

Tax Alert

A focus on topical tax issues – August 2013



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Clarity, controversy, or both: Inland Revenue's finalised guidance on tax avoidance

Campbell Rose and Matthew Scoltock

Introduction and high level observations

The tax community has at last received the Commissioner of Inland Revenue's long-awaited finalised interpretation statement on tax avoidance, "Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007" (the Interpretation Statement). The Interpretation Statement has had a nearly 10 year gestation, and comes 23 years since Inland Revenue's previous policy statement on tax avoidance.

One of the issues affecting timing has been the release of significant court decisions on tax avoidance. The need to factor in the court's pronouncements has caused delays in producing progressive drafts of the Interpretation Statement. This issue remains even with the release of the final statement - the impending appeal of the Court of Appeal's much-debated decision in *Alesco New Zealand Ltd v Commissioner of Inland*

*Revenue*¹ (*Alesco*) concerning optional convertible note financing will provide an opportunity for the Supreme Court to again apply the "Parliamentary contemplation" test for tax avoidance established in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*² (*Ben Nevis*). No doubt tax advisers and taxpayers alike will be interested to see if Justice Susan Glazebrook – prior to her appointment to the bench, a reputable tax lawyer and author of an authoritative text on the financial arrangements rules – is among the panel hearing the appeal.

On the positive side, the Interpretation Statement confirms the framework that Inland Revenue in all its guises (Assurance/Investigators, Litigation Management, the Disputes Review (formerly Adjudication) Unit and Taxpayer Rulings) will apply in considering issues of tax avoidance. We understand Inland Revenue will be taking steps to ensure staff are familiar with the contents of the Interpretation Statement and its approach to analysing avoidance issues, to ensure consistency. This will be helpful for taxpayers in preparing ruling applications or documents as part of the audit/disputes process.

What would have been more helpful is further examples of where Inland Revenue considers the line should be drawn by reference to real-world examples that are

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¹ [2013] NZCA 40.

² [2008] NZSC 115, [2009] 2 NZLR 289.



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not at the extreme ends of the spectrum. These could presumably have been drawn from unsuccessful ruling applications, and avoidance disputes that have not proceeded beyond the Adjudication Unit. However, Inland Revenue does not see their role as giving guidance on issues close to the line.

Much of the Interpretation Statement's 130 pages comprises a thorough and unobjectionable summary of general anti-avoidance principles, established and evolved by the courts over the years and particularly in more recent times. In developing these principles, the courts have made it clear that Parliament has chosen not to deliver certainty in this area, and so neither should the courts strive to create any greater certainty. It is difficult to argue with the proposition that the court's task in any particular avoidance case is to resolve the dispute on the facts that are before it. However, the Supreme Court's core test of "Parliamentary contemplation" (discussed below) has generated significant uncertainty in terms of its precise meaning and application – to be fair to Inland Revenue, the current uncertainty is not necessarily of its making.

That said, in this article we have highlighted some of the more debatable aspects of Inland Revenue's perspective on those principles. These serve as a reminder that general anti-avoidance is not a static concept (what the courts might have viewed as acceptable 10 years ago is not necessarily immune today), and that avoidance issues turn largely on their particular facts (evidential consistency and credibility are key to successfully defending an anti-avoidance challenge). They also illustrate the value of engaging with Inland Revenue – whether through a binding ruling application, or a less formal mechanism – at the time of implementing a transaction: the aim being to safeguard, to the best extent possible, against what is a persistently murky and fluid avoidance boundary.

Flowcharts from the Interpretation Statement, illustrating the steps that Inland Revenue will take in its general anti-avoidance analysis, are set out at the end of this article.

Contemplating what Parliament contemplated

The Parliamentary contemplation test – established by the Supreme Court in *Ben Nevis* and now forming the crux of any general anti-avoidance analysis – has proved the most challenging aspect of the courts' current approach on avoidance issues. This ultimate question was framed by the Court as being whether, looking at the arrangement in a commercially and economically realistic way, the arrangement made use of the specific tax rule in a manner that is consistent with Parliament's purpose. If not, the arrangement will involve tax avoidance.

Importantly, the Interpretation Statement has confirmed that the first step in this enquiry is ascertaining Parliament's purpose – prior to considering the "commercial reality and economic effects" of the arrangement. The Interpretation Statement notes that this is consistent with comments in *Ben Nevis* that the approach must be "firmly grounded in the statutory language".

This is sensible – the most appropriate starting point in determining what Parliament contemplated must logically be the actual words that Parliament used. The Interpretation Statement also clarifies that identifying economic effects of an arrangement does not involve identifying a different arrangement that is economically equivalent (i.e. an 'economic substance' approach).

However, this is in stark contrast to the approach we have seen taken on many investigations, which usually commence with intense fact-gathering. There is no initial interchange of views with taxpayers regarding what Parliament's purpose appears to be, and information requests do not appear to be guided by that identified purpose, as the Interpretation Statement requires. Often Inland Revenue's avoidance analysis commences by identifying purported artificiality and contrivance, then asserting a different "economic reality" from the legal form, and finally contending that the tax outcome is therefore not what Parliament contemplated. It is hoped that the revised approach mandated by the Interpretation Statement – assuming it is followed by relevant Assurance/Investigations staff - will result in a more appropriate and measured invocation of the general anti-avoidance provision in an investigations/audit context.



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A further more subtle issue with the Parliamentary contemplation test is the precise nature of the inquiry. In its subsequent judgment in *Penny & Hooper*³, the Court said that the inquiry is whether the taxpayer altered the incidence of tax in a way that was not within Parliament's contemplation. This is consistent with the formulation in *Ben Nevis*, namely whether "it is apparent that the taxpayer has used the specific provision (...) in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision".

