Tax Alert

A focus on topical tax issues – November 2015

In this issue

Business transformation: First real glimpse of what's in store for tax system modernisation

Robyn Walker and Nigel Jemson

After a very quiet 2014, 2015 must go down in the tax history books as the year of consultation. From debt remission, employee share schemes, non-resident withholding tax, land withholding tax, GST on cross-border goods and services, close companies, and tax bills, there has been a non-stop flow of papers to read and comment on (and that's ignoring all the work of the OECD on Base Erosion & Profit Shifting).

Inland Revenue's business transformation project is ramping up following two consultation papers released in March this year. After much theoretical musing about the tax system, a further three documents have just been released by the Government. These documents provide the first concrete details on proposals to be progressed under Business Transformation and represent another step along what is a long journey of consultation and implementation of changes.

Continued on page 2...

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These documents contain some important proposals that will form the foundation for the future tax system. For those readers who are suffering consultation fatigue, we summarise, as much as we can, the key matters to be aware of from these latest documents and we hope this will encourage you to look closer at the documents and to take the opportunity to comment before the consultation deadline of 12 February 2016. In this regard the documents set out a number of key questions to consider and comment upon.

The **first discussion document** Making Tax Simpler: Towards a new Tax Administration Act sets out proposals to modernise the framework underpinning tax administration with a particular focus on the role of the Commissioner (including her information-collection powers and secrecy obligations), and the roles of taxpayers and third parties.

The **second discussion document** Making Tax Simpler: Better administration of PAYE and GST considers changes to the administration of PAYE and GST by integrating PAYE and GST obligations into businesses' accounting systems, and also discusses improvements to the PAYE rules more generally.

The third document summarises the submissions and online comments received in respect of the two previous discussion documents (Making Tax Simpler – Better digital services and Making Tax Simpler – A Government Green Paper on Tax Administration) released earlier this year. The feedback has been incorporated into the first two documents that have just been released, so we haven't discussed this further in this article.

The purpose of the latest discussion documents is to consider how policy and legislative settings should frame and support Inland Revenue's business transformation programme in the areas covered in each discussion document. It is clear that rather than being an update to Inland Revenue's existing computer system, the proposals contained in each discussion document and future documents represent a fundamental opportunity to ensure that the tax rules match the capabilities of Inland Revenue's future computer system, and to ensure that the rules underpinning the tax system make it easier for taxpayers to comply with their obligations.

We provide a summary of the key proposals in each discussion document below.

Reform of the Tax Administration Act

This discussion document considers how the tax administration system can be improved. This is done via detailed policy proposals in some areas, while in other areas, the direction of further reform to the tax administration system is discussed.

Key areas considered in the discussion document are:

- The role of the Commissioner;
- Information collection and tax secrecy;
- The role of taxpayers and tax agents; and
- Future issues.

The discussion document includes proposals to clarify the Commissioners care and management responsibilities.

Role of the Commissioner

Of particular interest to taxpayers is the discussion document's consideration of the Commissioner's "care and management" responsibilities in the Tax Administration Act. A current restriction on the Commissioner's "care and management" responsibilities is that she cannot deliberately act contrary to her view of the correct interpretation of the law.

In this regard, the discussion document includes proposals to clarify the Commissioner's care and management responsibility to allow the Commissioner greater administrative flexibility in limited circumstances. It is proposed that the Commissioner would be able to:

- Apply a policy-based approach to small gaps in the tax legislation;

Green Paper on tax administration March 2015

Better digital services March 2015

Towards a new Tax Administration Act 2015

Better administration of PAYE/GST 2015

Business taxation 2016

Investment Income Information 2016

Individual interactions with IR 2016

Social policy 2017

- Deal pragmatically with legislative anomalies that are minor or transitory;
- Address cases of hardship (inequity) at the margins; or
- Deal with cases in which a statutory rule is difficult to formulate (meaning that the relevant legislation has failed to adequately deal with the particular situation).

This is a positive development and it would be pleasing to see the Commissioner being able to adopt a pragmatic approach in applying tax law in more cases than the current law allows, while not going too far in giving the Commissioner wide discretionary power to apply the law how she wishes. Of course, this is on the proviso that the Commissioner's discretion continues to only be applied in a taxpayer-favourable manner; something which the discussion document suggests should be the case. Ultimately to ensure any changes are workable there will need to be careful legislative drafting and clear guidelines on the application of the new rule.

