay charges)", *Tax Information Bulletin* Vol 27, No 1 (February 2015): 40

APPENDIX 1

GST Act relevant provisions

1.1 Section 5 relevantly provides:

SECT 5 MEANING OF THE TERM SUPPLY

(1) For the purposes of this Act, the term supply includes all forms of supply.

…

(7) For the purposes of this Act—

(a) Every local authority is deemed to supply goods and services to any person where any amount of rates is payable by that person to that local authority:

(b) the Chatham Islands Council is treated as supplying goods and services to a person if an amount of council dues, as defined in section 2 of the Chatham Islands Council Act 1995, is payable by the person to the Chatham Islands Council.

1.2 Section 6(1) provides:

SECT 6 MEANING OF THE TERM "TAXABLE ACTIVITY"

(1) For the purposes of this Act, the term taxable activity means—

(a) Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

(b) Without limiting the generality of paragraph (a) of this subsection, the activities of any public authority or any local authority.

1.3 Section 8(1) provides as follows:

SECT 8 IMPOSITION OF GOODS AND SERVICES TAX ON SUPPLY

(1) Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 15% on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after 1 October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

1.4 Section 20(3C) provides allows the deduction of input tax to the extent a good or services is used or available for use in making taxable supplies:

(3C) For the purposes of subsection (3), and if subsections (3D) or (3L) do not apply,—

(a) input tax as defined in section 3A(1)(a) or (c) may be deducted to the extent to which the goods or services are used for, or are available for use in, making taxable supplies:

BINDING RULINGS

(b) input tax as defined in section 3A(1)(b) may be deducted to the extent to which the goods are used for, or are available for use in, making taxable supplies other than—

(i) the delivery of the goods to a person in New Zealand:

(ii) arranging or making easier the delivery of the goods to a person in New Zealand.

LTA relevant provisions

1.5 Section 2(1) relevantly provides:

2 Interpretation

(1) In this Act, unless the context otherwise requires,—

…

enforcement authority, in relation to an infringement offence, means (except in relation to Part 17)—

(a) the New Zealand Police, in any case:

(b) the Agency, in the case of an infringement offence for which an infringement notice is issued by an employee of the Agency or on behalf of the Agency:

(ba) an airport authority:

(c) [Repealed]

(d) a local authority, in the case of an infringement offence for which an infringement notice is issued by an employee of the local authority or on behalf of the local authority:

(e) a public road controlling authority that is an enforcement authority for the purposes of an Order in Council made under section 46 of the Land Transport Management Act 2003, in the case of an infringement offence that is a toll offence.

…

infringement offence means—

(a) a moving vehicle offence:

(ab) a stationary vehicle offence:

(b) an overloading offence:

(ba) an offence against this Act concerning logbooks that is committed by a transport service driver:

(c) an infringement offence specified in regulations made under this Act:

(ca) a toll offence:

(d) any other offence against this Act or any other enactment that is specified as an infringement offence against this Act (other than an offence that carries a penalty of imprisonment or mandatory disqualification from holding or obtaining a driver licence):

…

local authority means any regional council or territorial authority within the meaning of the Local Government Act 2002

1.6 Section 141 provides:

141 Provisions relating to infringement fees

(1) The infringement fee payable in respect of an infringement offence is the appropriate infringement fee prescribed in respect of the relevant offence by or under this Act.

(2) If an infringement fee is paid to an enforcement authority other than the Police, the enforcement authority must give the Commissioner the particulars of the infringement and of the payment that the Commissioner requires.

(3) Subject to subsections (4) and (5), all infringement fees received under this Act by an enforcement authority or recovered under the Summary Proceedings Act 1957 must be paid into a Crown Bank Account, except that the enforcement authority may retain any portion of the fees so received that the Minister of Finance from time to time approves as being the expenses incidental to their collection.

(4) An enforcement authority that is the Agency or a local authority may retain the portion of the infringement fees received by it under this Act—

(a) that the Minister of Finance from time to time approves; and

(b) that is received in respect of an infringement offence in relation to the use of a special vehicle lane.

(5) An enforcement authority that is a road controlling authority may retain—

(a) all infringement fees that it receives in respect of offences that involve—

(i) parking in breach of a bylaw of the road controlling authority on any portion of a road where parking is for the time being governed by the location of parking meters placed pursuant to a bylaw of the road controlling authority; or

(ii) parking on any other portion of a road in breach of a bylaw of the road controlling authority that prohibits parking for a period in excess of the period fixed by the bylaw where the infringement notice in respect of the offence was issued by an officer or other person appointed by the road controlling authority; and

(b) all towage fees received by it; and

(c) the portion of all other infringement fees received by it that the Minister of Finance from time to time approves.

(6) The Commissioner must from time to time, out of money appropriated by Parliament for the purpose, pay to a road controlling authority the portions of the infringement fees (other than towage fees) that the Minister of Finance from time to time approves and that the Commissioner receives in respect of other offences that involve breaches of the road controlling authority's bylaws (not being offences that are also offences against an Act or a regulation).

(7) For the purposes of subsections (4) and (5), the Minister of Finance may approve the retention of different portions for road controlling authorities or enforcement authorities and different categories of infringement offences.

(8) For the purposes of this section, **road controlling authority** includes an airport authority.

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Order in Council

Minimum family tax credit threshold rises for 2017–18 tax year

The income threshold for the minimum family tax credit (MFTC), which guarantees eligible low-income working families a minimum level of after-tax income, rises from $23,764 to $23,816 on 1 April 2017.

The new threshold was approved by the Income Tax (Minimum Family Tax Credit) Order 2016 on 21 November 2016. The new regulation also revokes the Income Tax (Minimum Family Tax Credit) Order 2014 as it is now spent, and amends the Income Tax (Minimum Family Tax Credit) Order 2015 to limit its application to the 2016–17 tax year.

The MFTC provides a top-up to after-tax income to help eligible working families moving off a benefit into paid employment.

The increase applies for the 2017–18 and later tax years.

Income Tax (Minimum Family Tax Credit) Order 2016 (LI 2016/282)

INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 17/01: Income tax – deductibility of feasibility expenditure

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

Scope of this statement

1. This interpretation statement contains guidelines that the Commissioner considers relevant in determining whether feasibility expenditure is deductible under the general deductibility provisions in s DA 1. The statement applies where, having regard to the nature of the taxpayer's business, feasibility expenditure of the type in question is incurred as an ordinary incident of business and is recurrent in nature. Other feasibility expenditure (for example, expenditure associated with a one-off capital expansion or acquisition) is not covered by the statement. Ordinary deductibility principles should be applied to these situations to determine whether the general permission and capital limitation apply.
2. There are a number of specific deductibility provisions in the Act that may be applicable to some types of feasibility expenditure in some circumstances. These provisions may allow deductions for expenditure that may not otherwise be deductible under the general permission. Some examples are, ss DB 6 and DB 7 (interest), ss DB 18 and DB 20B (lease costs), s DB 19 (resource consents), s DB 33 (scientific research), s DB 34 (research or development), ss DB 36 and DB 37 (patent expenses), s DB 40B (unsuccessful software development), s DB 46 (pollution control) and s DB 62 (legal expenses). This statement does not consider the operation of these provisions.
3. Some types of expenditure also have their own deductibility regimes. For example, Part D, Subpart O (farming); Part D, Subpart P (forestry); Part D, Subpart S (film industry); Part D, Subpart T (petroleum mining); and Part D, Subpart U (mineral mining). This statement does not consider the operation of those regimes.
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).

Summary

5. This interpretation statement updates and replaces "IS 08/02: Deductibility of feasibility expenditure" *Tax Information Bulletin* Vol 20, No 6 (July 2008): 12 (the 2008 statement). Amendments to the 2008 statement were necessary to take account of the Supreme Court decision *Trustpower Ltd v CIR* [2016] NZSC 91, (2016) 27 NZTC 20-061.
6. In many situations, it is likely that feasibility expenditure will be non-deductible, either because it is:
   - 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 s DA 1(1), the general deductibility provision in the Act. So, for feasibility expenditure to be deductible under either paragraph of s DA 1(1) a sufficient relationship or nexus must exist between the expenditure and the taxpayer's business or income-earning activity. Any expenditure incurred before a taxpayer has commenced business or commenced a new business

INTERPRETATION STATEMENTS

or 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 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 taxpayer's intention in engaging in those activities (as set down in *Grieve v CIR* (1984) 6 NZTC 61,682 (CA)). 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 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 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 a sufficient nexus exists 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 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 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.

Capital limitation

14. When feasibility expenditure is deductible under s DA 1(1), it is still necessary to consider whether the expenditure is denied as a deduction under s 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. 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 and is not adding to the business structure or undertaken with a view to obtaining an enduring benefit, case law indicates the feasibility expenditure will more likely be treated as being on revenue account and deductible. It is not clear that the Supreme Court in *Trustpower* would have been as willing to find that preliminary expenditure could be deductible if the expenditure in question related to a one-off capital expansion for example. Consequently, the focus of this statement is feasibility expenditure that is (or will be) recurrent in nature and that is incurred as an ordinary incident of the taxpayer's business.

16. Where the taxpayer's ultimate goal is intended to result in the acquisition or development of a capital asset (or other enduring benefit), it is necessary to consider the relationship between the expenditure and the capital asset (or benefit). Where the asset that may ultimately be acquired or developed will be part of the taxpayer's profit-making structure and not part of the income-earning process, generally, any expenditure will be on capital account. However, some expenditure on the early stages of feasibility work may be deductible. Based on the Supreme Court decision in *Trustpower*, the Commissioner's view is that feasibility expenditure of a type incurred on a recurrent basis as a normal incident of the taxpayer's business is likely to be deductible in two, related, situations.

17. The first situation where expenditure may be deductible is where it is not directed towards a specific capital project (or the acquisition of a potential capital asset (or other enduring benefit) as applicable). This will usually, but not always, be where initial feasibility work is being undertaken before a specific capital project or projects (or capital asset or assets or enduring benefit or benefits) is identified. It is a question of fact and degree when expenditure will be sufficiently connected to a capital project, asset or other enduring benefit. However, in the Commissioner's view, the project, asset or benefit need only be identified in general terms; the exact details do not need to be known. However, where expenditure is referable to a specific capital project, asset or benefit, it is still possible that the expenditure may be revenue in nature.