The view taken in the Interpretation Statement is different, and more closely aligned with the High Court's decision in *BNZ Investments*⁴. There, the Court interpreted the Parliamentary contemplation test as asking whether, if Parliament had foreseen the particular arrangement when the tax rule was enacted, the arrangement would have fallen within the scheme and purpose of the rule⁵.

This is unquestionably the most baffling and problematic aspect of the Parliamentary contemplation test. As the courts have rightly pointed out, Parliament cannot be expected to have actually considered a particular arrangement. The challenge then is to ascertain what Parliament contemplated in a hypothetical exercise.

On the approach taken in the Interpretation Statement, there is considerable room for judicial license in deciding whether Parliament "would have" hypothetically contemplated the particular tax arrangement and tax outcomes in question. We believe this is more likely to result in the general anti-avoidance rule plugging legislative gaps and re-writing defective legislative policy, rather than leaving that task more appropriately to Parliament itself. The proper enquiry should be what did Parliament contemplate and is the tax outcome (through use of the particular tax rule in question) something that therefore "cannot" (hypothetically) have been within the contemplation and purpose of Parliament.

Finally, in terms of judicial application of the Parliamentary contemplation test, it is clear that taxpayers and advisers alike are waiting for a case closer to the boundary to be decided, in order for the courts

to provide more fulsome guidance on how to draw the line. The *Ben Nevis*, *Penny and Hooper* and *Alesco* cases all deal with core concepts of income derivation and expenditure incurrence. It will be interesting to see if the courts hear cases going forward dealing with less fundamental concepts and issues relating to regimes that are more specifically prescribed in legislative terms.

This could involve dealing with more complex regimes, which tend to be more heavily prescribed and involve statutory or tax constructs rather than commercial concepts (and therefore, arguably, a clearer articulation in the statute of Parliament's purpose). Examples could include regimes such as thin capitalisation, look-through company/limited partnership, tax consolidation and CFC/FIF.

In this respect the Interpretation Statement notes that, tax concepts/fictions may not necessarily have any real-world commercial or economic equivalent. This means that ascertaining Parliament's purpose first assumes particular importance, and reducing an arrangement in that context to its most fundamental level of economic substance will not necessarily aid an understanding of whether Parliament's purpose for the tax concept is given effect.

³ *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433.

⁴ *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582.

⁵ See paragraphs 18, 26 and 253 of the IS.

“What would have been more helpful is further examples of where Inland Revenue considers the line should be drawn...”

The need (or not) for counter-factual analysis

One of the troubling aspects of the Court of Appeal's decision in *Alesco* is the Court's view that a counter-factual analysis is not required in order to determine whether tax has been avoided. Such an analysis involves determining what other arrangement would the taxpayer have entered into, and how does the tax outcome(s) of that arrangement compare with the outcome(s) actually obtained (i.e. is any tax, which would otherwise have been payable, avoided).

The Interpretation Statement, as one would expect, adopts an approach consistent with the Court of Appeal's decision in *Alesco* on this issue. This area of Inland Revenue's framework will need to be revisited if the Supreme Court takes a different view on the *Alesco* appeal. In this respect, it is noteworthy that a counter-factual approach is required in Australia, and appears to be the method by which tax avoidance will be analysed under the proposed general anti-avoidance rule in the United Kingdom⁶.

In the absence of a counter-factual, the question of what is 'tax avoidance' is left begging and there is arguably a risk of the general anti-avoidance rule being applied to target 'undesirable' arrangements in a punitive manner.

Commissioner's power of reconstruction

The power of the Commissioner to "counteract" tax advantages obtained under a voided tax avoidance arrangement is a broad one.