Information collection and tax secrecy

A number of issues are considered in this section of the discussion document. Particular ones to note include clarifying the ability of Inland Revenue to access information stored in the "cloud", clarifying Inland Revenue's power for access to large third-party datasets. The discussion document recommends retaining a "necessary or relevant" standard (or something similar) for Inland Revenue to collect information (consistent with the current information gathering power in section 17 of the Tax Administration Act). What is missing is clarity about who Inland Revenue targets to provide third-party datasets, what is collected and how often it is collected. While Inland Revenue may consider documents as "necessary or relevant", the businesses supplying the information may find the process disruptive and a time consuming distraction. The discussion document partially recognises this when it states "… requiring third parties to provide this kind of information regularly could involve a significant compliance cost. This must be balanced against the wider compliance benefit to society from greater detection of under-reported or non-reported income, and the efficiency of collecting the information in a large dataset rather than needing to seek information from many taxpayers, including perhaps those who are not operating within the tax system."

The discussion document also discusses taxpayer secrecy and while acknowledging the starting point that the confidentiality of a taxpayer's individual affairs should remain protected, it proposes that the coverage of Inland Revenue's secrecy rule should be narrowed from all information to protecting information that identifies, or could identify a taxpayer.

The role of taxpayers and tax agents

This section considers a range of issues. One of the main issues covered is looking at an individual's obligations when they are issued income tax returns pre-populated with information by Inland Revenue, given this is an anticipated update as part of changes to Inland Revenue's tax system. Given the tax system is premised on a self-assessment basis, the document proposes that the taxpayer would be required to ensure that the correct amount of tax is paid and by a specified time, as it is currently. If the taxpayer failed to respond, a default assessment would estimate the amount of tax to pay and would remain in place until the individual filed a return.

Future issues

The discussion document outlines some areas where further reform is anticipated in future discussion documents and seeks feedback ahead of the release of more detailed proposals. These areas are:

- Advice and disputes procedure; including the options available for taxpayers to seek Inland Revenue's view;
- Application of the time bar, in particular the possibility of a reduced time bar applying in situations where Inland Revenue is comfortable the returns are very likely to be materially correct;
- Record-keeping requirements and whether these could be updated in the future to reflect the costs of keeping records in a digital environment. The discussion document also asks the question as to whether the current time periods for keeping records could be aligned with the time bar; and
- Whether Inland Revenue's new approach to compliance could result in a different approach to penalties.

PAYE and GST

PAYE and GST are central cogs of our tax administration system, and combined they make up 67% of total tax revenue. A key focus of the discussion document is to future proof the existing PAYE and GST rules by adapting them to changes in technology. In proposing changes to the way PAYE and GST are administered, the Government's goals are to:

- Minimise the costs of PAYE and GST processes – both compliance costs for employers and processing costs for Inland Revenue; and
- Improve the quality and timeliness of PAYE information.

To achieve these goals, the key premise on which many of the discussion document proposals are based is the ability of businesses' software packages to integrate with core tax functions such as PAYE and GST, rather than these being separate processes, as they currently are.

For example, rather than the completion of the employer monthly schedule being separate to a businesses' payroll processes, Inland Revenue envisages that PAYE information could be provided to Inland Revenue at the same time the payroll process is completed. Other envisaged changes include:

- Payroll packages and services including an option for a business to notify Inland Revenue of the decision to become an employer;
- Payroll software being used to advise Inland Revenue of a decision to permanently, or temporarily, cease to employ staff; and
- Enabling amendments to PAYE information to correct errors in prior pay periods to be made at the same time the changes are made in the employer's own payroll record.

The discussion document also proposes a modernised web-based portal for employers who do not have payroll systems which support the planned new digital services to submit PAYE information to Inland Revenue.