18. The second situation where expenditure may be deductible is where, even though a specific project (or asset or benefit) has been identified, the expenditure is so preliminary as not to be directed towards materially advancing that specific project (or capital asset or enduring benefit). This can be contrasted with expenditure that is aimed at making tangible progress on a capital project (asset or benefit).

19. Whether or not the expenditure ultimately results in a capital asset or enduring benefit is irrelevant to the question of deductibility (ie, deductibility does not turn on the success or failure of the project). When the creation of an asset fails to eventuate, the expenditure incurred cannot be re-characterised as revenue in nature – the expenditure must be considered at the time it is incurred.

Introduction

20. This statement updates and replaces the Commissioner's Interpretation Statement: "IS 08/02: Deductibility of feasibility expenditure" *Tax Information Bulletin* Vol 20, No 6 (July 2008): 12. In particular, the statement has been amended to reflect the Supreme Court decision in *Trustpower*.

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

Analysis

What is feasibility expenditure?

22. 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.

23. There are no specific income tax provisions relating to feasibility expenditure – the general deductibility provisions must be applied. 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 s 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 s DA 2(1), which prohibits a deduction for expenditure of a capital nature.

Deductibility under s DA 1(1)

General principles

24. 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 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA). 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 61,240; *Buckley & Young* at 61,274).
- A statutory nexus must exist between the particular expenditure and the assessable income of the taxpayer claiming the deduction (*Banks* at 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 61,242; *Buckley & Young* at 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 61,241).
- The phrase "to the extent that" expressly contemplates apportionment (*Banks* at 61,240; *Buckley & Young* at 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 61,282).

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Application to feasibility expenditure

25. The primary test for deductibility of expenditure under either paragraph of s DA 1(1) is that a sufficient nexus must exist 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.

26. Expenditure incurred before the establishment of a business or an income-earning process will not fulfil the statutory nexus required in terms of s 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, a deduction will be denied.

"In business"

27. 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 the nature of the activities carried on and the intention of the taxpayer in engaging in those activities. Richardson J (at 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.

28. 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

29. 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 Inland Revenue Commissioner* (1919) 12 TC 92 (KB).

30. 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".

31. *Birmingham* was cited by Barker J in the New Zealand Court of Appeal decision *Duff v CIR* (1982) 5 NZTC 61,131 (CA), at 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.

32. *Birmingham* was also confirmed by the Court of Appeal in *Calkin v CIR* (1984) 6 NZTC 61,781 (CA), 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 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.

33. *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 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.

34. Gallen J considered the Canadian case *Minister of National Revenue v MP Drilling Ltd* [1976] CTC 58 (FCA) (discussed from paragraph 88) 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.

35. Deciding when a taxpayer ceases incurring expenditure that is preliminary or 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

36. 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.

37. 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.

38. 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.

39. *MP Drilling* (noted in *Stevens & Stevens* and discussed from paragraph 88) was also briefly considered 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, the taxpayer's 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.

40. Judge Bathgate 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 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.

41. However, Judge Bathgate 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, Judge Bathgate was satisfied that the income-earning process had commenced. He stated (at 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.

42. Although this decision may at first glance seem inconsistent with cases such as *Stevens & Stevens* and *MP Drilling*, in reaching his decision, Judge Bathgate noted (at 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 2,394) that a business may have commenced before a taxpayer was actually trading or earning assessable income.

43. 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.

44. Judge Barber 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.

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

46. Therefore, *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.

47. 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. 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 be 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.

48. 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. The cases emphasise that the deductibility 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 s DA 1(1)(b) for deductibility (*Case S39*).

49. The position was summarised by the Supreme Court in *Trustpower* in the context of that case as follows:

> Section DA 1 denies deductibility to feasibility expenditure for a new, or an entirely separate, business venture which is not underway at the time the expenditure is incurred. If activities are undertaken to decide whether or not to enter a business (as against, as in this case, in the course of a taxpayer's existing business), the expenditure will lack the required nexus to a business and s DA 1 will not be satisfied. In determining whether a business has commenced, the commitment (or otherwise) of the taxpayer to that business – or, as [the 2008 statement] puts it, whether "a decision has been made to enter into that business or activity" – is highly material.

50. As the New Zealand case law in this area is somewhat limited, it is useful to also consider case law from other jurisdictions.

Cases: Australia

51. A leading Australian case in the context of feasibility expenditure is *Softwood Pulp and Paper Co Ltd v FCT* 76 ATC 4,438 (SC Victoria). 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.

52. 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 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]

53. The Australian full Federal Court decision in *FCT v Ampol Exploration Ltd* 86 ATC 4,859 (FCA) 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.

54. 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.

55. Lockhart J first considered whether the expenditure came within s 51 of the Income Tax Assessment Act 1936 (Cth), the equivalent of s 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.

56. Lockhart J 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.

57. 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 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]

58. Lockhart J was also satisfied that the total expenditure was deductible under the first limb of s 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, stating (at 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]

59. 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).

60. Although concluding that the expenditure was deductible in this particular case, Lockhart J did sound a cautionary note with regard to other fact situations (at 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.

61. 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.

62. 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 an 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 no relevant nexus exists and the expenditure will not be deductible. This was the case in *Esso Australia Resources Ltd v FCT* 98 ATC 4,768 (discussed from paragraph 74).

63. Another decision of the 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 (FCA). 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.

64. The taxpayer carried on the business of coal mining 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.

65. 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.

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

67. The majority held that the smelter feasibility costs were not deductible under s 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.

68. 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 s 51 of the Income Tax Assessment Act 1936 (Cth).

69. 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 from paragraph 51).

70. In *Goodman Fielder Wattie Ltd v FCT* 91 ATC 4,438 (FCA), the taxpayer was a company that carried on business in several divisions. In August 1981, the taxpayer contracted with the Queensland Institute of Technology 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, the institute 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.

71. 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 were 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.

72. 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 from paragraph 164.

73. *FCT v Brand* 95 ATC 4,633 (FCA) 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. His Honour referred to several decisions that placed an emphasis on the element of commitment, including *Goodman Fielder Wattie*. His Honour then stated (at 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.

74. 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.

75. From 1979 to 1984, the taxpayer claimed a deduction under s 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.

76. 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.

77. 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.

78. 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.

79. 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 (at 4,780) 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".

80. 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" (at 4,780). 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 s 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.

81. 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.

82. 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.

Summary: Australian cases

83. 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 variety of factual situations and provide a more detailed analysis. The usefulness of examining Australian cases in relation to a claim for a deduction under s 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 nothing in the New Zealand or Australian decisions indicates that a different approach should be adopted in New Zealand.

84. In the area of feasibility expenditure, the Australian cases also indicate that the question of deductibility under the equivalent of s 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.

85. A sufficient nexus must exist 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*).

86. 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.

87. 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

88. 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.

89. 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.

90. However, it is important to note that in reaching this conclusion the Court considered it "not without significance" (at 62) 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.

91. 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

92. For feasibility expenditure to be deductible under either paragraph of s 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 para (a) this requires that the expenditure be incurred in deriving assessable income. In relation to para (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.

93. 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.

94. 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*).

95. 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 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.

96. 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*).

97. 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 (ie 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 (ie be carried out with the intention of obtaining some reward from sale or exploitation) (*Ampol*, *Esso* and *Case S39*).

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

- A sufficient nexus must exist 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, 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

99. Several individuals who are employed by the marketing division of a nationwide 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 by travelling around the country and meeting 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.

100. 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

101. The directors of an established logging and saw-milling company are considering whether the company should start producing 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 clients to discuss the proposed venture.

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

103. 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

104. 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 2016 investigating possible ways to operate a business, including obtaining advice from an accountant and a solicitor and sounding out potential clients. In July 2016, 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 2016 they commence work for their first clients.

105. The expenditure incurred before July 2016 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.

106. The expenditure incurred from July 2016 is deductible, subject to the capital limitation (which is discussed from paragraph 107). 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 2016.

Prohibition of deduction under s DA 2(1)

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

General principles

108. In *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337, Dixon J described the distinction between expenditure on capital account and expenditure on revenue account as corresponding (at 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.

109. Dixon J identified three matters to be considered (at 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.

110. In *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634, Dixon J again summarised the distinction between expenditure on capital account and expenditure on revenue account (at 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.

111. His Honour indicated that determining whether expenditure was capital or revenue (at 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.

112. Similarly, in *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 (PC), Viscount Radcliffe stated (at 960):

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

113. The principles from these cases were adopted by the Privy Council in *BP Australia Ltd v FCT* [1965] 3 All ER 209 (PC). The *BP Australia* formulation was also adopted in New Zealand in cases such as *CIR v LD Nathan & Co Ltd* [1972] NZLR 209 (CA), *Buckley & Young, CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA), *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206 (HC), *CIR v Wattie* (1998) 18 NZTC 13,991 (PC), *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA), and *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981 (CA). In *Wattie*, the Privy Council noted that the approach adopted in *Hallstroms* has been recognised as exemplifying the "governing approach" in New Zealand.

114. The courts have formulated various indicia for helping to determine whether expenditure is capital or revenue. These factors can be useful where the classification of expenditure as capital or revenue is not clear. The following factors are relevant in this regard:
- The need or occasion that calls for the expenditure.
- Whether the expenditure is recurrent in nature.
- Whether the expenditure creates an identifiable asset.
- Whether the expenditure creates an advantage that 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.

115. 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.

116. It is also important to note that while the courts have formulated these factors to help in determining the capital or 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

Cases: New Zealand

117. The leading case on the deductibility of feasibility expenditure in New Zealand is the Supreme Court decision *Trustpower*. Trustpower is an electricity retailer. It generates about half the electricity it sells and buys the rest from other generators. In the years in question, Trustpower maintained a "development pipeline" of over 200 possible new generation projects, most of which would not be carried through to completion. During the 2006, 2007 and 2008 tax years, Trustpower incurred expenditure applying for and obtaining resource consents in relation to four proposed electricity generation projects. The Commissioner allowed deductions for some preliminary expenditure incurred in investigating the feasibility of the projects. However, the Commissioner denied a deduction for expenditure incurred in obtaining the resource consents. The issue was whether this expenditure on the resource consents was on revenue or capital account. The expenditure was described as feasibility expenditure on the basis that it was incurred to assist Trustpower to determine whether to complete the four generation projects.