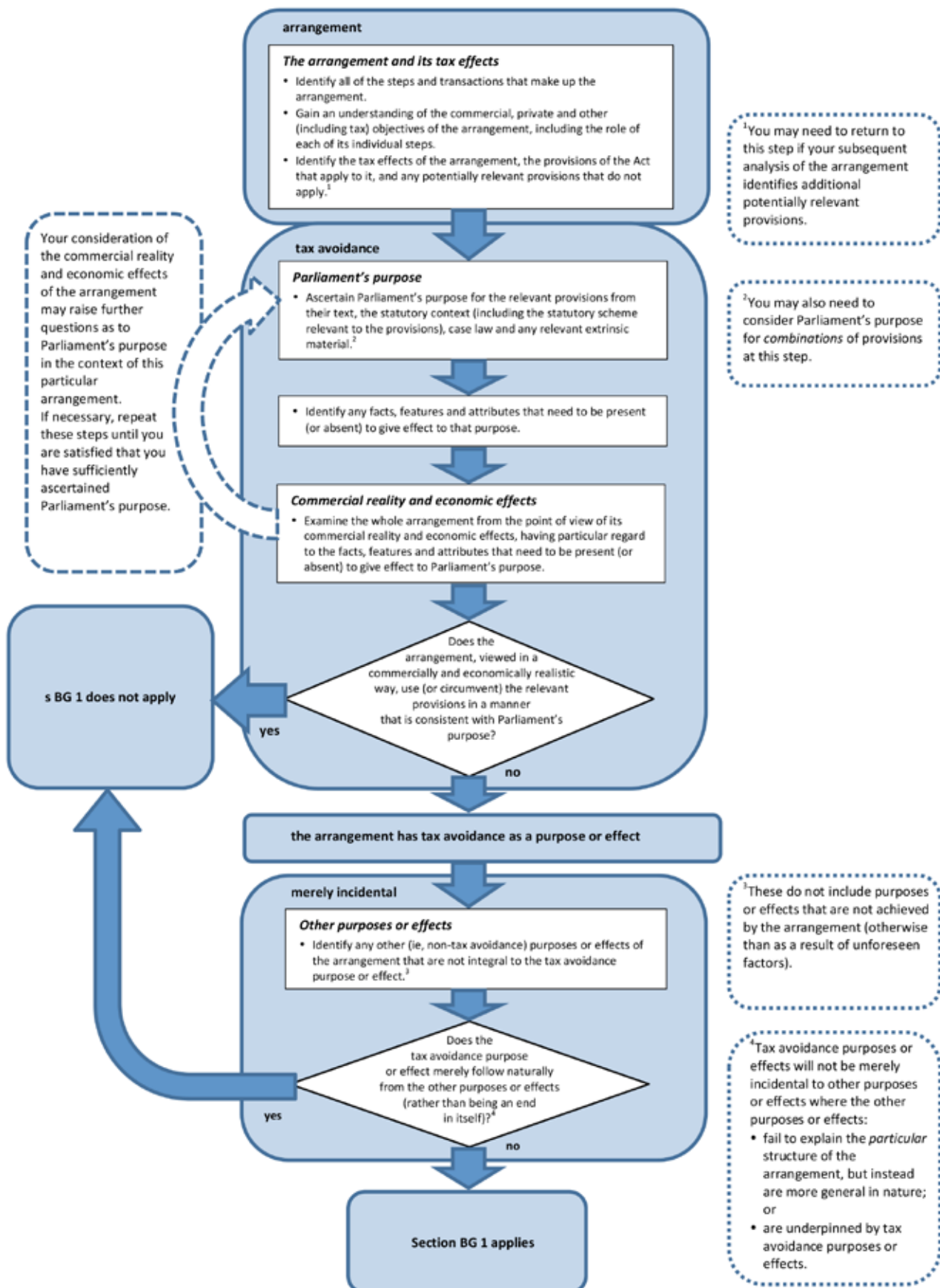
As the result of a constructive consultation process, the finalised Interpretation Statement valuably recognises that, if the voiding under the general anti-avoidance provision has removed "legitimate" tax outcomes, then the Commissioner must use her power to reinstate those outcomes.

The key issue will be determining which tax outcomes are legitimate. The Interpretation Statement sheds some light on this issue, noting that parts of an arrangement that are "so interdependent and interconnected with the tax avoidance parts as to be integral to them" would not be reinstated. This appears to provide fertile ground for discussion and debate between Inland Revenue and taxpayers in the future.

For a copy of the Interpretation Statement, please [click here](#). If you would like to discuss any aspect of the Interpretation Statement, please contact your usual Deloitte adviser.

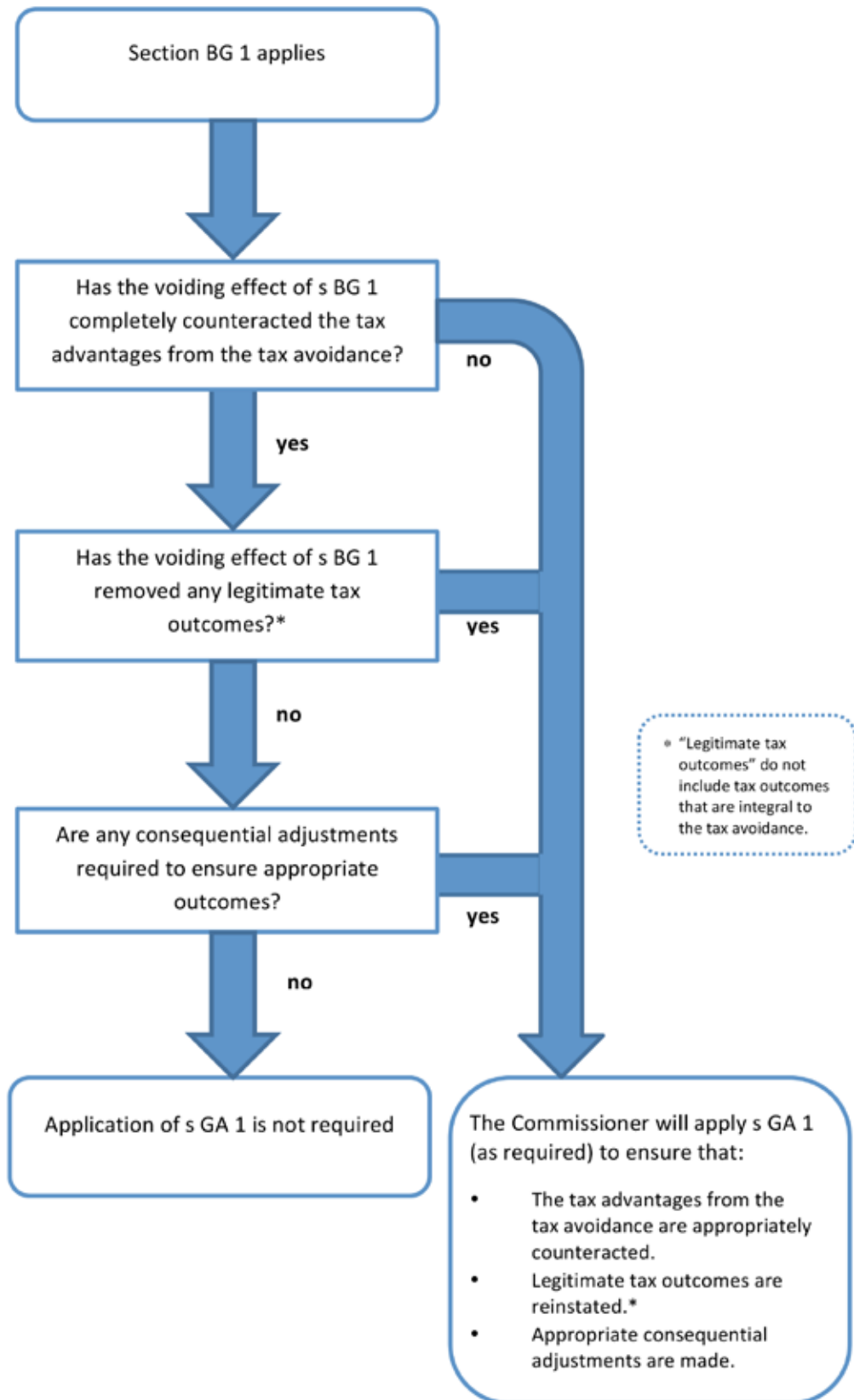
Flow chart from Interpretation Statement