In light of the anticipated integration of PAYE with business software packages, a number of changes are proposed to the PAYE rules which will enable employers to file digitally and/or provide PAYE information to Inland Revenue at the same time as the related business process. The discussion document proposes three different options to implement this:

- *Voluntary-first approach:* Legislation would be amended to allow employers the choice of meeting their PAYE obligations by submitting PAYE information at the same time as the related business process occurs. Under this approach, a legislative requirement for all employers to follow this approach would only be considered after a critical mass were using the new services and the costs and benefits to the system as a whole justify change.
- *Legislated approach:* Under this approach, the Government would set a time-line identifying when employers will have to follow the digital approach. This requirement would likely be staggered for different classes of employers.

- *Review approach:* A middle ground, under which there would be a defined period during which employers could voluntarily meet their PAYE obligations by providing PAYE information at the same time as the business process. This would be followed by a required review where the employer would be required to review the costs and benefits of adopting the new digital services. Depending on the outcome of the review, employers would then be given a lead-in period in which to adapt to the digital approach.

It will take time for employers to upgrade their payroll software systems and will likely involve significant costs for larger employers. Given this, in our view, we do not feel there is a need at this stage to require employers to adopt digital services for meeting their PAYE obligations. Rather the benefits of moving to digital services should speak for themselves. Given the likely reduction in compliance costs once an employer's payroll systems have adapted to the digital approach, it seems likely that the benefits of this will encourage many employers to voluntarily move to an updated software package which provides PAYE information to Inland Revenue at the same time as the related payroll process. Mandating a timeframe for employers to adapt to digital services is not necessary at this stage but could be revisited in the future.

The discussion document also considers real-time collection of PAYE and requests feedback on whether employers should be required to remit PAYE and related deductions at the time employees are paid. It is envisaged that this would be aligned with the update of digital services in how PAYE information is provided to Inland Revenue.

Other proposals the discussion document considers in relation to PAYE include:

- Reducing the threshold for electronic filing of PAYE information from $100,000 a year to $50,000 of PAYE and ESCT;

- Considering whether the method for determining the amount of tax to be deducted from an extra pay should be changed;

- Considering whether the tax treatment of holiday pay should be clarified legislatively or administratively by Inland Revenue publication;

- Considering whether a mechanism should be introduced to improve the accuracy of PAYE withholding in years in which an extra pay day will occur; and

- When there is a legislated rate change, considering whether the treatment should be aligned across tax types/products.

One chapter in the discussion document is devoted to GST. Similar to proposals for PAYE, the discussion document proposes to allow registered persons the option of providing GST information to Inland Revenue directly from their integrated accounting software rather than producing and filing a GST return as a separate manual process. In addition, the discussion document envisages further improvements under new digital services, such as the ability for registered persons to voluntarily attach accompanying documents or correspondence to a GST return, and enhanced payment solutions that make it easier for registered persons to pay GST.

None of the changes proposed in relation to GST will be mandatory for the foreseeable future. GST registered persons will have the option to adopt digital services in this area given that submission of GST information does not have a direct effect on third parties in the way that PAYE does.

Conclusion

The closing date for submissions on both discussion documents is 12 February 2016.

At this stage, it is not entirely clear what the way forward will be after this round of public consultation has finished. It is noted in the documents that a formal timetable will not be set until the Government has made a decision on the approach to sequencing Business Transformation changes across the tax system. It is expected that feedback from this consultation process will continue to be factored into future consultation as the proposals become more concrete, and ultimately converted into legislation.

For further information or should you wish to discuss these proposals further, please contact your usual Deloitte advisor.
Stayed tuned to Deloitte Tax@hand and Deloitte Tax Alerts for further developments.

Tax treatment of computer software acquired for use in a taxpayer's business

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By Ian Fay and Rosalind Li

On 21 October 2015, the Commissioner of Inland Revenue released a draft interpretation statement intended to update and replace the 1993 Policy Statement on computer software published in an Appendix to the Tax Information Bulletin Vol 4, No 1 (May 1993).

Before readers get too excited, the statement is limited to taxpayers who purchase, lease, licence, develop, or commission computer software for use in their business.

Disappointingly, the statement does not consider the income tax treatment of software that taxpayers develop for sale or licence. For a long period this has been an area of some uncertainty and confusion for taxpayers (particularly with regard to the interaction/application of the trading stock rules), which hasn't been helped by subsequent Inland Revenue statements suggesting caution in relying on the 1993 statement, and the fact that the conclusions reached in that document do not fit all circumstances.