118. Trustpower argued that expenditure on a capital project is on revenue account until the taxpayer commits to the completion of the project (the commitment approach). Trustpower also argued that the 2008 statement supported this argument.

119. In the High Court (*Trustpower Ltd v CIR* [2013] NZHC 2,970) the dispute centred on whether the resource consents were stand-alone assets. Justice Andrews concluded that they were not; rather the consents were "part and parcel" of the projects they related to. Her Honour, therefore, concluded that the expenditure on the consents should be treated the same as other expenditure on the generation projects (which the Commissioner had accepted was deductible). Justice Andrews went on to conclude that, even if the resource consents were stand-alone assets, they would be revenue assets and the expenditure incurred in obtaining them would be deductible. This was based on a weighing up of the factors from *BP Australia*.

120. The Court of Appeal (*CIR v Trustpower Ltd* [2015] NZCA 253) overturned the High Court decision and found that the expenditure was on capital account. The Court took the view that it was irrelevant whether the resource consents were stand-alone assets. The Court also found that it was irrelevant that Trustpower had not committed to proceeding with the four projects. The expenditure was incurred for the purpose of enabling Trustpower to extend or expand its electricity generation business. The Court found that there was a sufficient connection between the expenditure and capital. This was the case even though the final decision to apply for the resource consents had not been made and that decision was contingent on the outcome of the preliminary work. Although not in dispute, the Court of Appeal appeared to take the view that none of the expenditure on projects in the development pipeline would have been deductible as it all related to possible future capital projects (at [88]).

121. Following the Court of Appeal decision Professor John Prebble QC and Hamish McIntosh published an article[1] discussing the 2008 statement and the decisions of the High Court and Court of Appeal. Prebble and McIntosh took the view that any expenditure incurred to test the feasibility of acquiring or constructing possible capital assets is not deductible. They, therefore, agreed with the Court of Appeal that none of Trustpower's expenditure on projects in the development pipeline was deductible. As will be seen below, the Supreme Court referred to the article in its judgment.

122. The Supreme Court upheld the Court of Appeal decision that the expenditure was on capital account. The Court rejected the commitment approach argued by Trustpower (noting that this approach was not necessarily consistent with the 2008 statement as Trustpower had argued). Instead the Supreme Court found that most expenditure addressed to a capital project will be on capital account:

> [13] On this basis, the salient features of the case are as follows:
>
> …
>
> (e) We do not accept that the capital/revenue issue is controlled by the commitment approach. …
>
> (f) On a purist view of the capital/revenue distinction, any expenditure (feasibility in nature or otherwise) addressed to a capital project (as the generating projects in this case are) is necessarily on capital account. On this approach – which has been espoused by Professor John Prebble QC and Hamish McIntosh – the feasibility expenditure in issue was necessarily not deductible.
>
> (g) The approach which we adopt is broadly similar to that proposed by Professor Prebble and Mr McIntosh but, for reasons which we explain, **allows for some flexibility, for instance, in respect of initial stages of feasibility work**.
>
> (h) **As is apparent, we consider that some feasibility expenditure referable to proposed capital projects might sometimes be deducted. We do not, however, see such deductibility as extending to external costs incurred in respects which do, or were intended to, materially advance the capital project in question**.
>
> [Emphasis added and footnotes omitted.]

[1] Prebble and McIntosh "Deducting Expenditure to Assess the Feasibility of Constructing Capital Assets: Opinions from Inland Revenue, the High Court and the Court of Appeal" 6 VUWLRP 24/2016.

123. The Supreme Court, therefore, stated that the general rule is that expenditure referable to a proposed capital project will be capital. In this regard, the Court broadly agreed with the approach taken by Prebble and McIntosh. However, the Court also differed from the Prebble and McIntosh approach – choosing to adopt a somewhat wider, more flexible, approach to deductibility. In this regard, the Court went on to acknowledge that some feasibility expenditure referable to proposed capital projects might be deductible. However, it considered that this would not extend to costs that are intended to (or do) materially advance the capital projects in question. The Court declined to construct a test for determining when feasibility expenditure will cease to be deductible (at [47]). It also accepted that, in marginal cases, the application of the capital/revenue distinction many involve indeterminate questions (at [69]); this was seen as being implicit in the underlying rule. However, the Court did give some, limited, guidance as to when feasibility expenditure would be deductible (at [47]):

> However, for reasons which we will explain, we consider that preliminary expenditure on feasibility studies may sometimes be deductible.

At [63]:

> To the extent that the judgments of Noel ACJ and Davies J proceed on the basis that expenditure on a capital project is on capital account only if an asset is created, we disagree. **On the other hand, we can envisage situations in which a judgment call may have to be made in relation to feasibility assessments which are so preliminary in nature that they cannot sensibly be seen as "directed to the acquisition of an asset of an enduring character", to use the language of Davies J.** [Emphasis added]

And at [71] and [72]:

> The expenditure on obtaining resource consents in this case was directly related to specific projects that would be on capital account if they came to fruition. The projects could not proceed without resource consents. **Obtaining the consents thus represented tangible progress towards their completion**. The expenditure is thus on capital account and not deductible.
>
> We are not required to determine the status of the expenditure which preceded the decisions to apply for resource consent. It may be that the Commissioner could have denied deductibility in relation to at least some of that expenditure. **We are, however, also of the view that expenditure associated with early stage feasibility assessments may be deductible. Such assessments can be seen as a normal incident of business**. Treating the associated costs as deductible is consistent with the passages of the judgments of Noel ACJ and Davies J which we have set out. It is also consistent with the use of the expression "to the extent" in the capital limitation [in s DA 2], which, as noted, suggests that questions of degree may be involved. **Expenditure which is not directed towards a specific project or which is so preliminary as not to be directed towards the advancement of such a project is likely to be seen as being on revenue account**. [Emphasis added and footnotes omitted]

124. In summary, the Supreme Court made it clear that expenditure that relates to a possible capital asset is non-deductible, regardless of whether a capital asset ultimately results and regardless of whether the taxpayer had committed to completing the project. This is consistent with the English cases *ECC Quarries Ltd v Watkis (Inspector of Taxes)* [1977] 1 WLR 1386; [1975] 3 All ER 843 (Ch) and *Sargent (Inspector of Taxes) v Eayrs* [1973] 1 WLR 236; [1973] 1 All ER 277 (Ch) cited by the Supreme Court). Nor did it matter that Trustpower did not own all of the land required to complete the projects.

125. However, the Court found that early stage feasibility expenditure may, nevertheless, sometimes be deductible. This was variously described in different parts of the judgment:

- Expenditure in relation to feasibility assessments "which are so preliminary in nature that they cannot sensibly be seen as directed to the acquisition of an asset of an enduring character" may be deductible (at [63]);
- Expenditure associated with early stage feasibility assessments can be seen as a normal incident of business and may be deductible (at [72]);
- Expenditure that "is not directed towards a specific project" is likely to be deductible (at [72]); and
- Expenditure "which is so preliminary as not to be directed towards the advancement" of a specific project is likely to be deductible (at [72]).

The Court also referred to what it saw as capital expenditure:

- Expenditure which does, or was intended to, "materially advance" a capital project is not deductible (at [13(h)]); and
- Expenditure on something that represents (or is intended to represent) "tangible progress towards" completion of a capital project will not be deductible (at [71]).

126. This raises an issue as to the distinction between expenditure that is preliminary and does not advance a specific project (which is likely to be deductible) and expenditure that materially advances (or results in tangible progress on) a specific project (which will not be deductible). On one level, any expenditure on a project is likely to be expended with the intention of "advancing" the project – otherwise, there would seem to be little point incurring the expenditure. Therefore, in the Commissioner's view, "advancement" can only sensibly be read as referring to material advancement (in the sense that it is "not immaterial").

127. It is not entirely clear whether the Supreme Court was intending "advancement of a specific project" and "tangible progress towards completion" of a capital project to be different ways of expressing the same concept. However, in the Commissioner's view the two phrases are generally synonymous in this context. Where there is "material advancement" of a project there will most likely also have been "tangible progress" on the project and vice versa. However, if a situation arises where the two do not overlap, it is not necessary to find both tangible progress and material advancement. An amount will be capital as long as the expenditure was intended to achieve either material advancement **or** tangible progress.

128. The Supreme Court also found that, in some circumstances, expenditure associated with early stage feasibility assessments could be seen as a normal incident of business (at [72]). The Court was considering this in the context of Trustpower's fact situation. The nature of Trustpower's business was such that it was regularly exploring new generation possibilities. In this regard, incurring feasibility expenditure was a normal incident of its business. It is not clear that the Supreme Court would have been as willing to find that preliminary expenditure could be deductible if the expenditure in question related to a one-off capital expansion for example. Consequently, the focus of this statement is feasibility expenditure that is (or will be) incurred on a recurrent basis by a taxpayer as an ordinary incident of its business. It is possible that feasibility expenditure that is not incurred on a recurrent basis could be deductible in some circumstances. However, this statement does not consider these situations.

129. Therefore, in the Commissioner's view, expenditure is likely to be deductible in accordance with the Supreme Court decision if it is of a type incurred on a recurrent basis as a normal incident of the taxpayer's business and it satisfies one of the following:

- the expenditure is not directed towards a specific capital project; or
- if the expenditure is directed towards a specific capital project, the expenditure is so preliminary as not to be directed towards materially advancing a specific capital project – or, put another way, the expenditure is not directed towards making tangible progress on a specific capital project.

130. It is noted that the Supreme Court often referred to feasibility expenditure in relation to a capital "project" rather than an enduring "asset" or other enduring benefit (which is the more common terminology in capital/revenue cases). This is likely due to the facts of the case, which related to electricity generation projects that involved a number of potential capital assets. The relevant definition of "project" in the *Concise Oxford English Dictionary* 12th ed (Oxford University Press, 2011) is "an enterprise carefully planned to achieve a particular aim". A "capital project" in the sense used by the Supreme Court seems to be an enterprise carefully planned to achieve a particular aim that includes (or is intended to include) one or more capital assets or other enduring benefits. Despite its reference to "projects" rather than "assets", in the Commissioner's view, the Supreme Court was not suggesting that different capital/revenue tests apply. The fact that the Supreme Court cited and quoted (with seeming approval) case law such as *Griffin Coal Mining* which referred to "acquisition of an asset of an enduring character" supports this. Consequently, in the Commissioner's view the same capital/revenue tests apply whether the taxpayer is acquiring or developing a single capital asset (or other enduring benefit) or undertaking a wider capital project that involves multiple capital assets (and/or other enduring benefits).