Section BG 1: a suggested approach



Flow chart from Interpretation Statement

Approach to s GA 1





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Succession and divestment

By Mark Lash

Selling your business is likely to be the largest and most important financial transaction any business owner will ever make. So why is it then that this very important succession process is often overlooked or undermanaged?

Start planning early

Not starting early enough with the process of preparing a business for sale, whether as part of a succession plan or divestment process, is common. Good planning and preparation is essential to ensure you extract maximum value when you decide it is time to exit.

While the value of a business is based on the business's cash flows, the other part of the value equation which relates to the certainty of those cash flows is often overlooked. Ensuring that key contractual arrangements and in particular the ownership of intellectual property of the business is documented is fundamental to meeting your price expectations as a vendor. It may also be the difference between the sale proceeding or not and in some cases the smallest detail can completely derail the process.

For example, overlooking the need for a clause in contracts with key staff or contractors that confirms that ownership of intellectual property created while they are providing services resides with your business could cause real problems for a purchaser, if they are concerned about being subject to a claim by those employees or contractors later down the track.

Engagement with a third party to undertake pre-sale due diligence is the most effective way of ensuring the business is in the best position to maximise value.

Plan the approach

When you are selling your business as part of a divestment or succession plan is it important to consider the way in which the sale is to occur and to ensure that you have considered the income tax and GST implications of the options available to you.

Share transactions

Where the shares in the business have not been acquired as part of a business of dealing in shares or with the purpose of resale then the gain on sale of the shares should generally not be subject to income tax. As the sale of shares should be an exempt supply for GST purposes, generally the parties should not need to account for GST on the sale.

While it is usually relatively easy to document a share transaction, there are usually higher due diligence costs for the purchaser and vendor given that the trading history and therefore historical liabilities remain with the business. Planning for this process in advance and ensuring that you are ready to respond to the purchasers enquiries will assist them in gaining confidence in the business and its processes.



Because historical liabilities transfer with the business, this can mean that comprehensive warranties and indemnities are required to be provided by the vendor and can result in the vendor being tied to the transaction for a number of years following settlement or having an amount of the purchase price being held in escrow.

Where there is a progressive transfer of the business through a succession plan, it may be possible to dispense with some of the complexity relating to warranties and indemnities given the vendor remains involved in the ownership of the business.

The income tax treatment of earn-out payments and also any restraints of trade, particularly where the owner continues to provide services following the sale, also need to be carefully considered and documented in the agreement for sale and purchase.

Sale of assets

In some situations it may be appropriate to divest a business by selling the underlying assets rather than by sale of the shares.

These situations might include circumstances where:

- The parties do not want the purchaser to take on the historical trading risk of the business and rely on the strength of warranties or indemnities provided; or
- The purchaser wishes to obtain a step up in the cost base of the assets it is acquiring, where the market value of the assets are greater than the current accounting / tax book value.

In an asset transaction, the tax consequences on the sale of the assets will fall on the vendor. As such, it is important that you take income tax advice prior to the sale, particularly regarding how the various assets will be treated on disposal and how the proceeds from the sale will be treated when returned to you.

Whilst manageable, the GST consequences of the sale of assets needs to be considered and relevant clauses included in the agreement for sale and purchase depending on whether the parties intend for the sale to be zero-rated or subject to GST at 15%.

In an asset transaction, due diligence typically focuses less on the business and more on the assets being acquired. Consideration should be given to how the purchase price will be apportioned across the various assets, as this apportionment will impact on the tax treatment for both parties.

Lowest price

Where settlement may be deferred, the financial arrangement rules may operate to treat part of the purchase price as being interest. It is important that consideration is given to what the lowest price would be for the shares or assets under the agreement and the inclusion of a clause in the agreement for sale and purchase to this effect.

Related parties

There are a number of income tax and GST rules that can give rise to adverse consequences where the sale of assets or shares occurs between related parties as part of a succession plan.

These can include:

- Limitations on the ability to get a cost base uplift on the transfer of assets and limitations on the tax depreciation rates that are available;
- Taxation on the return of proceeds from the sale to owners where the gain is from a transaction with a related party; and
- GST timing rules resulting in the obligation to account for GST earlier than would normally apply.

Concluding comments

Whether you are looking to sell your business as part of a succession plan or divestment it is important that you start early with the process of preparing a business for sale and take tax advice on the options available if you want to maximise value.



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Clarifying the tax consequences for deregistered charities

By *Stephen Richards*

Inland Revenue released an officials' issues paper "Clarifying the tax consequences for deregistered charities" on 18 July 2013. This paper discusses the problems with the current tax treatment of deregistered charities and considers possible solutions for clarifying the tax consequences of deregistration for these entities.

On 1 February 2007, the Charities Act 2005 introduced a system for registering charities. Registration under the Charities Act is voluntary and non-registration does not mean an entity is not charitable in purpose. However, from 1 July 2008 registration as a charity became an additional requirement for a charity to rely on the charitable exemptions from income tax in the Income Tax Act 2007. Before that date, a charity may have received confirmation from Inland Revenue that it was entitled to the charitable income tax exemptions or may have self-assessed its eligibility for those exemptions.