The draft interpretation statement says that the intention is to consider this area in a later item so for now it's "watch this space".

In some cases, the draft has the potential to confuse rather than assist.

As the above has been left out of consideration, unsurprisingly the conclusions reached in the draft interpretation statement aren't too different from the 1993 statement (the stated reason for the issue of the statement is that there have been a number of legislative changes that mean that parts of the 1993 statement are now out of date).

However, as software and how it is used has come a very long way since 1993 (think cloud software providers as a starting point), under current drafting, the statement does have the potential to confuse rather than assist. For example:

- The statement specifically excludes the application of any specific research and development provisions. In particular, section DB 34 (which was introduced after the 1993 statement) allows a deduction for expenditure on research and development of intangible assets that are not permitted to be capitalised for financial reporting purposes under IFRS. In its current form, the statement notes that expenditure should be capitalised once a decision has been made to proceed with the development but doesn't reconcile this comment to the capital override in section DB 34.

- The statement includes comments on "periodic payments for the rights to use software" which appear intended to cover online and cloud based software service providers. However, in most cases, online and cloud based software service providers will not be providing an end user license for "rights to use software" but instead will be providing a service (which is not a "right to use"). This distinction is very important when considering derivation of income, lease classification and potentially withholding taxes.

- It would also be useful for Inland Revenue to clarify whether the statement applies to "software as a service" providers who do not sell or licence software as noted above.

In addition, the number of examples included in the draft statement has reduced as compared with the 1993 statement and guidance on issues such as post-implementation maintenance and upgrades is limited. The statement also seems to stop short in a number of instances in providing guidance on how to distinguish costs which should be capitalised vs costs which are deductible as ongoing maintenance so there could be room for improvement here.

The draft interpretation statement is open to submission until 2 December 2015.

Please contact your Deloitte tax advisor if you wish to make a submission or would like to discuss this in more detail.

Currency conversions for branches

By Emma Marr and Lori Liu

Our July Tax Alert covered the Inland Revenue's proposed approved methods for converting foreign currency amounts into New Zealand Dollars ("NZD") for tax returns involving branches. This included annual and monthly methods and, in some cases, currency conversion methods adopted under IFRS. At the time we noted that although the draft was a welcome development, there were a few unanswered questions in the draft, and some potential areas for improvement.

It is pleasing to see, therefore, that Inland Revenue has taken on board many submissions on those points, and incorporated them in the final version of the "Approval-Income tax – Currency conversions for branches", published in the October Tax Information Bulletin.

We have summarised below the main concerns with the exposure draft, and the way Inland Revenue has dealt with those concerns in the final Approval. For more detail on the exposure draft, refer to our earlier **article** from the July Tax Alert.

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NZ$10m group turnover limit

- Inland Revenue proposed that the annual methods would be available only to taxpayers who are members of a group with an annual worldwide turnover of less than NZ$10m. This would preclude those taxpayers who may be large globally, but have a small New Zealand presence and ultimately a low New Zealand tax liability.

- Following submissions on this point, we are pleased to see that the final Approval has been amended so that the NZ$10m threshold will apply only to the New Zealand group (both the branch and any associated New Zealand entities) rather than the worldwide group. This is a much more sensible position for small branches of multinational corporations.

Notification of change in method

- The Approval has been amended so that if a taxpayer no longer qualifies to use the annual method because it breaches the NZ$10m threshold, it is not mandatory to notify the Commissioner. The taxpayer will simply transition to one of the new approved methods, and would only notify the Commissioner if the taxpayer wants approval to continue using one of the annual methods or an alternative currency conversion method.

Amounts already converted by bank

- Originally the exposure draft stated that if a foreign currency amount has been directly credited to a New Zealand bank account, and the bank has converted that amount to NZ$, that NZ$ amount must be used for tax purposes and the other conversion methods would not be available. This would result in the taxpayer having to split out and exclude those transactions from their chosen conversion method.

- Following submissions, this requirement has been removed from the final Approval, so an entity has the option of using any of the currency conversion methods for which it qualifies. Again, this is a practical position and the Inland Revenue's change in approach is welcomed.

The final Approval is a real improvement on the draft proposals.