131. In the context of feasibility expenditure, the capital items being sought will most often be of a tangible nature – for example land, buildings and infrastructure assets. However, they could also be assets or enduring benefits that are intangible in nature – for example, depending on the context, agency contracts, supply contracts and resource consents.

132. Whether feasibility expenditure is deductible will depend on the particular facts and must, like all capital/revenue decisions, be considered on a case by case basis. Consistent with the Supreme Court's comments, this will often involve a judgement being made on the specific facts of a taxpayer's case. Ultimately, the question comes down to whether the expenditure is directed to the acquisition of a capital asset or other enduring benefit.

133. It is noted that at [13(h)] the Supreme Court referred to "external costs" in a way which could be taken to suggest that the deductibility of external and internal costs may differ:

> As is apparent, we consider that some feasibility expenditure referable to proposed capital projects might sometimes be deducted. **We do not, however, see such deductibility as extending to external costs incurred** in respects which do, or were intended to, materially advance the capital project in question.
>
> [Emphasis added]

134. It is not clear why the Supreme Court referred specifically to external costs. It may be because the costs at issue in the case were largely external costs. It may also have been because the Court thought that external costs were more likely to be incurred on expenditure that would materially advance a capital project. In some circumstances this may be the case. However, in the Commissioner's view the deductibility or otherwise of particular expenditure will be the same regardless

of whether the costs are incurred internally or externally (see *Christchurch Press*). For example, the costs of carrying out an environmental study will be treated the same (for deductibility purposes) whether the study was carried out by an employee or commissioned from a third party.

135. The Supreme Court in *Trustpower* referred to the High Court decision in *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 (HC). In that case, 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 two sites and Fraser's expenditure on an aggregate prospect. 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.

136. 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 s 74(2)(b) of the Income Tax Act 1976. The Commissioner considered that the expenditure by Milburn at one site (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. Another site (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.

137. 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.

138. Wild J based his view on the following factors (at 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.

139. Wild J then reached the following conclusion (at 17,023):

> 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]

140. The comparison drawn by the High Court provides support for the argument that in the capital or 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 one or more particular prospects has been made. Once a decision has been made to expend money acquiring or developing a particular 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. Although Wild J did not specifically find that expenditure on the other 48 sites was deductible (the issue not being in dispute) the fact his Honour drew the comparison tends to suggest that he thought the expenditure on the 48 sites was not directed to the development of capital assets.

141. 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.

142. Wild J rejected the taxpayers' argument (at 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 [sic] on the outcome of the various applications for consent. There is no logical nexus, and categorisation dependant [sic] upon outcome has been firmly rejected in New Zealand, Australia and England.

143. 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 taxpayer had made a decision to expend money developing the site.

144. 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 17,025) "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 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.

145. 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 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]

146. 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 (or not) of a resource consent on appropriate terms, whether an economic resource capable of development existed.

147. It would seem that Wild J's rejection of the taxpayers' argument, that the expenditure was incurred to ascertain the existence of an economic resource, was also based on his earlier findings. Wild J listed six factors (set out in paragraph 138 above) that indicated to him that the taxpayers "had made business decisions to expend money in developing the sites for commercial production" (at 17,023). The first step, or one of the first steps, towards developing the sites was to apply for the necessary consents. Since the decision to spend money on development 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.

148. 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.

149. In relation to the capital–revenue distinction, Judge Barber 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. Of note are Judge Barber's obiter comments in relation to product development expenditure (at 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.

150. 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 revenue in nature (not capital). The expenditure essentially comprised the salary cost of the taxpayer's design engineer who modified existing helmet designs and built samples 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.

151. Judge Barber 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* Judge Barber concluded that the expenditure was a reasonable and normal trading or revenue expenditure. The TRA found that altering helmets was an ordinary incident of the taxpayer's 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*.

152. The New Zealand authorities in this area 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 s 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 s DA 2(1). This will involve a careful consideration of the nature of the taxpayer's business. In some cases, expenditure will be deductible because it is part of the taxpayer's ordinary business operations and, in the context of the taxpayer's business, does not give rise to a capital asset or enduring benefit (as Judge Barber found was the case in *Case P3*).

153. However, where the taxpayer's goal is intended to result in the acquisition or development of a capital asset (as was the case in *Trustpower* and *Milburn*), generally, any expenditure referable to that asset will be on capital account. Despite this, in *Trustpower* it was acknowledged that some expenditure on the initial stages of feasibility work may be deductible. In the Commissioner's view expenditure incurred as a recurrent part of the normal operations of the taxpayer's business is likely to be deductible in the following circumstances:

- The expenditure is not directed towards a specific capital project (or the acquisition of a potential capital asset (or other enduring benefit) as applicable).
- Even where it is directed towards a specific capital project (or the acquisition of a potential capital asset (or other enduring benefit)) the expenditure is so preliminary as not to be directed to materially advancing the project (or acquisition). This can be contrasted with expenditure that is aimed at making tangible progress on a capital project.

154. Whether or not the expenditure ultimately results in a capital asset is irrelevant to the question of deductibility. That is, deductibility does not turn on the success or failure of the project.

Cases: Australia

155. The Supreme Court in *Trustpower* cited and quoted from the minority judgment in *Griffin Coal Mining* (Davies J being the only judge who considered whether the taxpayer's expenditure was capital or revenue). The facts of the case are set out above in paragraphs 63–65).

156. Davies J, in dissent, concluded that the general permission was satisfied and, more relevantly, that the capital limitation did not apply (at 4,877):

> In my opinion, the expenditure **at this early stage was relevant and incidental to Griffin's existing business** and was not of a capital nature. It is clear that no capital was contributed to the venture. The time for the contribution of capital to the venture had not arrived. **The expenditure was not directed to the acquisition of an asset of an enduring character.** In relation to the aluminium project, no asset was acquired. The expenditure was not on items such as roads and drainage works necessary in the event of the opening up of the new mines, or on the taking away of the overburden, or on the construction of buildings and the acquisition of plant and equipment. The subject expenditure was expenditure by a coal mining company made out of current revenue directed to ascertaining whether the development of an enhanced market for the coal was feasible, as well as attaining the intangible ends I have mentioned. [Emphasis added]

157. The Supreme Court did not express a view as to whether Davies J was correct in his conclusion that the expenditure in question was not on capital account. However, it did cite the above quotation in support of its conclusion that there are situations where feasibility assessments are so preliminary in nature that they cannot sensibly be seen as "directed to the acquisition of an asset of an enduring character" (*Trustpower*, at [63] and [72]).

158. In *Softwood Pulp and Paper* (see paragraphs 51 and 52), Menhennitt J, having reached the view that the expenditure under consideration was preliminary to the commencement of business, so was non-deductible on that basis, went on to conclude that even if he were 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 108 and 109).

159. 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 and arrangements made for the supply of water, electricity, timber and so on. In these circumstances, even if the expenditure had satisfied either of the first two limbs of s 51 of the Income Tax Assessment Act 1936 (Cth), the expenditure would have been held to be capital.

160. The facts in *Softwood* can be contrasted with those in *FCT v Ampol Exploration Ltd 86* ATC 4,859 (FCA). 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.

161. In *Ampol*, Lockhart J, in the majority, concluded that the expenditure was deductible under both limbs of the equivalent of s DA 1(1) before going on to consider the "more difficult question" of whether the expenditure was 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.

162. 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.

163. 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 (ie the process by which the company earned its rewards). On this basis, therefore, the expenditure was of a revenue nature.

164. 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 s DA 1(1), is also critical in the capital or revenue context.

165. In *Goodman Fielder Wattie*, Hill J concluded that the expenditure incurred before November 1982 was incurred before the commencement of the business (discussed in paragraphs 69 and 71). 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.

166. Hill J considered the decisions in *Sun Newspapers, Ampol* and *Hallstroms* and stated (at 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.

167. 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 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.

168. Therefore, 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. The expenditure was not directed towards obtaining any rights of an enduring kind.

169. The decisions in Australia in relation to the application of the equivalent to s DA 2(1) 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. The decisions in *Ampol* and *Goodman Fielder Wattie* highlight that when the expenditure relates to the income-earning process (ie, 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 (eg, a capital asset or another accretion to the business or profit-making structure), the expenditure will generally be of a capital nature.

Cases: Canada

170. As the Supreme Court in *Trustpower* noted, there is Canadian authority that suggests expenditure on a capital project that does not result in a capital asset is deductible (see, for example, *Bowater Power Co Ltd v Minister of National Revenue* [1971] FC 421, [1971] CTC 818 (FC), *Gartry v R* 94 DTC 1947 (TCC) and *Wacky Wheatley's TV & Stereo Ltd v Minister of National Revenue* [1987] 2 CTC 2,311 (TCC)). The Supreme Court rejected this proposition (*Trustpower* at [51]).

171. 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.

172. 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.

173. The Federal Court found for the taxpayer. Judge Noel 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. Judge Noel 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.

174. Judge Noel concluded that the costs of the feasibility studies were on revenue account, so were deductible. He stated (at 837–838):

> I do not … feel that merely because the expenditure was made for the purpose of determining whether to bring into existence a capital asset, it should always be considered as a capital expenditure and, therefore, not deductible. In distinguishing between a

> capital payment and a payment on current account, regard must always be had to the business and commercial realities of the matter. While the hydroelectric development, once it becomes a business or commercial [reality] 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. I can, indeed, see no difference in principle between all of these cases.

175. The Supreme Court in *Trustpower* cited the above quotation with approval. In particular, the Supreme Court found that the quotation supported its conclusion that early stage feasibility assessments may be deductible as a normal incident of business (at [61], [63] and [72]).

Summary

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

177. 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 and is not adding to the business structure or undertaken with a view to obtaining an enduring benefit, the cases indicate the feasibility expenditure will more likely be treated as being on revenue account and deductible. *Ampol* and *Goodman Fielder Wattie* are two cases where the courts found that the nature of the taxpayer's business meant that the expenditure was on revenue account because the expenditure was not directed to obtaining an enduring benefit.

