Tax Alert

A focus on topical tax issues– June 2014

In this issue

Sam Hornbrook

Manager
+64 (0) 9 303 0974
sahornbrook@deloitte.co.nz

Andrea Scatchard

Associate Director
+64 (0) 7 838 4808
ascatchard@deloitte.co.nz

GST - Timing errors do matter

By Sam Hornbrook and Andrea Scatchard

In mid-May, Inland Revenue updated its annual tax statistics for the year ended June 2013. The revenue statistics show that, once again, GST leads the way in terms of percentage increase in revenue collection for the department. This news, combined with the GST coverage in Inland Revenue's Compliance document (released towards the end of 2013), show that GST is a continuing area of focus for Inland Revenue. The Compliance document focusses on five key areas where GST is being treated incorrectly, one of which is accounting for GST later than required. This issue is relevant when businesses proactively identify and correct GST errors in relation to underpayments of GST. There is a common misconception that where such errors are identified, they can be corrected in the next GST return rather than requesting a re-assessment of the original GST period in question. However, future corrections can only be made where they are classed as 'minor', i.e. the total discrepancy that is caused by the error is $500 or less. In practical terms, this means that most errors identified should be corrected by a voluntary disclosure.

We have seen a number of cases where businesses have made corrections of underpaid output tax or over-claimed input tax in the next GST return they file. Whilst the correct amount of GST has ultimately been accounted for, the proper process was not followed. Inland Revenue expect a voluntary disclosure to be submitted and they are becoming increasingly focussed on timing differences. Where businesses take the approach of making corrections in future GST returns, they run the risk of shortfall penalties which can usually be avoided completely if a voluntary disclosure is made.

The key messages here are firstly that Inland Revenue does care about timing errors, especially for GST, and that while businesses may see correcting the most recent GST return as sufficient this is unlikely to satisfy Inland Revenue.

If you would like to discuss the above in more detail please contact your Deloitte advisor.

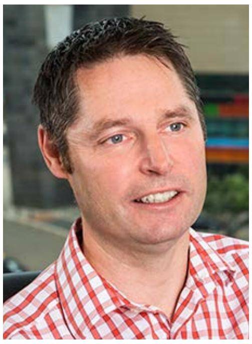
Continued on page 2...

Overseas borrowings on offshore rental property – a new focus

By Jayesh Dahya and Paul Pettit

Jayesh Dahya

Associate Director
+64 (0) 4 470 3644
jdahya@deloitte.co.nz



Paul Pettit

Partner
+64 (0) 4 495 3905
paulpettit@deloitte.co.nz

Having reminded taxpayers of their obligations to account for non resident withholding tax ("NRWT") on overseas borrowings, the Inland Revenue is now focussing its attention on taxpayers who may not be returning exchange gains or losses in relation to these overseas borrowings.

New Zealand tax residents (typically inbound expatriates and migrants) who have an overseas mortgage or borrowings on say, their property, are generally required to pay non-resident withholding tax (NRWT) on the interest paid to their foreign bank (see **here**).

For those that are eligible, there is an option to register the borrowings as a security under the approved issuer levy ("AIL") regime and account for approved issuer levy of 2% (as opposed to the usual NRWT rate of 10%). As part of this process, the security must be registered with Inland Revenue.

But this story is not about NRWT or AIL, it is about the financial arrangement rules. The AIL securities registration information held by Inland Revenue is now being used to check that taxpayers are correctly reporting income and expenditure (exchange gains and losses) under the financial arrangement rules.

In some cases, unrealised exchange movements from year to year need to be brought to account unless a person is a "cash basis person". The Inland Revenue as part of its review is challenging whether taxpayers are cash basis persons or not.

A cash basis person would only account for the cash amounts paid or received in relation to the borrowing and ignore unrealised exchange differences. A wrap up adjustment would be performed once the financial arrangement matures, is disposed of or the person ceases to be a NZ tax resident.

In order to be a cash basis person, the difference between calculating income and expenditure on an accruals basis and a cash basis must be no more than NZ$40,000 (this is known as the 'deferral threshold'). In addition, one of the following thresholds must also be met:

- the absolute value of income and expenditure from all financial arrangements is NZ$100,000 or less per year (the 'income and expenditure threshold'); or
- the total value of all financial arrangements is no more than NZ$1,000,000 (the 'absolute value threshold') on any day during the income year.