Using the IFRS method when no separate branch financial statements prepared

- The exposure draft allowed entities to use IFRS compliance conversion methods if the entity prepared financial accounts that complied with IFRS. It wasn't clear whether this included branches that didn't prepare separate financial statements, but were included within main entity's accounts that were prepared in accordance with IFRS. The Approval clarified that a branch can use the IFRS method when the entity (of which the taxpayer is a part) prepares IFRS financial statements that include the branch.

Conversion of financial arrangements

- Despite submissions that it would be useful for the Approval to provide for a simpler way of converting financial arrangements in a foreign branch, the final Approval remains unchanged in requiring entities to use a specific conversion method if prescribed by tax legislation. In that case an entity can't use the annual or monthly conversion methods for that particular transaction, and will have to thoroughly examine its accounts to identify and carve out such transactions.

As a final note, it would have been preferable if the Approval applied not only to branches, but also to New Zealand companies who have non-NZ$ presentational currencies. However, the final Approval is a real improvement on the draft proposals, and the development of this document is an excellent example of the policy development process working in favour of taxpayers and allowing policymakers to take helpful feedback on board.

Tax shortfall penalties: understanding the trends

By Virag Singh and Hamish Tait

Earlier this year, Inland Revenue released its 2014 financial year report to the Minister of Finance on penalties applied in relation to tax shortfalls under the Tax Administration Act 1994 ("TAA"). Shortfall penalty reports must be prepared annually and presented to Parliament pursuant to section 141L of the TAA. These reports provide interesting insights into both taxpayer behaviour and the level and nature of Inland Revenue review activity in various areas.

In this article, we briefly summarise the NZ penalty regime by way of background. We then review and analyse Inland Revenue's penalty activity for the year.

NZ Tax Shortfall Penalty System

Where a taxpayer takes an incorrect tax position, that taxpayer may be liable to pay a tax shortfall penalty. The framework for this is set out in Part 9 of the TAA.

Shortfall penalties are generally imposed as a percentage of the taxpayer's tax shortfall. The percentages are determined by reference to a framework which aims to assess the taxpayer's level of culpability for the shortfall. The table below summarises the range of penalties.

Shortfall penalties may be remitted where the taxpayer meets certain criteria. Full reductions are available where the taxpayer makes a full voluntary disclosure to Inland Revenue before the taxpayer is notified of an impending audit or investigation (in cases where the shortfall penalty is for not taking reasonable care or for taking an unacceptable tax position, or a 75% reduction for other penalties). A 40% reduction in shortfall penalties is available where voluntary disclosures are made post notification but prior to the start of an audit. Taxpayers also benefit from a 50% reduction for "prior good behaviour" (essentially where the taxpayer has not had a penalty of that type in the preceding four years).

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Penalty type	% of tax shortfall	Applies when:
Not taking reasonable care	20%	Taxpayer does not take reasonable care in taking a tax position.
Unacceptable tax position	20%	Viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct. Must exceed $50k or 1% of total tax for relevant return period.
Gross carelessness	40%	Doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences.
Abusive tax position	100%	Having met the unacceptable tax position threshold, a taxpayer enters into or acts in respect of arrangements or interprets or applies tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits.
Evasion or similar act	150%	Evades the assessment or payment of tax by the taxpayer or another person under a tax law or a similar act.
Promoter penalty	The sum of the tax shortfalls arising as if the promoter had been the party to the arrangement.	Applies to a 'promoter' who has sold, offered, issued or promoted an arrangement to 10 or more persons, where a shortfall penalty for an abusive tax position is imposed on a party to the arrangement as a result.

Inland Revenue Reports

The dollar value of penalties shown below is after available reductions, unless otherwise stated.

Note: The data referred to/graphed in this article is sourced from Inland Revenue's reports on the application of shortfall penalties pursuant to section 141L of the TAA, for the years ended 30 June 2011-14.

The incidence of penalties for unacceptable tax positions (20%) and abusive tax positions (100%) has remained relatively static since FY 11. However, it is clear there has been significant movement in the imposition of other penalties.

There has been a clear upwards trend in penalties for evasion or a similar act (150%). In FY 14, this was the most commonly charged of all penalty types.