178. Where the taxpayer's ultimate goal is intended to result in the acquisition or development of a capital asset (or other enduring benefit), it is necessary to consider the relationship between the expenditure and the capital asset (or benefit). Where the asset that may ultimately be acquired or developed will be part of the taxpayer's profit-making structure and not part of the income-earning process, generally, any expenditure will be on capital account. However, some expenditure on the early stages of feasibility work may be deductible. Based on the Supreme Court decision in *Trustpower*, the Commissioner's view is that feasibility expenditure of a type that is (or will be) incurred on a recurrent basis as a normal incident of the taxpayer's business is likely to be deductible in two, related, situations. Although the Supreme Court discussed these situations by reference to capital "projects", in the Commissioner's view the same capital/revenue tests apply whether the taxpayer is acquiring or developing a single capital asset (or other enduring benefit) or undertaking a wider capital project that involves multiple capital assets (and/or other enduring benefits).

179. The first situation where early stage expenditure may be deductible is where it is not directed towards a specific capital project (or the acquisition of a potential capital asset (or other enduring benefit) as applicable). This will usually, but not always, be where initial feasibility work is being undertaken before a specific capital project or projects (or capital asset or assets or enduring benefit or benefits) is identified. It is a question of fact and degree when expenditure will be sufficiently connected to a capital project, asset or other enduring benefit. However, in the Commissioner's view, the project, asset or benefit need only be identified in general terms; the exact details do not need to be known. For example, for a taxpayer whose business involves leasing out space in commercial buildings, it would be sufficiently specific to have identified a project that relates to the construction of a new commercial building to be leased out. The fact that it may not have been decided exactly how many floors the building is going to be or even where the building is going to be built, will not mean that the project is not "specific". However, where expenditure is referable to a capital project, asset or benefit, it is still possible that the expenditure may be revenue.

180. The second situation where expenditure may be deductible is where the expenditure is so preliminary as not to be directed towards materially **advancing** a specific project (or capital asset or enduring benefit). This can be contrasted with expenditure that is aimed at making tangible progress on a capital project. Expenditure that the Court in *Softwood* found was too connected to the establishment of a profit-making structure to be deductible included acquiring options over land and making arrangements for the supply of water, electricity and timber. Similarly, in *Trustpower* and *Milburn*, expenditure on resource consents was too connected to the profit-making structure. It will be a matter of fact and degree when expenditure will be seen as materially advancing a capital project.

181. Whether or not the expenditure ultimately results in a capital asset is irrelevant to the question of deductibility (ie, deductibility does not turn on the success or failure of the project). When the creation of an asset fails to eventuate, the expenditure incurred cannot be re-characterised as revenue in nature. As Wild J stated in *Milburn* (at 17,025), "[t]he correct approach is to look at the expenditure at the time it was incurred".

182. 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

183. 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.

184. 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. From a practical and business point of view, the expenditure is calculated to create a product (information) that can be sold. In addition, the expenditure is not directed to obtaining an enduring advantage for the company.

Example 5

185. A company undertakes continual investigations into potential quarry sites as part of its normal business operations. The initial investigations involve:

- an employee travelling around the country to identify possible suitable locations;
- contacting land owners at those locations to determine whether they are amenable to selling or leasing their land to the company; and
- engaging a geologist to write a preliminary report on the suitability of the site for quarrying.

186. The company considers the information and determines which sites it will spend money on to seek to develop. If a site proceeds to the next step, the company will enter into negotiations with the land owner to purchase or lease the land, commission more detailed technical and environmental impact reports, and apply for appropriate resource consents to operate the quarry. Following this, a final decision is made to proceed with development of the quarry in question.

187. The point at which the company has a specific project will depend on the circumstances. If, for example, the company is just looking around to see what quarry options many be available and has no particular quarry specifications in mind, the costs of the employee travelling around the country to identify possible locations are likely to have been incurred prior to any specific project being identified. However, if, for example, the company wanted to develop a quarry to certain specifications and the employee was looking for a suitable location, then it is more likely that there is already a specific project in existence. In either case, it is likely that once suitable sites have been identified and discussions with landowners are taking place, this expenditure will be related to a specific project.

188. However, regardless of when it could be said that the expenditure was related to a specific project, the expenditure of the company in undertaking its initial investigations into potential quarry sites is deductible (ie, expenditure on the identification of potential sites, initial discussions with landowners and the preliminary geological reports). The expenditure is of a type incurred on a recurrent basis by the company in the normal course of its business. Further, the expenditure is not directed towards the material advancement of a specific capital project (or capital asset or other enduring benefit).

189. However, the subsequent expenditure on negotiations with landowners, detailed technical and environmental reports, and applying for resource consents will be on capital account. This is because the expenditure is aimed at materially advancing the relevant project (or, put another way, making tangible progress on the project).

Example 6

190. 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 2016 income year, it investigated 20 potential sites for development and undertook geological surveys to determine the best sites for development.

191. Preliminary engineering reports were commissioned on the top five sites to determine their quarrying potential. Based on the information outlined in the engineering reports, the company acquired the land and started developing two of the sites. The expenditure on the geological surveys and engineering reports is on revenue account. The expenditure is of a type incurred on a recurrent basis by the company in the normal course of its business. In addition, even though the expenditure could be seen as relating to a specific capital project (or projects) being the development of one or more quarries, it was not aimed at materially advancing those projects (or the acquisition of any asset). Put another way, there was no tangible progress on any capital project.

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

193. Work continued on the second site, although the company was aware that 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.

194. Expenditure incurred **after** the geological surveys and engineering reports (referred to in [191]) were obtained is on capital account. The expenditure after this time is referable to the development of a capital asset (and the expenditure was intended to result in material advancement/tangible progress on the project). This is the case despite one of the sites never being successfully completed (because of the earthquake damage) and despite the development of the second site being contingent on water levels not being too high.

195. Also in the 2016 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 in New Zealand and 10 were in Australia. Fifteen 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 its sole asset.

196. The company procured preliminary 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.

197. Expenditure on the engineering reports is deductible. This is the case regardless of whether the quarries were situated inside or outside New Zealand and whether the quarries were purchased as a stand-alone asset or by way of shares in an asset-owning company. However, expenditure incurred on putting together the three bids would be on capital account as it is incurred for the purpose of acquiring a specific capital asset and materially advances that aim.

198. The following year, the company investigated a single site in Hawkes Bay to determine whether it would be suitable for developing as a quarry. It undertook a geological survey and commissioned a preliminary engineering report to determine whether the site had potential for use as a quarry. The engineering report showed that the site was unsuitable for quarrying and the project was abandoned.

199. The expenditure incurred by the company was deductible. The expenditure related to a specific project (being the potential development of a quarry). However, the expenditure incurred was preliminary and did not materially advance the project.

Example 7

200. Acme Electricity Generation Ltd generates electricity for sale to consumers. Currently, its electricity is predominantly generated by coal-fired power plants. However, it also has some small hydro stations and one wind farm. Acme routinely investigates new generation opportunities and intends to focus its future generation projects on sustainable sources.

201. Acme sends an employee to Norway on a general fact finding trip to learn about the generation methods that they use and the pros and cons of each of them. Expenditure on the fact finding trip is deductible as it is not linked to a specific capital project or asset.

202. One of the generation types that Acme learned about in Norway is "blue energy", which uses seawater and fresh water to generate electricity. Acme identifies five potential places in New Zealand that it believes would be suitable for this type of generation plant. Acme then sends two employees to Norway to talk to the generation company involved. They get general information about "blue energy" including the water conditions that are required for successful generation, the land area required for a plant, the potential generation capacity and ballpark costs for running a plant. This expenditure is also deductible. The expenditure relates to a specific project (a "blue energy" generation plant). However, the expenditure is preliminary and it does not result in any tangible progress of the project or any capital asset or other enduring benefit.

203. Based on the information that Acme gathered in Norway, it chooses one of the five potential sites that it believes has the best conditions for a viable "blue energy" plant. Acme sends the two employees back to Norway with site plans to get expert advice on the best design for the plant. While there they commission a Norwegian engineer to draw blueprints for the plant. This expenditure is not deductible as having the expert advice and plans for construction materially advances the capital project.

Example 8

204. A national restaurant chain is continually looking for new sites on which to build restaurants. It is considering opening a new restaurant in Wellington. To help identify a suitable potential site, the company hires a contractor to survey traffic flows in different areas around Wellington. Following on from this, marketing studies and demographic analysis are undertaken and 15 potential sites are identified. Initial financial forecasting is also undertaken to determine the likely profitability of each site. This expenditure is deductible. The expenditure relates to a specific project (building a new restaurant). However, the expenditure is preliminary and it does not result in any material advancement or tangible progress of the project or any capital asset or other enduring benefit.

Appendix

This diagram considers only the general permission and capital limitation. It does not consider any specific deductibility provisions that may apply to allow the taxpayer to deduct expenditure that would not otherwise be deductible under the general permission and/or capital limitation.

Stage One: General permission

(a) Has a **business** or income earning activity **commenced**?

Four factors are relevant:

- It is criticial to determine the nature of the business or activity.
- A commitment must have been made to enter into that business or activity.
- A profit-making structure must be in place for that business or activity.
- The ordinary current operations of the business or activity have begun.

No → No deduction is allowed for the expenditure.

Yes ↓

(b) Has the expenditure been incurred as part of the **ordinary current operations** of that business or income-earning activity?

No → No deduction is allowed for the expenditure.

Yes ↓

Stage Two: Capital limitation

A deduction can be denied where expenditure is of a capital nature:

This has been described as:

- Expenditure that creates an advantage that is of an enduring benefit to the business or activity.
- Expenditure on the profit-making structure (rather than the profit-making process).

Yes ↓

Is the expenditure of a type incurred on a recurrent basis as a normal incident of the taxpayer's business or income-earning activity?

No → Outside the scope of this interpretation statement.

Yes ↓

(a) Is the expenditure directed towards a **specific capital project** (or acquisition of **potential capital asset**)?

No → A deduction is allowed for the expenditure.

