



SUBMISSION: Black hole and feasibility expenditure

Date: 06/07/17
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A handwritten signature in black ink, appearing to read "Andrew Curtis", with a long horizontal stroke extending to the right.

(Andrew Curtis, CEO IrrigationNZ)

IrrigationNZ would like to engage with the IRD over the points made in this submission.

IRRIGATION NZ

1. IrrigationNZ (INZ) is a national body that promotes excellence in irrigation. INZ represents the interests of over 3,600 irrigators (including irrigation schemes and individual irrigators) and this totals over 50% of NZ's irrigated area. It also represents the interests of the majority of irrigation service providers (over 150 manufacturers, distributors, design and install companies and consultancies).

OVERVIEW

2. We appreciate the efforts made by the Government to address the issues arising in relation to the deductibility of black hole and feasibility expenditure, which have a large impact on our members and developing irrigation schemes.
3. Specifically, we agree that the lack of availability of deductions for such expenditure impacts our members' economic decision making when considering ideas and proposals for new irrigation schemes, as well as the modernisation and expansion of existing infrastructure. This is harmful to the New Zealand economy. Irrigation currently contributes \$2.4 billion annually at farm gate, with future development this is forecast to grow too \$3.5 billion by 2021. Irrigation is also one of the government's current economic development priorities.

4. Despite this, we do have some concerns as to design of the proposed new rules. We therefore appreciate the opportunity to comment on the Government's black hole and feasibility expenditure discussion document.

SUBMISSION

Nature of irrigation schemes

5. Irrigation schemes are typically established as a co-operative or a limited liability company run on co-operative principles. Both have the sole purpose of developing and operating the irrigation scheme. Typically, the company is operated as a cost sharing entity with the aim of being cash flow neutral over time. The full cost of funding and operating the scheme is on charged to the members over its life.
6. From time to time schemes raise new capital as debt or equity from their shareholder members. This capital is usually used to pay for capital expenditure and developing the scheme. However, many schemes have ongoing feasibility costs to help them plan for future requirements. These costs are generally funded through increased water charges which are treated as taxable income by the scheme and deductible expenditure by the farmer shareholders.
7. Where the water charge income is used to fund non-deductible feasibility and black hole expenditure, the scheme suffers tax leakage which pushes up the members' water charges and the deductions claimed by those members. This does not materially alter the level of revenue collected by Inland Revenue, but it creates significant compliance costs for irrigation schemes which need to maintain a neutral cash flow position.
8. The issue is universally problematic for irrigation schemes and has a negative impact on investment and the ongoing efficiency of the sector.

Aligning accounting and tax treatment

9. The differences in treatment of feasibility expenditure between accounting and tax create an increased compliance burden for irrigation schemes, which would be required to calculate their feasibility expenditure twice using both accounting and tax concepts. Aligning the accounting and tax treatments would help to ease this burden.
10. Based on the experience of our members, irrigation schemes usually begin to capitalise for financial reporting purposes at or around the time at which a commitment is made to acquire or develop the relevant asset. Therefore a deduction for expenditure based on accounting treatment should not significantly increase the amount of expenditure that would be deductible.
11. Irrigation schemes generally have a preference to capitalise expenditure in respect of an asset and have that expenditure reflected in the scheme's balance sheet, rather than having such expenditure reflected in a statement of profit and loss. This is important for irrigation schemes to ensure they meet their lending requirements. This preference provides a natural counterweight to any other incentive to delay the point at which expenditure is capitalised, in order to obtain an upfront deduction, providing the Commissioner with a degree of comfort that financial reporting is unlikely to be manipulated in order to achieve tax outcomes.

12. Finally, we are also concerned that mismatches between the accounting and tax treatments may give rise to gaps where expenditure will remain non-deductible either upfront, or as part of the cost of depreciable property. This might occur, for example, if pre-commitment expenditure is capitalised for accounting or post-commitment expenditure is expensed for accounting and such expenditure did not form part of the cost of depreciable property.
13. We consider that the new rules should not allow for the possibility of such mismatches. By relying on accounting treatment only should eliminate the possibility of further black hole expenditure arising, in addition to reducing the compliance burden on irrigation schemes.

Feasibility expenditure – increase de minimis threshold

14. We support the inclusion of a *de minimis* threshold below which feasibility expenditure should be deductible, whether or not the expenditure is expensed under IFRS. This will significantly reduce compliance costs for smaller irrigation schemes incurring only minimal feasibility expenditure.
15. However, we submit that this *de minimis* threshold should be increased to \$50,000. We consider this increased threshold is reasonable, given that under the proposed rules that taxpayers would otherwise be required to apply IFRS in order to claim a deduction, even where they do not apply IFRS for reporting purposes. The requirement for a taxpayer to apply IFRS for this purpose only can be an expensive exercise as they will need to obtain accounting advice.

Expenditure on an abandoned asset – residual black hole expenditure

16. We appreciate and support the proposal to allow a deduction for expenditure incurred on an abandoned asset. We agree with officials that black hole expenditure undermines economic efficiency and should be eliminated as much as possible.
17. However, we are concerned that the proposed deduction for black hole expenditure will only have limited impact in resolving the problem of black hole expenditure for irrigation schemes. Specifically, black hole expenditure will still arise in circumstances where expenditure is capitalised under IFRS but Inland Revenue may not consider that expenditure to form part of the cost of resulting depreciable property.
18. For irrigation schemes the requirement that the expenditure incurred would have formed part of the cost of an item that would have been depreciable property if it had been completed will result in significant black hole expenditure. This is because a portion of an irrigation scheme's capital expenditure relates to assets that may not be depreciable property under the current rules. The proposal as currently drafted will therefore be of limited benefit in respect of assets abandoned by irrigation schemes.

19. In our view, such expenditure should be deductible in the same manner and for the same reasons as other expenditure would be deductible under the current proposals. In order to achieve this, the deduction for black hole expenditure should be broadened and the requirement that the item would have been depreciable property if it had been completed should be removed. This will ensure that black hole expenditure will not arise in relation to abandoned assets and therefore the decision to abandon will not be adversely affected by tax outcomes.

Application date

20. We submit that the proposals around the deductibility of feasibility expenditure should be retrospective in nature, operating at least from the date of the Supreme Court's decision in *Trustpower*. If this was not the case, taxpayers would be required to understand and apply three different sets of rules in relation to the deductibility of feasibility expenditure in only a few years (being the pre-*Trustpower* position, the post-*Trustpower* position, and the position that results from the proposed changes).

SUBMISSION ENDS