Registration under the Charities Act 2005 is not necessarily a permanent status. Charities Services or its predecessor, the Charities Commission, has deregistered over 3,900 charities since the Charities Register opened for registrations. The vast majority of these charities were deregistered for failing to file an annual return (2,489). Voluntary deregistration accounts for most of the remaining deregistered charities (1,375). However, charities were also deregistered due to having a non-charitable purpose (34), failing to produce evidence of a charitable purpose (7), failing to meet registration requirements (4), and due to serious wrongdoing (3).

Deregistration from the Charities Register means that an entity is no longer entitled to the charitable income tax exemptions in the Income Tax Act 2007. Following deregistration an entity will become subject to the general tax rules that apply to an entity of its legal form and undertaking its activities.

An issue that arises on deregistration is when the change from tax-exempt entity to tax-paying entity occurs. When an entity transitions from tax-exempt entity to tax-paying entity will depend on the reason for deregistration.

When deregistration is due to an entity failing to file an annual return or voluntarily deregistering, the entity will become subject to income tax from the effective date of deregistration. Generally, this will mean that tax provisions will have prospective application to the entity. Activities undertaken before deregistration will generally remain tax exempt and only activities arising after deregistration will give rise to income tax obligations. This is a reasonably fair outcome as income tax obligations are all prospective. However, the entity may find that as its activities were structured in the context of it being tax-exempt, that the manner in which it conducts those activities are not optimal for a tax-paying entity. A deregistered charity could find itself on the wrong side of the tax avoidance rules if it sort to restructure itself to take account of effect of income tax on its activities.

When deregistration results from a finding that the entity lacks a charitable purpose, the income tax provisions will have retrospective application, potentially back to the date that the entity was established. This is because to be eligible for the



income tax exemptions for charities, an entity must be both a registered charity and have a charitable purpose. A finding that an entity lacks a charitable purpose means it was never entitled to the tax exemptions for charities despite being initially a registered charity. This retrospective application of taxing provisions to an entity that may have been in existence for several years and considered itself to be tax-exempt due to being a registered charity will likely have a serious financial impact on the entity. As well as having tax liabilities for its previous activities for which it will not have provided, it may also have significant use of money interest exposures on those liabilities. In these circumstances, Officials are proposing that where an entity had received confirmation from Inland Revenue of its charitable status before 1 July 2008 the tax provisions would only apply from that date.

Another group of entities are those that came in to existence after 1 February 2007, and therefore, never received Inland Revenue confirmation of their charitable status, but were initially registered as a charity only to be subsequently deregistered for a lack of charitable purpose. These entities are potentially subject to tax back to their date of formation. Officials acknowledge that reasons of equity and consistency suggest that where an entity has acted in good faith and complied with all registration requirements that liability for income tax should only commence on the date of deregistration. However, Officials are also concerned with protecting the revenue base and the integrity of the charities registration process and seek submissions on when tax provisions should apply in these circumstances. It would seem that where an entity has acted in good faith and fulfilled all its obligations under the Charities Act 2005 that its liability for income tax should only arise on deregistration. At some stage Charities Services has considered it charitable and the entity has done all that is required of it in terms of the Charities Act 2005 and the Income Tax Act 2007 to obtain tax-exempt status to the best of its knowledge. It seems unduly onerous for such an entity to incur retrospective tax liabilities due to someone else's error.

Once the date that an entity becomes subject to tax is established, it is then necessary to deal with the consequences of the transition from tax-exempt entity to tax-paying entity. This raises issues such as determining the opening value of depreciable property,

the consideration for financial arrangements, and how distributions of income accumulated when the entity was tax-exempt are to be treated. The Income Tax Act already has provisions that deal with a charitable trust that ceases to be a charitable, and a trust or company that elects to become a Maori Authority. Generally, these provisions provide that the cost of depreciable property and trading stock on the date of the change in tax status is the value it would have had had the trustee always been subject to income tax. Officials are proposing that these rules be further developed and expanded to deal with deregistered charities in general and are seeking submissions on how this should be done.

One area of concern for Officials is that a deregistered charity can apply its assets (including accumulated income) towards non-charitable purposes without giving rise to a taxable event. Some countries have dealt with this issue by requiring deregistered charities to apply their accumulated "charitable income and assets" to charitable purposes or be subject to income tax on them, or require the deregistered charity to transfer the assets to another charity. Officials are seeking submissions on how accumulated income and assets of a deregistered charity should be treated.

Identifying a deregistered charity's income tax liabilities from its historical activities can be a drawn out and complex process. A deregistered charity's activities will not often conform to normal commercial activities and it will have structured itself and its transactions without regard to the tax outcomes. Issues can arise whether its business-like activities were a business as the entity may have lacked a profit motive in conducting them. This can be a two-edged sword as in some circumstances a deregistered entity may wish to argue that its activities amount to a business to assist with the claiming of deductions for its expenditure. However, in other circumstances it may be beneficial to assert there is no business; for example, where an entity's "income" would be a non-taxable capital receipt in the absence of a business or where the finding of a business of dealing or developing land would result in the tainting of other land holdings. It can also be problematic determining whether grants and other payments made to the entity should be characterised as taxable income. Further issues can arise due to provisions in the Income Tax Act dealing with government and local body grants applying once the entity becomes a tax-paying entity and having tax consequences that were not anticipated when the

entity received and spent those grants. A particular issue arises with suspensory loans made to the entity when it was tax-exempt that later convert to a grant after the entity is deregistered resulting in debt remission income for the entity that was not foreseen when the loan was made. It would have been useful if the paper had considered some of these issues, in particular those relating to grants and suspensory loans.