Yes ↓

(b) Is the expenditure so preliminary as not to be directed towards **materially advancing** (or making tangible progress on) a specific capital project (or capital asset)?

Yes → A deduction is allowed for the expenditure.

No ↓

No deduction is allowed for the expenditure (but a depreciation deduction may be available over time for capitalised expenditure.

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Related rulings/statements

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Capital, deductibility, feasibility expenditure, income tax

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Hallstroms Pty Ltd v FCT (1946) 72 CLR 634
Milburn NZ Ltd v CIR (2001) 20 NZTC 17,017 (HC)
Minister of National Revenue v MP Drilling Ltd [1976] CTC 58 (FCA)
Poverty Bay Electric Power Board v CIR (1999) 19 NZTC 15,001 (CA)
Sargent (Inspector of Taxes) v Eayrs [1973] 1 WLR 236; [1973] 1 All ER 277 (Ch)
Softwood Pulp and Paper Co Ltd v FCT 76 ATC 4,438 (SC Victoria)
Stevens & Stevens v CIR (1989) 11 NZTC 6,001 (HC)
Sun Newspapers Ltd v FCT (1938) 61 CLR 337
Trustpower Ltd v CIR [2013] NZHC 2,970
Trustpower Ltd v CIR [2016] NZSC 91, (2016) 27 NZTC 20-061
Wacky Wheatley's TV & Stereo Ltd v Minister of National Revenue [1987] 2 CTC 2,311 (TCC)

Other references

Prebble and McIntosh, "Deducting Expenditure to Assess the Feasibility of Constructing Capital Assets: Opinions from Inland Revenue, the High Court and the Court of Appeal" 6 VUWLRP 24/2016

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

Minor amendment made to Standard Practice Statement 16/01 *Requests to amend assessments*

Under s 113 of the Tax Administration Act 1994 (the TAA), errors are generally required to be corrected in the return period in which they arose. However, s 113A of the TAA allows taxpayers to correct minor errors made in income tax returns (including RWT and NRWT), FBT returns or GST returns in the next return that is due after the discovery of the error.

Previously, s 113A(1)(c) stated that a minor error included an error that was caused by a clear mistake, simple oversight or mistaken understanding on the taxpayer's part and that, for a single return, causes a discrepancy in the assessment of that return of $500 or less. By virtue of s 112 of the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Act 2017, and with effect from the 1 April 2017, this monetary threshold has been increased to $1,000.

Standard Practice Statement 16/01 *Requests to amend assessments* (SPS 16/01) has been amended (at [87]) to include this change. The amended SPS 16/01 can be found at **www.ird.govt.nz** (search keyword "SPS 16/01").

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

Determination FDR 2016/07: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994 (the Act). This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager, Investigations and Advice, under section 7 of the Act.

Discussion (which does not form part of the determination)

Class A shares in the K2 Alternative Strategies NZ Portfolio Limited ("K2"), to which this determination applies, are attributing interests in a foreign investment fund ("FIF") for New Zealand resident investors.

New Zealand resident investors are required to apply the FIF rules to determine their tax liability in respect of their investment in shares in K2 each year.

K2 invests, directly and indirectly (via a broadly diversified portfolio of underlying hedge funds) in a mix of asset types, including cash, equities, debt securities and derivatives. Its investment objective provides exposure to equity, credit, currency and commodity markets. K2 enters into foreign currency hedging arrangements to provide investors with New Zealand dollar denominated exposure.

Section EX 46(10)(c) of the Income Tax Act 2007 (ITA) could potentially apply to prevent investors from using the fair dividend rate method in the absence of a determination under section 91AAO of the Act.

Notwithstanding that K2 may have assets predominantly comprising financial arrangements and the presence of any hedging arrangements, the overall arrangement contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument. Accordingly, I consider it is appropriate for resident investors to use the fair dividend rate method to calculate FIF income from their attributing interest in K2.

Scope of determination

This determination applies to Class A share investments in K2 held by New Zealand resident investors.

K2 Alternative Strategies NZ Portfolio Limited:

- is a company incorporated under the laws of the Cayman Islands;
- issues Class A shares, which are denominated in New Zealand dollars;
- invests in underlying assets predominantly consisting of cash and cash equivalents, derivative instruments, equity and debt securities, which provide exposure to a range of equity, credit, currency and commodity markets.

The investment in the Class A shares are subject to foreign currency hedging arrangements undertaken by K2 for the purposes of mitigating exchange rate risk for New Zealand investors.

These currency hedging arrangements are targeted to be highly effective (80-125%).

The determination is subject to the following conditions:

1. The investment in K2 is not part of an overall arrangement that seeks to provide investors a return that is equivalent to an effective New Zealand dollar denominated interest exposure.
2. In the event K2 directly holds equities offering a fixed rate of return or financial arrangements that provide funds to another person of an amount that is equal to or greater than 80% of K2's net asset value (NAV), it is expected that the level of such financial arrangements will be restored within 45 days (to less than 80%). Failure to restore the investment to this level would result in this determination ceasing to apply from the first day of the following Quarter.

3. K2 must be a foreign PIE equivalent in terms of section HM 3 of the ITA at all times. In the event that K2 ceases to meet the requirements set out in section HM 3 at the end of two consecutive quarters, this determination will cease to apply from the first day of the following quarter.

Interpretation

In this determination unless the context otherwise requires:

"Controlled foreign company" means controlled foreign company under section EX 1 of the Income Tax Act 2007;

"Fair dividend rate method" means fair dividend rate method under section YA 1 of the Income Tax Act 2007;

"Financial arrangement" means financial arrangement under section EW 3 of the Income Tax Act 2007;

"Foreign investment fund" means foreign investment fund under section YA 1 of the Income Tax Act 2007;

"Foreign PIE equivalent" means foreign PIE equivalent as defined under section HM 3 of the Income Tax Act 2007;

"K2" means K2 Alternative Strategies NZ Portfolio Limited;

"PIE" means a portfolio investment entity as set out in subpart HM of the Income Tax Act 2007;

"The investor" means the person who has a share in K2.

Determination

This determination applies to an attributing interest in a FIF, being a direct income interest in K2. This is a type of attributing interest for which the investor may use the fair dividend rate method to calculate FIF income from the interest.

Application Date

This determination applies for the 2017 and subsequent income years.

However, under section 91AAO(3B) of the Act, this determination also applies for an income year beginning before the date of this determination for a person who invests in K2 and who chooses that the determination applies for that income year.

Dated this 22nd day of December 2016.

John Trezise

Investigations Manager, Investigations and Advice

2017 International tax disclosure exemption ITR28

Introduction

Section 61 of the Tax Administration Act 1994 ("TAA") requires taxpayers to disclose interests in foreign entities.

Section 61(1) of the TAA states that a person who has a control or income interest in a foreign company or an attributing interest in a foreign investment fund ("FIF") at any time during the income year must disclose the interest held. In the case of partnerships, disclosure needs to be made by the individual partners in the partnership. The partnership itself is not required to disclose.

Section 61(2) of the TAA allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of the international tax rules (as defined in section YA 1) contained in the Income Tax Act 2007 ("the ITA").

To balance the revenue forecasting and risk assessment needs of the Commissioner with the compliance costs of taxpayers providing the information, the Commissioner has issued an international tax disclosure exemption under section 61(2) of the TAA that applies for the income year corresponding to the tax year ended 31 March 2017. This exemption may be cited as "International Tax Disclosure Exemption ITR28"("the 2017 disclosure exemption") and the full text appears at the end of this item.

Scope of exemption

The scope of the 2017 disclosure exemption is the same as the 2016 disclosure exemption.

Application date

This exemption applies for the income year corresponding to the tax year ended 31 March 2017.

Summary

In summary, the 2017 disclosure exemption **removes** the requirement of a resident to disclose:

- an interest of less than 10% in a foreign company if it is not an attributing interest in a FIF or if it falls within the $50,000 de minimis exemption (see section CQ 5(1)(d) and section DN 6(1)(d) of the ITA). The de minimis exemption does not apply to a person that has opted out of the de minimis threshold by including in the income tax return for the income year an amount of FIF income or loss.
- If the resident **is not** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country or territory, and the fair dividend rate or comparative value method of calculation is used.
- if the resident **is** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10% if the fair dividend rate or comparative value method is used for the interest. The resident is instead required to disclose the end-of-year New Zealand dollar market value of all such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

The 2017 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

Commentary

Generally, residents who hold an income interest or a control interest in a foreign company, or an attributing interest in a FIF are required to disclose these interests to the Commissioner. These interests are considered in further detail below.

Attributing interest in a FIF

A resident is required to disclose an attributing interest in a FIF if FIF income or a FIF loss arises through the use of one of the following calculation methods:

- attributable FIF income, deemed rate of return or cost methods; or
- fair dividend rate or comparative value methods, if the resident is a "widely-held entity" or
- fair dividend rate or comparative value methods, if the resident is not a widely-held entity and the country in which the attributing interest is incorporated or otherwise tax resident in a country or territory with which New Zealand **does not** have a double tax agreement in force as at 31 March 2017.

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The 40 countries or territories that New Zealand does have a double tax agreement in force as at 31 March 2017 are listed below.

Australia	France	Malaysia	South Africa
Austria	Germany	Mexico	Spain
Belgium	Hong Kong	Netherlands	Sweden
Canada	Viet Nam	Norway	Switzerland
Chile	India	Papua New Guinea	Taiwan
China	Indonesia	Philippines	Thailand
Czech Republic	Ireland	Poland	Turkey
Denmark	Italy	Russian Federation	United Arab Emirates
Fiji	Japan	Samoa	United Kingdom
Finland	Korea	Singapore	United States of America

For the avoidance of doubt, the term "double tax agreement" does not include tax information exchange agreements or collection agreements and is limited to the double tax agreements negotiated with the 40 countries or territories listed in this 2017 disclosure exemption.

No disclosure is required by non-widely-held taxpayers for attributing interests in FIFs that are income interests of less than 10% and are incorporated or otherwise tax resident in a tax treaty country or territory, if the fair dividend rate or comparative value methods of calculation are used.

A "widely-held entity" for the purposes of this disclosure is an entity which is a:

- portfolio investment entity (this includes a portfolio investment-linked life fund); or
- widely-held company; or
- widely-held superannuation fund; or
- widely-held group investment fund ("GIF").