The following table shows how the deferral threshold is calculated:

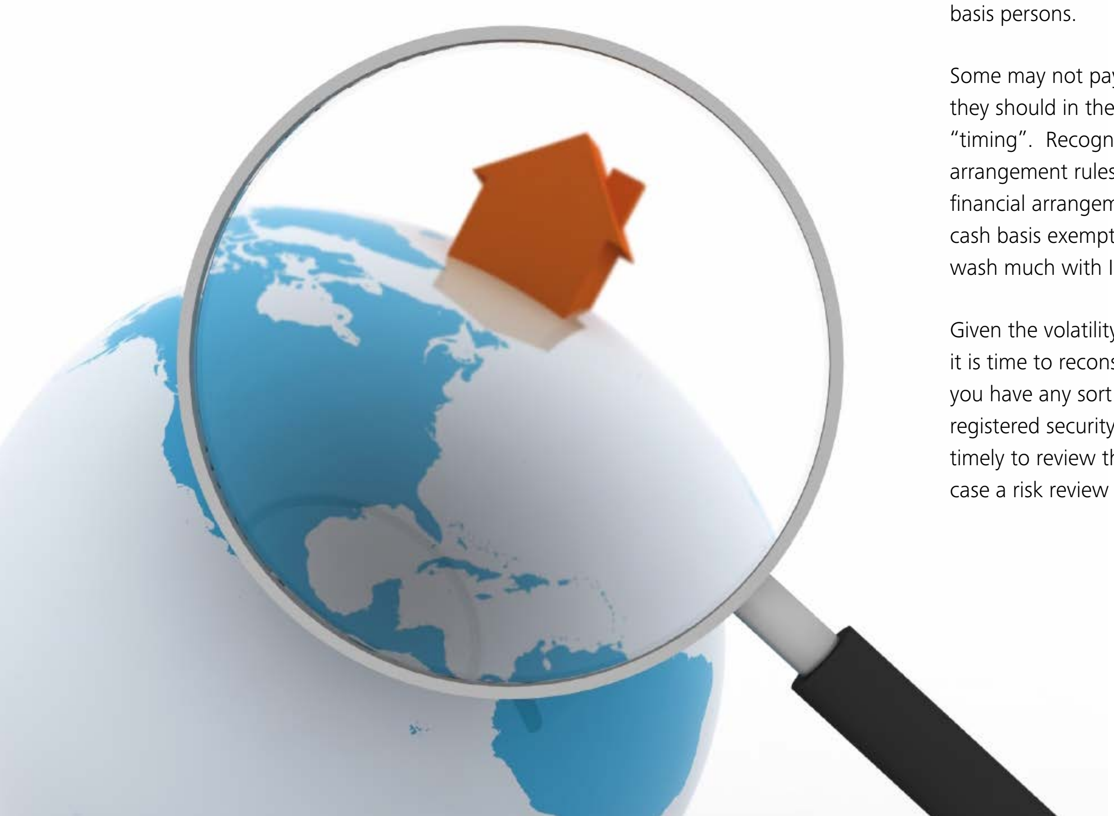
Foreign Currency Loan				
		£		$
Balance	1 April	110,000	0.3945	278,834
Balance	31 March	110,000	0.4680	235,043
Gain				**43,791**

In this example, as the exchange gain is more than $40,000, the deferral threshold would not be met and the taxpayer would not qualify to be a cash basis person for that income year.

Risk review letters have been issued to taxpayers with registered AIL securities in order to check the "cash basis person" status where claimed. This is a timely reminder about the rules that apply here which are often overlooked.

Determining that a taxpayer may be a cash basis person will initially be done at the outset, but it is important to note that this is not a "set and forget" exercise. The above thresholds should be tested annually, particularly where unrealised exchange gains and losses are involved. Further, the income and expenditure and the absolute value thresholds are calculated taking into account all other financial arrangements (loans, term deposits, bonds etc) a person may have, whether positive or negative.

A misunderstanding perhaps is that the cash basis person rules equal less compliance. This is not the case as at a minimum it is necessary to calculate income and expenditure under both methods to work out whether the deferral threshold is met for each income year.



