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PUB00223: Draft Questions We've Been Asked: Income Tax – Deductibility of seismic assessment costs

Introduction

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the draft Questions We've Been Asked *Income Tax – Deductibility of seismic assessment costs* (the draft).

General Comments

2. The Law Society agrees that the proper method for determining whether the capital limitation in section DA 2 of the Income Tax Act 2007 applies to prevent an amount paid in respect of detailed seismic assessment (DSA) costs being deductible is to consider the *BP Australia*[1] factors.

3. The Law Society agrees with the manner in which these factors have been analysed in the draft. However, the Law Society considers that the relationship with feasibility expenditure is more relevant than contemplated by the draft. The Law Society contends that the expenditure incurred in obtaining a DSA is part of the expenditure incurred in determining the feasibility of the different options for addressing seismic weakness in a building and so should be determined in accordance with *Interpretation Statement IS 08/02: Deductibility of feasibility expenditure.*

4. With this in mind, the Law Society notes that it may be premature to finalise the draft while the litigation in the *Trustpower*[2] matter continues, as the decision of the Supreme Court will have a bearing on the proper treatment of feasibility expenditure.

5. Notwithstanding the Law Society's views on the draft, it is concerned that the lack of tax deductibility for the costs of strengthening buildings may lead to landlords relinquishing unsafe buildings, potentially leaving them abandoned or derelict. The costs of strengthening buildings are not insignificant and, following the reduction of the depreciation rate for buildings to 0%, now constitutes black-hole expenditure. Accordingly, the Law Society suggests that this is an

[1] *BP Australia Ltd v FCT* [1965] 3 All ER 209
[2] *CIR v Trustpower Ltd* [2015] NZCA 253

issue that ought to be considered further and if necessary dealt with by way of legislative amendment.

Specific comments

6. The Commissioner states at paragraph 31 of the draft that “the Commissioner considers that feasibility expenditure in the context of this QWBA is distinguishable from the type of feasibility contemplated in IS 08/02”. The reason given is that IS 08/02 apparently contemplates feasibility expenditure that is incurred in evaluating one or more proposals for acquisition or development of a new asset.

7. Feasibility expenditure is described in paragraph 23 of IS 08/02 as “expenditure incurred by a taxpayer for determining the practicability of a new proposal”. That paragraph goes on to note that “a typical feasibility exercise would involve determining *whether a particular course of action should be taken* or certain capital assets acquired or developed” [emphasis added] and that “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 relate to proposals to expand the existing business or commence a new business”.

8. It is implicit from those comments that the scope of feasibility expenditure is not necessarily as tightly circumscribed as suggested in the draft. The Law Society suggests that section of the draft be expanded to consider more fully the relationship between expenditure on obtaining a DSA and feasibility expenditure.

9. In any event, the Law Society considers that it is arguable that expenditure for the purpose of obtaining a DSA *is* incurred in evaluating a proposal for the development of a new asset. DSAs are usually required when a building has been identified as an earthquake-prone building. The Law Society understands that once a building is identified as earthquake prone existing tenants may seek to terminate their leases on the basis that the building is unsafe for their staff/customers. The building may become un-tenantable. A landlord in this situation may well be considered to have discontinued their previous business on the basis that the income producing asset is defunct. That landlord is in reality faced with the decision of developing a new (probably enhanced) asset that will attract tenants or abandon the investment altogether and dispose of the defunct asset. This exercise would involve determining whether a particular course of action should be taken or certain capital assets acquired or developed as contemplated by IS 08/02.

Conclusion

10. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours faithfully

Chris Moore
President