Portfolio investment entity, widely-held company, widely-held superannuation fund and widely-held GIF are all defined in section YA 1 of the ITA.

The disclosure required, by widely-held entities, of attributing interests in FIFs which use the fair dividend rate or the comparative value method of calculation is that, for each calculation method, they disclose the end-of-year New Zealand dollar market value of investments split by the jurisdiction in which the attributing interest in a FIF is held, listed, organised or managed. In the event that tax residence is not easily determined, a further option of a split by currency in which the investment is held will also be accepted as long as it is a reasonable proxy - that is at least 90-95% accurate - for the underlying jurisdiction in which the FIF is held, listed, organised or managed. For example, investments denominated in euros will not be able to meet this test and so euro-based investments will need to be split into the underlying jurisdictions.

FIF interests

The types of interests that fall within the scope of section 61(1) of the TAA are:

- rights in a foreign company or anything deemed to be a company for the purposes of the ITA (eg, a unit trust)
- an entitlement to benefit from a foreign superannuation scheme, if a person acquired the interest before 1 April 2014 and treated the interest as a FIF interest in a return of income filed before 20 May 2013 and for all subsequent income years
- an entitlement to benefit from a foreign superannuation scheme, if a person's interest in the scheme was first acquired whilst the person was tax resident of New Zealand
- an entitlement to benefit from a foreign life insurance policy
- an interest in an entity specified in schedule 25, part A of the ITA

However, the following interests are exempt (under sections EX 31 to EX 43 of the ITA) from being an attributing interest in a FIF and do not have to be disclosed:

- an income interest of 10% or more in a CFC (although separate disclosure is required of this as an interest in a foreign company)
- certain interests in Australian resident companies listed on an approved index of the Australian Stock Exchange and required to maintain a franking account (refer to the IR871 form that can be found on Inland Revenue's website **www.ird.govt.nz** (keywords: other exemptions or IR871))

LEGISLATIONS AND DETERMINATIONS

- an interest in an Australian unit trust that has an New Zealand RWT proxy with either a high turnover or high distributions
- an interest of 10% or more in a foreign company that is treated as resident, and subject to tax, in Australia (although separate disclosure is required of this as an interest in a foreign company)
- a beneficial interest in a foreign superannuation scheme which was first acquired whilst the person was not a tax resident of New Zealand and which has not been treated as an attributing interest in a FIF by a person
- certain foreign pensions or annuities (see Inland Revenue's guide *Overseas pensions and annuity schemes (IR257)* for more information)
- an interest in certain venture capital investments in New Zealand resident start-up companies that migrate to a grey-list country
- an interest in certain grey-list companies owning New Zealand venture capital companies
- an interest in certain grey-list companies resulting from shares acquired under a venture investment agreement
- an interest in certain grey-list companies resulting from the acquisition of shares under an employee share scheme
- an interest held by a natural person in a foreign entity located in a country where exchange controls prevent the person deriving any profit or gain or disposing of the interest for New Zealand currency or consideration readily convertible to New Zealand currency.

De minimis

Interests in foreign entities held by a natural person not acting as a trustee also do not have to be disclosed if the total cost of the interests remains under $50,000 at all times during the income year. This disclosure exemption is made because no FIF income under section CQ 5 of the ITA or FIF loss under section DN 6 of the ITA arises in respect of these interests.

This de minimis exemption does not apply to a person who has opted out of the de minimis threshold by including in the income tax return for the year a FIF income or loss. Please note that a person opting out of the de minimis threshold needs to include FIF income or loss in any of the four subsequent income years even if the total cost of all attributing interests is $50,000 or less. Even after four years a person must continue to apply the FIF rules if they hold any of the shares they held at the time of opting out.

Format of disclosure

The forms for the disclosure of FIF interests are as follows:

- IR443 form for the deemed rate of return method
- IR445 form for the fair dividend rate method (for widely-held entities)
- IR446 form for the comparative value method (for widely-held entities)
- IR447 form for the fair dividend rate method (for individuals or non-widely-held entities)
- IR448 form for the comparative value method (for individuals or non-widely-held entities)
- IR449 form for the cost method
- IR458 electronic form for the attributable FIF income method (this form can also be used to make electronic disclosures for all other methods).

It is now possible to download a spreadsheet as a working paper or complete the disclosures online. If you're downloading the spreadsheet you will be able to save it as a working paper on your computer and when completed submit the form by using Inland Revenue's online services.

You will still be able to complete the disclosure online without downloading a spreadsheet by directly entering the disclosure online.

The IR445 and IR446 forms, which reflect the disclosure for fair dividend rate and comparative value for *widely-held entities*, must be filed online. As discussed above this disclosure is by country rather than by individual investment as is the general requirement of section 61 of the TAA. In order to be exempt from the general requirements, the alternative disclosure must be made electronically.

The IR447, IR448 and IR449 forms, applying to the fair dividend rate and comparative value methods for *individuals or non widely-held entities* as well as the cost method for all taxpayers, may be completed online.

As noted above, all of the above disclosures can now be filed using the IR458 electronic disclosure.

The online forms can be found at **www.ird.govt.nz** "Get it done online", "Foreign investment fund disclosure".

Income interest of 10% or more in a foreign company

A resident is required to disclose an income interest of 10% or more in a foreign company. This obligation to disclose applies to all foreign companies regardless of the country of residence. For this purpose, the following interests need to be considered:

a) an income interest held directly in a foreign company

b) an income interest held indirectly through any interposed foreign company

c) an income interest held by an associated person (not being a controlled foreign company) as defined by subpart YB of the ITA.

To determine whether a resident has an income interest of 10% or more for CFCs, sections EX 14 to EX 17 of the ITA should be applied. To determine whether a resident has an income interest of 10% or more in any entity that is not a CFC, for the purposes of this exemption, sections EX 14 to EX 17 should be applied to the foreign company as if it were a CFC.

Format of disclosure

Disclosure of all interests in a controlled foreign company is required using a *Controlled foreign companies disclosure (IR458)* form. This form, which involves uploading a prescribed spreadsheet, can cater for up to 500 individual disclosures.

The IR458 form must be completed online at **www.ird.govt.nz** (keyword: ir458). Please note that electronic filing is a mandatory requirement for CFC disclosure.

Overlap of interests

It is possible that a resident may be required to disclose an interest in a foreign company which also constitutes an attributing interest in a FIF. For example, a person with an income interest of 10% or greater in a foreign company that is not a CFC is strictly required to disclose both an interest held in a foreign company and an attributing interest in a FIF.

To meet disclosure requirements, only one form of disclosure is required for each interest. If the interest is an attributing interest in a FIF, then the appropriate disclosure for the calculation method, as discussed previously, must be made.

In all other cases, where the interest in a foreign company is not an attributing interest in a FIF, the IR458 for controlled foreign companies must be filed.

Interests held by non-residents and transitional residents

Interests held by non-residents and transitional residents in foreign companies and FIFs do not need to be disclosed.

This would apply for example to an overseas company operating in New Zealand (through a branch) in respect of its interests in foreign companies and FIFs; or to a transitional resident with interests in a foreign company or an attributing interest in a FIF.

Under the international tax rules, non-residents and transitional residents are not required to calculate or attribute income under either the CFC or FIF rules. Therefore disclosure of non-residents' or transitional residents' holdings in foreign companies or FIFs is not necessary for the administration of the international tax rules and so an exemption is made for this group.

Persons not required to comply with section 61 of the Tax Administration Act 1994

This exemption may be cited as "International Tax Disclosure Exemption ITR28".

1. Reference

This exemption is made under section 61(2) of the Tax Administration Act 1994 ("TAA"). It details interests in foreign companies and attributing interests in FIFs in relation to which any person is not required to comply with the requirements in section 61 of the TAA to make disclosure of their interests, for the income year ended 31 March 2017.

2. Interpretation

For the purpose of this disclosure exemption:

- to determine an income interest of 10% or more, sections EX 14 to EX 17 of the Income Tax Act 2007 ("ITA") apply for interests in controlled foreign companies. In the case of attributing interests in FIFs, those sections are to be applied as if the FIF were a CFC, and
- double tax agreement means a double tax agreement in force as at 31 March 2017 in one of the 40 countries or territories as set out in the commentary.

The relevant definition of "associated persons" is contained in subpart YB of the ITA.

Otherwise, unless the context requires, expressions used have the same meaning as in section YA 1 of the ITA.

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3. Exemption

i. Any person who holds an income interest of less than 10% in a foreign company, including interests held by associated persons, that is not an attributing interest in a FIF, or that is an attributing interest in a FIF in respect of which no FIF income or loss arises due to the application of the de minimis exemption in section CQ 5(1)(d) or section DN 6(1)(d) of the ITA, is not required to comply with section 61(1) of the T AA for that interest and that income year.

ii. Any person who is a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct interest of 10% or more in a foreign company that is not a foreign PIE equivalent, and uses the fair dividend rate or comparative value calculation method for that interest, is not required to comply with section 61(1) of the TAA in respect of that interest and that income year, if the person discloses the end-of-year New Zealand dollar market value of investments, in an electronic format prescribed by the Commissioner, split by the jurisdiction in which the attributing interest in a FIF is held or listed.

iii. Any person who is not a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct income interest of 10% or more, and uses the fair dividend rate or comparative value calculation method is not required to comply with section 61(1) of the TAA in respect of that interest and that income year, to the extent that the FIF is incorporated or tax resident in a country or territory with which New Zealand has a double tax agreement in force at 31 March 2017.

iv. Any non-resident person or transitional resident who has an income interest or a control interest in a foreign company or an attributing interest in a FIF in the income year corresponding to the tax year ending 31 March 2017, is not required to comply with section 61(1) of the TAA in respect of that interest and that income year if either or both of the following apply:

- no attributed CFC income or loss arises in respect of that interest in that foreign company under sections CQ 2(1)(d) or DN 2(1)(d) of the ITA; and/or
- no FIF income or loss arises in respect of that interest in that FIF under sections CQ 5(1)(f) or DN 6(1)(f) of the ITA.

This exemption is made by me acting under delegated authority from the Commissioner of Inland Revenue pursuant to section 7 of the TAA.

This exemption is signed on the 7 March 2017.