Some taxpayers may well flip-flop in and out of the cash basis threshold, particularly for loans that are close to the upper thresholds

The real benefit of being a cash basis person means that tax is not paid on the unrealised exchange differences (i.e. gains) that arise under the accruals method and taxpayers therefore have more certainty about future tax liabilities (e.g. provisional tax). In most cases, however, the thresholds should still be tested each year.

Some taxpayers may well flip-flop in and out of the cash basis threshold, particularly for loans that are close to the upper thresholds. In this case there is always the option for cash basis holders to elect not to be cash basis persons.

Some may not pay as close attention to these rules as they should in the belief that the differences are only "timing". Recognising that the point of the financial arrangement rules are to bring to account income from financial arrangements on an unrealised basis unless the cash basis exemptions apply, this argument isn't likely to wash much with Inland Revenue.

Given the volatility of the foreign exchange rate, maybe it is time to reconsider the deferral threshold limits? If you have any sort of foreign borrowings which are a registered security under the AIL regime, then it could be timely to review this matter with your tax advisor just in case a risk review letter arrives from Inland Revenue.

Questions Inland Revenue has been asked on tax avoidance

Inland Revenue released a draft Question We've Been Asked (QWBA) for comment on whether certain scenarios concerning interest deductions, look-through companies, substituting debentures and debt capitalisation constitute tax avoidance. The draft QWBA has been released following a session at the NZICA tax conference in November 2013 at which these examples were raised.

Briefly the four scenarios covered are as follows:

Scenario 1 - Interest deductions where shareholder loans replaced

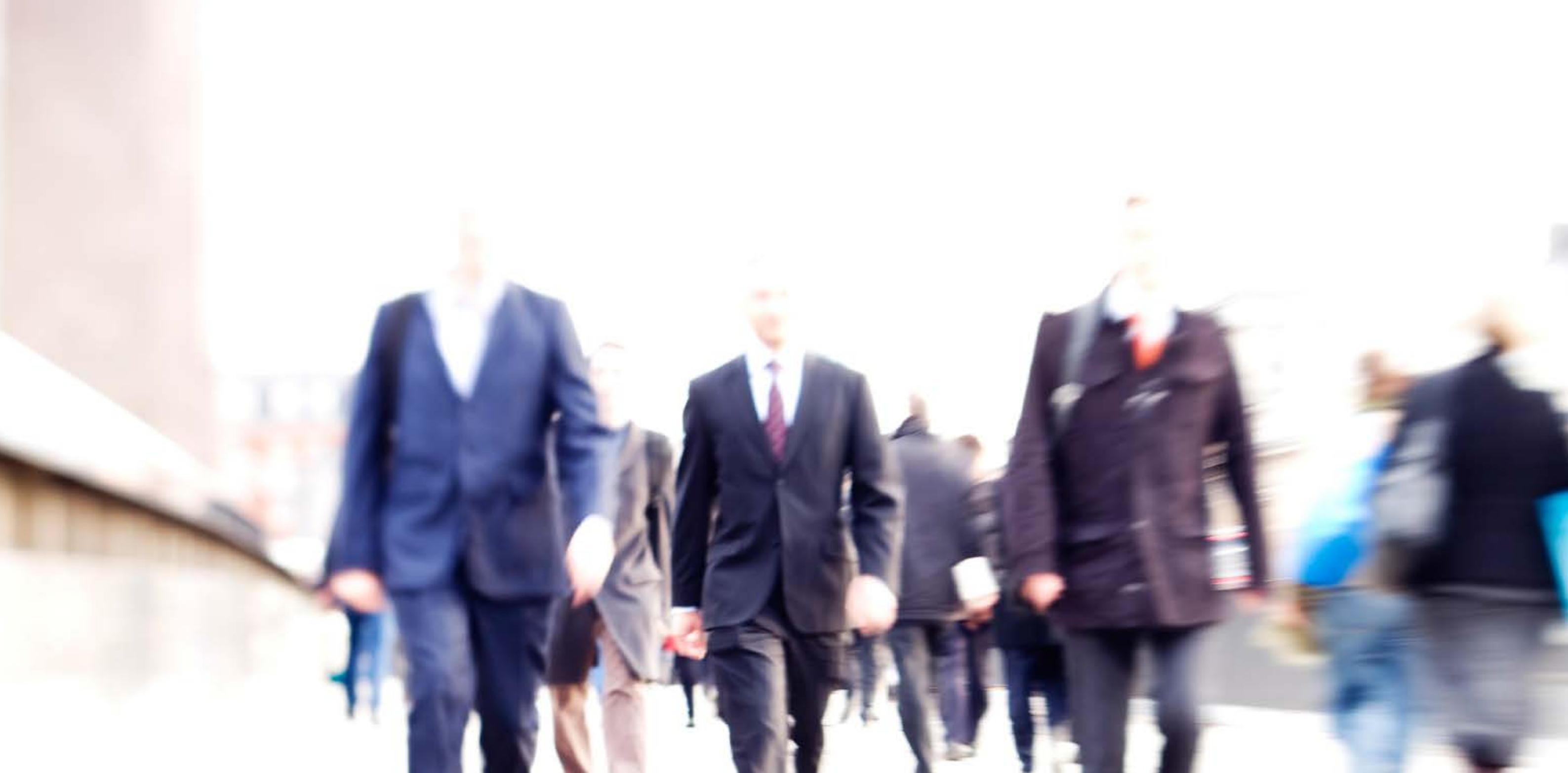
Company A is wholly owned by a Trust. The trust has advanced $1m in shareholder loans to Company A. Company A borrows funds from a third party lender to repay the shareholder loans. Trust assets are used as security for the third party loan.