Officials are proposing that any legislative changes take effect from the 2014-15 income year, which means that any new rules will not apply to the 3,900 existing deregistered charities. Given the large number of deregistered charities and Officials expectation that the number of charities deregistered going forward will be much smaller due to Charities Services changing its deregistration policy around non-filing of annual returns, it would appear that the problems identified are largely historical. This suggests retrospective application of at least some of the changes may be appropriate. The consequences of a charity being deregistered should have been addressed at the time that the registration requirement for tax-exempt status was introduced.

There is a potential flow on effect of a charity being deregistered for those who have donated cash to the entity and claimed tax relief for that donation through claiming either a tax credit or a deduction. Deregistration of an entity does not necessarily mean that it loses its donee organisation status as this status is not dependent on being a registered charity. A deregistered charity may retain donee status due to having benevolent, cultural or philanthropic purposes. If the deregistered charity is not eligible for donee organisation status, the donors to that entity were not entitled to the tax relief claimed for their donations to it. Under current tax law, Inland Revenue can reverse previously claimed tax relief for those donations. In deciding whether to reverse tax relief for donations Inland Revenue takes into account a number of factors, including the circumstances of the entity's deregistration, the donor's knowledge of those circumstances, Inland Revenue resource constraints, and the impact on compliance and the integrity of the tax system. Officials are not proposing any change to this process, but are seeking submissions on specific circumstances where reversal of donations tax relief is appropriate.

Submissions close on 23 August 2013. For more information, contact your usual Deloitte tax advisor.

Identifying a deregistered charity's income tax liabilities from its historical activities can be a drawn out and complex process.





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Research and development expenditure: Deja vu?

By Aaron Thorn

The reintroduction of a tax based R&D incentive was a key announcement in the recent budget. An officials' issues paper was released on 23 July 2013, entitled *R&D tax losses* in which Officials have suggested allowing "R&D-intensive start-up companies" (R&D companies) to "cash-out" certain losses related to R&D expenditure.

Current tax setting for R&D

Current tax provisions delay the ability of loss-making R&D businesses to use their deductions as they are required to carry the losses forward until such time as they make a tax profit. This in turn creates cashflow problems for R&D companies who are in a tax loss position. For R&D companies, this bias is compounded by longer periods of losses for innovative projects, broader capital constraints and difficulties in securing lending or investment.

- This tax treatment disproportionately adversely affects R&D companies for a number of reasons:
- R&D companies are expected to be in an on-going loss position over consecutive periods through the R&D phase.
- R&D companies generally do not have other sources of income to apply the loss against.
- The high-risk nature of R&D investment increases the risk of failure. The resulting failure would mean losses are never utilised by R&D companies.
- In some cases, R&D companies do not realise any gain on investment until the R&D output is sold.

Suggested policy changes

To address these issues, Officials' have suggested allowing R&D companies to "cash-out" certain losses related to R&D expenditure. There are three primary facets to these proposals.

Eligible R&D companies

Officials propose certain R&D tax losses will be refundable to eligible R&D companies. R&D companies will be eligible if they meet the following criteria.

- The company must be in a tax-loss position for the applicable income year;
- The company must be resident in New Zealand;
- The company must not be a look-through company, listed company, qualifying company or special corporate entity; and
- The company's R&D expenditure on wages and salaries must be at least 20% of total group expenditure on wages and salaries.

Of particular importance is the last of these criteria (referred to as "R&D wage intensity"). R&D wage intensity has been linked by Inland Revenue to the innovation life cycle. During the initial loss-making phase of the innovation cycle, R&D companies typically invest a greater proportion of their labour costs in R&D for the initial creation of intellectual property. As the business matures, activities shift towards production and sales which leads to a reduction in the proportion of R&D staff (and therefore expenditure on wages and salaries for R&D). Setting a 20% R&D wage intensity threshold therefore targets this policy towards start-up R&D companies and will generally exclude established businesses.

"Cash-out" limit

Eligible R&D companies would be able to cash-out the lesser of:

- 1.5 times the company's R&D expenditure on salary and wages;
- Total losses;
- Total qualifying R&D expenditure; and
- The total overall cap on eligible losses for the relevant year (initially \$500,000 of losses, rising over time to \$2 million).



Certain R&D expenditure only

It is important to recognise that the “cash-out” amount is limited to total qualifying R&D expenditure. This means the definition of R&D expenditure is critically important.

Officials suggest using existing definitions of R&D found in NZIAS 38, modified to exclude certain activities and expenditure. Activities excluded from the definition of R&D include:

- Prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal energy;
- Research in social sciences, arts or humanities;
- Market research, testing, development or promotion;
- Quality control;
- Making cosmetic changes to products;
- Commercial, legal and administrative aspects of patenting, licensing or other activities;
- Activities involved in complying with statutory requirements;
- Clinical trials; and
- Late stages of software development.

Further, expenditure excluded from the definition of R&D includes:

- Determining R&D wage intensity;
- Determining total qualifying R&D expenditure;
- Interest expenses related to R&D;
- Purchases of existing R&D assets;
- R&D undertaken offshore; and
- Lease payments.

Readers will recall that these exclusions are broadly consistent with those in the R&D tax credit regime that was repealed by the current Government.

Our thoughts

It’s good to see support for R&D in start-ups through this tax-related budget initiative. It’s also important to note that there are other components to Government’s support of R&D as seen in the recent announcement regarding business R&D grants.

It is obvious that the success of start-up R&D-intensive companies is ultimately good for the NZ economy and this policy’s efforts to provide tax support is to be applauded. The proposed policy risks being too narrow however and is in danger of being mere lip service to supporting innovation without actually providing support where it is actually required.