Dr Peter Loerscher
Principal Advisor (International Tax)

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

Unsuccessful application to set aside statutory demand after taxpayer's breach of binding agreement with the Commissioner regarding tax debt

Case	Elementary Solutions Ltd v Commissioner of Inland Revenue [2017] NZHC 32
Decision date	27 January 2017
Act(s)	Companies Act 1993 ss 289, 290, 291 Contractual Remedies Act 1979 s 7 Tax Administration Act 1994 ss 6, 6A, 7
Keywords	Binding agreements, statutory demands, application to set aside, contractual remedies, estoppel, delegated authority, liquidations

Summary

Elementary Solutions Ltd ("the applicant") was unsuccessful in its application to set aside the Commissioner of Inland Revenue's ("the Commissioner") statutory demand for unpaid taxes. The Court held that the parties had reached a binding agreement, where the Commissioner would not pursue the debt pending the outcome of a separate defamation proceeding. The Court held that an essential term of the agreement was that for the next 12 months the applicant and its director meet their ongoing tax obligations. When they failed to do so, the Court held that the Commissioner was entitled to cancel the agreement and pursue recovery of the applicant's tax debt.

Impact

This judgment makes it clear that the Commissioner can enter a binding agreement under which she may accept payment of less than the full amount of tax that she considers is lawfully due (and assessed).

It is not clear whether, for such a binding agreement, consideration is required and the rule in *Foakes v Beer* (1884) App Cas 605 that a promise to pay part of a debt is not consideration for forgiveness of the balance applies.

The Commissioner may be estopped from serving a statutory demand where an estoppel defence is made out: an expectation is created through the actions or representation of the Commissioner, the expectation is relied on, detriment will be suffered if the expectation is departed from and it would be unconscionable for the Commissioner to depart from the expectation.

Inland Revenue staff can bind the Commissioner only if they have delegated authority. Here the High Court considered that there is nothing to suggest that an acting manager does not have the same authority and powers as an ordinary manager.

Facts

The applicant brought proceedings to set aside a statutory demand dated 18 February 2016 issued by the Commissioner for unpaid taxes.

The applicant did not dispute its liability for any of the taxes, but said that the demand should be set aside under s 290(4)(a) of the Companies Act 1993 ("the Act"). The applicant contended that it made an arrangement with the Commissioner in May 2013 for enforcement of its tax debt to be stayed pending the outcome of a separate defamation proceeding, for which the gross proceeds would be paid to the Commissioner. The applicant said the statutory demand was in breach of contract and that the Commissioner was estopped from claiming payment. The applicant also ran arguments as to counterclaim under s 290(4)(b) and other grounds under s 290(4)(c).

The Commissioner denied making any binding arrangements with the applicant in May 2013 but stated that she entered into an agreement with the applicant and its director, Daniel Ayers, in September 2013 to stay enforcement against them in return for receiving the proceeds of the defamation case. The Commissioner said that it was a term of the agreement that they would meet their ongoing tax obligations and as they breached these conditions, she was entitled to cancel the agreement.

Setting aside under s 290

His Honour noted that the general purpose of s 290 is to allow statutory demands to be set aside. On application under s 290(4)(a) the onus is on the applicant to show a substantial dispute, and that there is a fairly arguable basis for it to succeed. He noted that the Court does not resolve disputed questions of fact on affidavits and if there is a genuine dispute it should be more properly decided in other proceedings.

The Commissioner's ability to enter into agreements for the collection of taxes

The applicant's grounds for the dispute were based on the argument that it had entered into a binding contact with the Commissioner for the payment of its tax arrears, and that the Commissioner was estopped from issuing the demand because of representations by her officers.

Associate Judge Bell stated that that there was no dispute that the Commissioner was able to enter into binding agreements under which she may accept payment of less than the full amount of tax due, and that this was consistent with ss 6(1) and 6A(2) and (3) of the Tax Administration Act 1994 ("TAA"). The Judge also noted that under s 7 of the TAA the Commissioner may delegate her powers, and that officers can bind the Commissioner only if they have the delegated authority to do so. His Honour said that ordinary principles of contract law, agency law and the law as to equitable estoppel apply.

The meeting of 8 May 2013 and following events

Since 2009 the applicant had been a non-compliant taxpayer. Towards the end of 2012 the Commissioner advised that a statutory demand would be served, which occurred on 15 April 2013.

On 8 May 2013, a meeting took place between two collections officers on behalf of the Commissioner and the applicant's director, Mr Ayers, and his tax agent. The parties disagreed as to whether a binding agreement had been reached at that meeting, with the applicant asserting that the Commissioner had agreed to cease enforcement action in return for receiving the proceeds of the defamation action. The collections officers referred to the need to obtain an appropriate undertaking from the applicant's solicitor, which was not forthcoming.

The Judge noted that neither collections officer had the delegated authority to bind the Commissioner as the arrangement exceeded their level of financial delegation. A further meeting was held on 27 May 2013, where it was discussed that recovery options would need to be discussed with the Area Manager. Mr Ayers was also asked to supply further information, including a report from a health professional.

His Honour noted that the Commissioner's evidence appeared more persuasive, but added that there were obstacles to the applicant's claim that there was a binding agreement concluded on 8 May 2013. First, even Mr Ayers accepted the Commissioner's requirements for his defamation lawyer to give an undertaking so as to assure payment of the litigation proceeds. Second, the collections officers did not have the authority to enter into an agreement binding the Commissioner given the level of unpaid taxes.

The Court held that equitable estoppel was not available as on the facts of the case there is nothing in the evidence to suggest the collections officers were clothed with any ostensible authority to bind the Commissioner, and the arrangements were always subject to obtaining the solicitor's undertaking.

The meeting of 17 September 2013

A further meeting took place on 17 September 2013 between Mr Ayers and the Group Manager Collections and Collections Principal Advisor. Mr Ayers contended that he had never conceded that the proposed arrangement from the previous meeting had ended. Mr Ayers did not accept that he entered into a new agreement on 17 September.

The Group Manager acknowledged that Mr Ayers may have left the 8 May meeting under the impression an agreement had been reached, even though Inland Revenue's position was that none had.

Various email correspondence was exchanged between Mr Ayers and the Group Manager and, even if there was uncertainty as to what was discussed on 17 September, that was cleared up by the emails. The email exchange shows that Mr Ayers, the applicant and the Inland Revenue entered into a binding agreement. The Judge considered that there was no difficulty with questions of consideration as the agreement resolved a dispute – whether an agreement was made on 8 May 2013. Whatever prior discussions that had taken place had been replaced by a new agreement, with both Mr Ayers and the applicant being parties to the agreement giving cross-undertakings as to each other's tax obligations.

The agreement required the following from the applicant and Mr Ayers:

1. Ongoing compliance with tax obligations for the next 12 months;
2. Continuing with the defamation case, which arose implicitly from the promise to pay from the litigation proceeds; and
3. Voluntary payments as and when able.

The Court did not accept Mr Ayers' claim that the first term was subject to a condition that his compliance was not to be impeded by his health.

Cancellation of the agreement of September 2013

His Honour noted that the only way to cancel the agreement was for a breach under s 7 of the Contractual Remedies Act 1979 ("CRA").

The Commissioner relied on failures to comply with tax obligations for the following 12 months as the basis for cancelling the contract. The applicant failed to file three GST returns by the due date and Mr Ayers filed his 2013 income tax return late. The Court held that in accordance with s 7(4)(a) of the CRA it was an essential term of the contract that tax obligations must be kept up to date for the next 12 months. Accordingly, it did not matter how minor the breaches were.

On 19 January 2016 the Commissioner advised the applicant that she no longer considered herself bound by the earlier agreements for payment to be deferred. The Court held that notice was appropriately given under s 8 of the CRA. As at 19 January 2016 the taxes owing under the assessments referred to earlier had not been fully paid.

The Court held that the Commissioner had not affirmed the contract in any of its subsequent correspondence.

The Court also noted that unpaid GST that had accrued in the 12 months after 17 September 2013 was not part of the moratorium for the historic debt under agreement, and the Commissioner was entitled to recover it without first cancelling the agreement.

The applicant's estoppel argument

The applicant argued that the respondent was estopped from serving the statutory demand because of the representations made in the September 2013 meeting, that the applicant had acted to its detriment in continuing with the defamation proceeding and incurred legal costs. The Judge concluded that any estoppel argument would fail in light of the respondent's entitlement to cancel the contract and no longer be bound by any representations she had made. Further, the meeting also set expectations for the applicant (to meet its ongoing tax obligations for the next 12 months) and when it failed to meet those expectations, in circumstances where the Commissioner was entitled to cancel the agreement, it cannot be unconscionable for the Commissioner to move from the arrangement made.

His Honour concluded he was not persuaded that there was a substantial dispute under s 290(4)(a) of the Act whether the debt is owing or due.

Counterclaim under s 290(4)(b)

The applicant also raised a counterclaim against the Commissioner for lost earnings as a result of the Commissioner's breach of the alleged May 2013 agreement by filing and serving a liquidation application in June 2013. The Court held that as this was raised for the first time in the applicant's submissions, the Commissioner would be prejudiced by this issue being raised late. His Honour further noted that the claim was implausible on questions of causation and damage, as the report from the health professional included in Mr Ayers' affidavit was that Mr Ayers had said that the initial defamation (2-3 years earlier) had had a serious effect on the company and Mr Ayers' health problems had also affected its business for some time already. His Honour noted that this was against very heavy tax liabilities that were long overdue. The Court considered that any suggestion that the Commissioner caused the downfall of the company by her liquidation application is fanciful.

Other grounds under s 290(4)(c)

The applicant asserted that the statutory demand was an abuse of process.

The Judge noted that the applicant had been in default of its tax obligations since 2009. The Court further noted that any difficulties in funding litigation and taxes were there at the time before the statutory demand in April 2013 and the demand did not cause any difficulties, it merely exposed them. The Court concluded that there were no circumstances that made it unjust for non-compliance with the demand to lead to a presumption of insolvency.

Decision

The Court held that:

1) The application to set aside the statutory demand was dismissed.
2) Under s 291(1)(a) of the Act, the applicant is to pay the Commissioner $343,182.30 by 24 February 2017.
3) The time for complying with the statutory demand expires on 24 February 2017.
4) The applicant is to pay the costs of the application.

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