The Commissioner's view is that, without more, section BG 1 of the Income Tax Act 2007 (which deems tax avoidance arrangements void) would not apply to this arrangement to deny Company A's interest deductions.

Scenario 2 - Look through company (LTC) election

Company B is owned equally by two trusts. One of the trusts operates a farming business that incurs losses for tax purposes. Company B is operating a profitable business and has built up significant reserves. If these reserves were to be distributed they could be distributed with full (28%) imputation credits attached. An election for LTC status is made for Company B. The existing reserves of Company B are distributed to the shareholders in the first year after attaining LTC status.

The Commissioner's view is that section BG 1 would not apply to this arrangement as the overall objectives would appear to be for company B and its shareholders to avail themselves of options provided by the legislation. However, the Commissioner considers section BG 1 would potentially apply if at the time of electing LTC status, Company B's directors had contracted to sell the company's business and resolved to liquidate the company and distribute the surplus assets to shareholders. This is because the objective would appear to be to use the LTC regime to enhance the value obtained by the shareholders from winding up company B.



Scenario 3 - Substituting debentures

Company C is jointly owned by two shareholders. Company C is funded by a combination of ordinary shares, non-participating redeemable shares and interest bearing shareholder debt (issued in proportion to the ordinary shares). On the occurrence of an insolvency type event Company C can convert the shareholder debt to shares.

Under this scenario the taxpayer has effectively structured around the substituting debenture rule. The Commissioner's view is that section BG 1 would potentially apply to this arrangement to deny Company C's interest deductions having regard to the circumvention of the substituting debenture rule in section FA 5(2). It is of note that the November Tax Bill contains a proposal to repeal the substituting debenture rule from 1 April 2015 and therefore the analysis in the QWBA may have limited application for future arrangements. The QWBA notes that it is useful to comment on this scenario as it illustrates the application of section BG 1 where a provision's purpose has become less clear over time. In such situations, the Commissioner considers that the text of the provision, supported by the scheme of the Act, will generally be the key determinant of Parliament's purpose.

Scenario 4 - Debt capitalisation

Company D is insolvent. It has assets of $200 (cash) and liabilities of $700 (being a loan from the shareholder). The shareholder subscribes for $500 worth of shares in Company D as partial repayment of the shareholder loan, with the remaining amount repaid in cash.

The Commissioner considers that section BG 1 would potentially apply to this arrangement on the basis that the arrangement allows Company D to eliminate the loan owed in a circumstance where the company is unable to repay it and in doing so avoids debt remission income that would arise under the financial arrangement rules.

This example is likely to be the one up for most discussion and debate as it potentially raises more questions than it answers. There is no mention of the context here and it is not clear what difference it might make if there was a commercial reason for capitalising an insolvent subsidiary. The Commissioner does however state that variations in facts may not give rise to tax avoidance – for example if the issue of shares was to a third party by a solvent company. The draft states that each case would need to be considered on a case by case basis and goes on to say *"The Commissioner accepts there may be situations where any tax avoidance purpose or effect of such arrangements is merely incidental to some non tax avoidance purpose or effect. If so, section BG 1 would not apply".*

Submissions on the draft QWBA close on 4 July 2014. If you have any questions or comments to make on the examples, or wish to make a submission please contact your usual Deloitte Tax Advisor.