There are some particular exclusions/requirements in the proposal that are particularly worrying:

Software coding & clinical trials exclusion – this could effectively lock out companies in the important software and biotech industries during the most important phase of their R&D investment.

20% labour intensity requirement – it is questionable whether this 20% threshold is realistic or whether it sets the bar too high. This test is the primary targeting mechanism to ensure that this incentive is only available to R&D start-ups. We consider that this may be a missed opportunity to provide R&D tax incentives to established companies or those undertaking R&D but which also have existing revenue streams.

Listed companies – it seems that this policy would be more effective if it were applicable whether a company is listed or not.

Please contact us if you would like to make a submission on this Issues Paper.



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Bloodstock investors finish down the track

By Andrew Babbage

Racehorse ownership is a risky enough business. Try to claim a tax deduction for losses on your equine investment and, based on the recent High Court decision of *Drummond v Commissioner of Inland Revenue*, you truly fall into the ranks of an outsider. While the decision in this case has significant implications for investors in bloodstock breeding syndicates, the decision also provides useful learnings for anyone entering a new venture and seeking to establish whether a business has actually commenced.

The plaintiffs were members of an unincorporated syndicate, called Te Akau Stallion Syndicate (No. 1) ("the syndicate") which was formed in March 2008 with the stated object of acquiring, training and racing a recently purchased blueblood (*Roman Gladiator*), "and any other thoroughbred colts acquired by the Syndicate, with a view to increasing their value as thoroughbred Stallions".

Big things were expected of this colt. By Cambridge Stud's champion sire, the syndicate outlaid \$550,000 plus GST to secure him at the 2008 Karaka Premier yearling sales. The syndicate manager, David Ellis, had a proven record in buying well-bred colts and through carefully managed racing careers promoting those colts as commercial stallion prospects that could eventually be worth several millions of dollars. Despite Mr Ellis' track record, this was still a highly speculative venture. The Court heard in evidence that fewer than 5% of good pedigree colts sold annually at Karaka end up standing at stud. While Mr Ellis had notably more success in this regard (achieving a success rate of around 25% to 30%), the Court noted that the risk of failure was still high.

While success on the racetrack is not essential to standing a horse at stud, its worth as a stallion would be greatly enhanced if it did prove its worth on the track. With that in mind, the colt was sent to a leading trainer to be prepared for racing. However, that racing career did not unfold as hoped. The colt proved to be an unruly individual and on Christmas Day 2008 attacked and seriously injured his jockey. In his early trials his performances fell well short of his price tag. His temperament worsened to the extent he was

considered too dangerous to be kept intact. Any hope of a stallion career for Roman Gladiator was literally cut off in October 2009 when he was gelded.

The investors meanwhile sought to claim some tax relief on what they were now facing as a potentially disastrous investment. In their 2008 tax returns they claimed a deduction equivalent to 75% of the cost price of the colt on the grounds they satisfied the requirements of section EC 39(1)(c), i.e. that they had bought bloodstock:

"... with the intention of using it for breeding in their breeding business".

A further deduction was claimed in their 2009 tax returns.

In analysing section EC 39, the Court concluded that the provision required a person to already have a breeding business. Without an existing business, the Court concluded the plaintiffs could not bring themselves within the scope of the section. By itself, the acquisition of the colt was not enough to signify that there was any existing breeding business.

An alternative argument was put forward by the plaintiffs to the effect that section EC 39 was not concerned with whether a business existed at the time that bloodstock was acquired, as long as a business was ultimately carried out. They argued that the real focus of the provision was whether the taxpayer has used the bloodstock in *their* business (as opposed to in someone else's business).

However, both of these arguments required the existence of a breeding business yet, in a finding that was fatal to the plaintiffs' case, the Court determined that no bloodstock breeding business had been established.

The Court did conclude that the plaintiffs were carrying on a racing business however that finding was of little comfort. The paltry race earnings earned by the horse were in any event exempt from tax, meaning the costs of racing the colt were non-deductible. *[Footnote: as a final post-script the Court heard that with a meagre \$8,600 to his name, Roman Gladiator was re-named, sent to Singapore and in a further handful of starts failed to earn a single dollar, effectively bringing to an end his race career].*

While the decision follows established principles, the case re-affirms the criteria needed to determine whether a venture constitutes a 'business', as that term is used in a tax context. Richardson J in *Grieve v CIR (1984) 6 NZTC 61,682* had developed the following test which the High Court, and others, have since followed:

"... the decision whether or not the taxpayer is in business involves a two-fold inquiry - as to the nature of the activities carried on, and as to the intention of the taxpayer in engaging in those activities."

The fundamental notion is that an activity must be conducted in an organised and coherent way directed to an end result. In looking at the nature of the activities carried on, regard needs to be had to factors such as the period over which the activities are carried out, the scale of operations, volume of transactions, commitment of time, money and effort, the pattern of activity and the financial results.

The fact that a venture may be highly speculative does not prevent a business commencing. However, if the commencement of the business is contingent on other factors then until those factors are present a business is unlikely to have commenced.

In *Drummond*, from the moment the colt was acquired there was a fixed intention of racing it. By contrast, there was never a fixed intention to stand the colt at stud. That would require a conscious decision by the syndicate (followed by activities aimed specifically at implementing that decision), yet the Court could find no evidence that such a decision had ever been made.

"Buying a colt with the fixed intention of racing it and a contingent intention of one day standing it at stud does not establish a breeding business. If it did then anyone buying a thoroughbred with the intention of racing it and possibly breeding from it would be in the business of breeding bloodstock."