Mike Williams

Associate Director
+64 (0) 9 303 0747
michaelswilliams@deloitte.co.nz

When is a tax resident not a tax resident?

By Mike Williams

In our **April Tax Alert** we discussed the implications of the Commissioner of Inland Revenue's much anticipated interpretation statement on residence. In light of this, many overseas taxpayers may be wondering where they stand in terms of their tax residence position and their New Zealand tax obligations. Thankfully, Inland Revenue has released a transitional statement to provide clarity on this issue.

Inland Revenue's previously authoritative standpoint on residence was Public Information Bulletin 180 (PIB 180), which was published in 1989. This has now been replaced by Interpretation Statement 14/01 (IS 14/01), with effect from 1 April 2014. This is supported by a transitional operational statement that offers guidance where the Commissioner's latest views on residence differ from those put forward under the old PIB 180. The transitional statement acknowledges the weight that taxpayers put on earlier guidelines by allowing those who have previously relied on its contents to do so until 31 March 2014. However, it also notes that certain situations previously giving rise to a non-resident position may no longer do so. The most notable example of this is the "three-year away from New Zealand" scenario.

Under the previous rules, it was commonly accepted that a three year absence from New Zealand was generally considered to be enough to prevent someone from being a tax resident, as long as other ties to New Zealand were limited and the home which was lived in before leaving was unavailable due to commercial rental arrangements. However the new statement makes clear that there is no bright line test in determining non-residence (and never was if the commentary is to be believed). To determine tax residency under the new laws a more holistic approach must be taken (see the **April Tax Alert** for further guidance).

However, for those expats living overseas who have relied on "the three year rule", not all hope is lost. Where individuals have correctly relied on the guidance provided by PIB 180, there will be no retrospective change. Nevertheless, the transitional guidance is clear that they must now re-evaluate their residence position from 1 April 2014 using the new Interpretation Statement and, in particular, consider this carefully where a property that was previously the family home has been retained.

If this reassessment leads to a conclusion that a non-residence position can no longer be supported from 1 April 2014, there is still the potential that broadly the same outcome is achieved through the network of double tax agreements[1.] (DTAs) New Zealand has signed with other jurisdictions for the period the individual is resident in that jurisdiction.

When considering a situation where an individual is resident in two jurisdictions under relevant domestic law, all DTAs rely on a series of tie-break tests. The first of these tests usually looks at a "permanent home" concept, whereby if a taxpayer is considered to have a permanent home available to them in one country and not in another then their residence for DTA purposes will be where their available permanent home is. The Commissioner's residence statement clearly indicates that if a New Zealand property is let out on an arm's length basis to an unassociated party then it will be unlikely to be considered a permanent home available to the owner for DTA purposes (even if it still constitutes a "permanent abode" for them under the tests of residence under New Zealand domestic law).

By way of example, James has been offered a secondment in the Singapore office of his firm for four years, with an expectation to return to New Zealand at the end of his secondment. His underlying employment with the New Zealand employer remains in place during this period. The Singapore office will provide him and his family with an apartment for the duration of his stay. His family moves with him to Singapore for this time and he rents out his family home with the intention of returning to New Zealand once his kids are ready to attend high school.

There are also potential opportunities for those who departed New Zealand and did not retain property...

Under New Zealand domestic law, James would likely be considered to remain a tax resident in New Zealand as he retained a property here that he has strong personal links to and intends to return to, and that combination could be considered a "permanent place of abode" under the IS 14/01 guidelines. Whilst Singapore would have the first right to tax James' employment income, his income would remain assessable in New Zealand and a top-up tax liability would arise.

However, the New Zealand/Singapore DTA can be used to intervene in this situation. Under DTA provisions, James has a permanent home available in Singapore and no permanent home available in New Zealand. Consequently, James would be a treaty resident of Singapore and a treaty non-resident of New Zealand. Other articles within the DTA would then typically remove New Zealand's ability to apply the top-up tax to James' employment income by exempting his earnings from New Zealand taxation[2].

Clearly, this offers some protection for Kiwis living in low tax jurisdictions such as Singapore, Hong Kong and even the United Arab Emirates in some instances.

A word of warning though – the same outcome would not generally be available for Kiwis living in countries with which New Zealand does not have a double tax agreement, as the former soldier in TRA case 43/11 found to his cost!

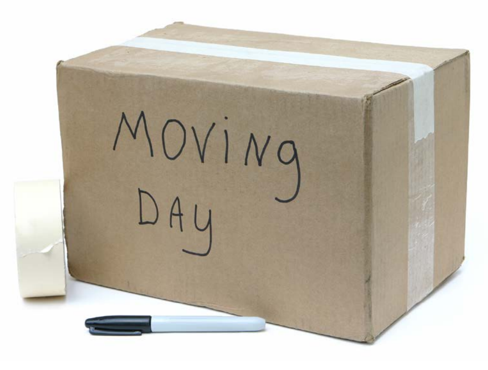
There are also potential opportunities for those who departed New Zealand and did not retain property here but assumed they would remain resident due to perhaps not being away for long enough. The transitional guidelines offer the possibility of revisiting past years where an individual assumed they had remained a tax resident and continued paying New Zealand tax. Where the Interpretation Statement makes it clear that they had become a non-resident of New Zealand, applications can be made to the Commissioner for a re-assessment of those years…though those applications are not guaranteed to be accepted in all cases.

The Commissioner has acknowledged that the New Zealand residence rules are intended to make it relatively easy to become a resident here, and more difficult to become a non-resident. However, it is pleasing to see that the current guidelines and the transitional arrangements take a relatively common sense approach in their application.

If you have any concerns about your resident status under the new rules, please contact your Deloitte tax advisor.

1. New Zealand currently has a network of 39 DTAs in force with our main trading and investment partners. For a full list please visit ***http://taxpolicy.ird.govt.nz/tax-treaties***

2. Additional conditions must be considered to determine whether or not an exemption under a double tax agreement can be claimed



Inland Revenue issues Alert over donation claims

Late last month, Inland Revenue issued a Revenue Alert to warn of an arrangement whereby people are claiming tax credits for purported donations in situations where Inland Revenue considers the payments are not a gift. The arrangement re-characterises as a gift, payments made to attend a private education centre such as a private school or childcare centre. Inland Revenue considers that in the absence of evidence of a contrary intention, the contributions made by the parents are a substitute for fees and therefore are not a gift. Under these arrangements, the donor will typically pay no or low fees to the private education centre. An associated issue is the GST treatment of the payments received by the private education provider. Inland Revenue considers these are subject to GST as they are essentially "consideration" for the supply of services.

Inland Revenue has commenced investigations into a number of taxpayers who have entered into these childcare or private school funding "donation" arrangements. Inland Revenue will seek to recover the excess tax credit from the person making the claim and will look to ensure that the GST position is corrected if it has not been returned on the contributions received. Late payment penalties and use of money interest may also be applied to taxpayers who have partaken in these arrangements. Shortfall penalties may also be applied; however these may be reduced for those taxpayers who make voluntary disclosures. If you consider that this issue may apply to you, we recommend you discuss the matter with your tax advisor and consider making a voluntary disclosure.

Follow us on Twitter
@DeloitteNZTax

Queries or comments regarding Alert can be directed to the editor, Veronica Harley, ph +64 (9) 303 0968, email address: vharley@deloitte.co.nz.

This publication is intended for the use of clients and personnel of Deloitte. It is also made available to other selected recipients. Those wishing to receive this publication regularly are asked to communicate with:

The Editor, Private Bag 115033,
Shortland Street, Auckland, 1140.
Ph +64 (0) 9 303 0700.
Fax +64 (0) 9 303 0701.

New Zealand Directory

Auckland Private Bag 115033, Shortland Street, Ph +64 (0) 9 303 0700, Fax +64 (0) 9 303 0701
Hamilton PO Box 17, Ph +64 (0) 7 838 4800, Fax +64 (0) 7 838 4810
Wellington PO Box 1990, Ph +64 (0) 4 472 1677, Fax +64 (0) 4 472 8023
Christchurch PO Box 248, Ph +64 (0) 3 379 7010, Fax +64 (0) 3 366 6539
Dunedin PO Box 1245, Ph +64 (0) 3 474 8630, Fax +64 (0) 3 474 8650
Internet address http://www.deloitte.co.nz