"The evidence establishes that the syndicate members, when acquiring the colt, did so with the desire that it would one day stand at stud and return the members an income in the form of service fees. But I infer there were decisions still to be made which would determine whether, or how, that desire might be achieved. For example, how long would the colt be raced? Who would decide? What if an attractive purchase offer were

received? At what stud would the colt (as a stallion) stand?

"The fact that the venture of breeding is speculative does not prohibit a breeding business commencing. If that were the case, then no breeding business would ever exist. But in the face of that risk, a commitment to a plan and structure to get the colt from acquisition to the end point of being able to service mares is to be expected. The syndicate agreement speaks more of an objective that the colt be developed so as to be worth as much as possible when the time came to make decisions about its stud future. The decisions actually made went to the best interests of the colt's racing career. The decisions as to any potential stud career were left to the future. This demonstrates a lack of commitment to a profit-making structure for breeding. The only structure actually in place was the structure to seek profit from potential race winnings."

The Court acknowledged that if the plaintiffs had had an established breeding business then all that they did in acquiring and developing the colt would have been recognised as being pursuant to that business. So, when considering whether to proceed with a new business venture, the existence of contemporaneous evidence will be an essential pointer to establishing when that new business has commenced.

If you would like to discuss the issues this case raises, please contact your usual Deloitte tax advisor.





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A necessary review of allowances

By Mike Williams

Overview

An Official Issues paper released by Inland Revenue in November 2012 reviewed the treatment of employee allowances and other expenditure payments. In particular it focused on meal, accommodation and clothing allowances and highlights how the position has not been clearly defined in the legislation. Consequently it has resulted in varying tax outcomes, depending on how the rules are applied in practice.

Further announcements by the Inland Revenue and recent media speculation around the potential tax liability faced by plain-clothed police officers highlights the importance of treating employee allowances correctly in the first instance...and the necessity of regularly reviewing historical positions.

Principles regarding Clothing Allowances

In general, where clothing allowances are paid to employees towards the costs of their uniform, protective or specialist clothing that is required for a particular occupation and is not suitable for private use, it may be a non-taxable allowance.

However, when an employee wears ordinary clothing to work, the cost of purchasing, maintaining and replacing that clothing is generally considered to be a private expense. Therefore, clothing allowances used to cover these costs are generally fully taxable even if the clothing is considered to be for work purposes. Similarly, any allowance paid to cover the costs of cleaning and maintaining this clothing would also be taxable, unless the working conditions are considered unnecessarily dirty or hazardous.

Determining whether an item of clothing is regular clothing or clothing that is considered a uniform or specialist clothing for work is a contentious area. Speaking as a tax advisor and owner of a large selection of shiny, threadbare suit trousers but immaculate suit jackets, I would argue that my suits are specialist work clothing – after all, given a choice, I'd be comfortable wearing shorts and a t-shirt and the quality of my tax advice is in no way influenced by whether or not I wear a suit. Nevertheless, my employer much prefers that I do so.

However it is the Inland Revenue's view that my suits could just as equally be worn when going to the theatre, watching the kids play sport on a Saturday or to the family BBQ on those long sunny summer weekends. Whether I choose to do that or not, you have to say that there is a certain logic to it, and the same couldn't perhaps be said of the uniformed policeman or the local volunteer fireman!

A clothing allowance made in relation to ordinary clothing worn at work is therefore substantially private in nature – we all need to wear clothes – and the private element arguably goes beyond being merely incidental to the work purpose.

On this basis, if the item of clothing is indistinguishable from clothing that is suitable for a person to wear outside of work, it seems hard to argue against any allowance to buy that clothing being taxable.

Issues with the clothing allowance provided to the police

The Inland Revenue's recent pronouncements on taxing clothing allowances paid to plain-clothed officers serves to remind us that historical positions cannot be relied on, and further highlights not only the need to constantly review remuneration policies and collective agreements, but also that historical positions cannot be relied on...regardless of whether or not the Inland Revenue previously provided tacit agreement. You only have to look at the Commissioner's recent announcement on the tax treatment of accommodation to realise that previously agreed or published positions can retrospectively be dismissed or changed with scant regard for the historical consequences of such a belated change of heart.

Where to from here?

The landscape of taxing employment income is changing and, in the absence of clear legislation and consistent application by the Inland Revenue, employers face a great deal of uncertainty when trying to establish a correct tax position. This is often not helped when collective employment agreements or negotiated group positions are effectively rolled over without considering the evolution of taxation.

We welcome the Inland Revenue's efforts to provide some clarity around this area...but have significant reservations around a tendency to apply any changes retrospectively, and a general one-eyed view that everything should be taxable.

The implications of applying evergreen allowances and remuneration policies could result in adverse consequences given the Commissioner's increased scrutiny over the taxability of allowances. Deloitte would therefore always recommend that collective agreements and other group arrangements be carefully reviewed on a regular basis to ensure that any tax position taken is robust and consistent with current thinking.

For more information, please contact Mike Williams or your usual Deloitte tax advisor.



Deloitte announces new tax partner

Deloitte is pleased to announce Mark Lash as its newest tax partner. Mark has many years' experience advising large and small businesses on the tax consequences of acquisitions and divestments in New Zealand and restructuring domestic and international operations.

He is passionate about helping his clients realise their potential on a domestic and global stage, ensuring that tax is not an impediment to realising their aspirations.

While Mark's main focus areas are working with our private clients and with iwi to create value for the long term, he also works with a number of larger corporate organisations, meaning he can draw on those experiences to add value.

Mark has the privilege of working with some of the fastest growing and most successful organisations in New Zealand. This may be as a client or through his role as the Wellington and Lower North Island regional leader of the Deloitte Fast 50 programme.

See Mark's article in this issue on Succession and divestment.



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