However, perhaps a more interesting trend is the decrease in the incidence of the not taking reasonable care penalty (20%), together with an increase in the incidence of the gross carelessness penalty (40%). In FY 14, taxpayers were penalised for gross carelessness 2,202 times (FY 13: 1,759 times), while in respect of not taking reasonable care, penalties were imposed 1,067 times (FY 13: 1,553 times).

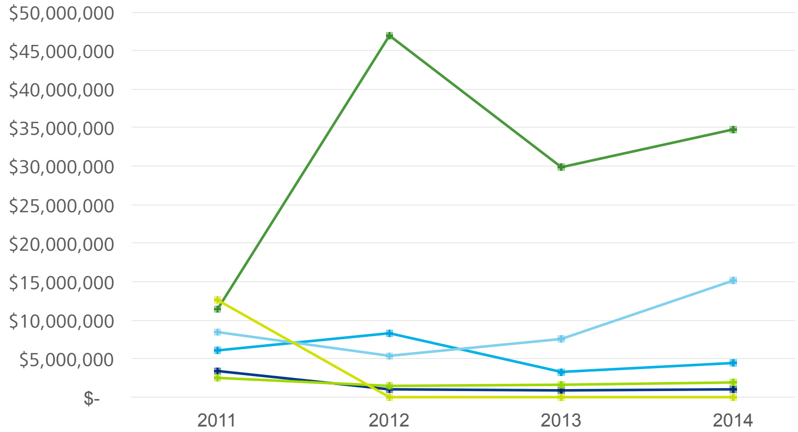
It is of course difficult to draw firm conclusions based on this limited data. However, assuming similar taxpayer behaviour across these years, the data may indicate a trend of Inland Revenue increasingly applying the 40% gross carelessness penalty instead of the 20% not taking reasonable care penalty. There could be a couple of reasons for this. Inland Revenue could be taking a particularly aggressive view of taxpayer culpability, or through the voluntary disclosure regime, there may now be more taxpayers who are coming forward to make disclosures of tax shortfalls. Further information from Inland Revenue allowing more analysis of this trend would be welcome. The increase in the incidence of the evasion penalty reflects Inland Revenue's increased focus on the cash economy and more sophistication in its investigative techniques and analytics tools.

Incidence of Penalties by Penalty Type

Dollar Value by Penalty Type

Probably unsurprisingly, the abusive tax position penalty (100%), which in all years has been applied well under 200 times, is the highest source of shortfall penalty income for Inland Revenue. In FY 14, although applied in just 171 out of 5,984 cases, penalties totalling $34.8 million were charged for abusive tax positions. In FY 12, this penalty topped $47.0 million. Despite the relatively small number of arrangements considered to involve taking an abusive tax position, the absolute value of the funds involved is very large. This corresponds to Inland Revenue's on-going success in general anti-avoidance cases both in the courts and prior to litigation through the disputes process.

Dollar Value by Penalty Type



An important point to note in relation to the penalty for taking abusive tax positions is that the Inland Revenue must first be able to establish that the taxpayer had taken an unacceptable tax position i.e. when viewed objectively, the tax position of the taxpayer fails to meet the standard of being "about as likely as not to be correct." When reporting back on the legislation introducing the unacceptable tax position test, the Finance and Expenditure Committee ("FEC") confirmed that Inland Revenue officials had assured the FEC that a position that was "about as likely as not to be correct" was a position which would be seriously considered by a court.

We do not have confidence that, in practice, in cases involving assertions of tax avoidance, Inland Revenue is interpreting the unacceptable tax position test as confirmed by the FEC, and by case law consistent with this. In practice, we have seen legal propositions relied upon by the taxpayer, where there was little doubt that the tax position adopted would be one that would be seriously considered by a court. However, the Inland Revenue has instead categorised this as an abusive tax position. This is concerning behaviour by Inland Revenue officers in charge of tax disputes and arguably translates into the significantly higher abusive tax penalties being imposed in dollar value terms, particularly where the relevant taxpayers do not have the resources to pursue and complete the disputes process. Inland Revenue has recognised the issue of shortfall penalties being used as 'leverage' in the below comments included in its recent Standard Practice Statement entitled "SPS 15/01 - Finalising agreements in tax investigations":

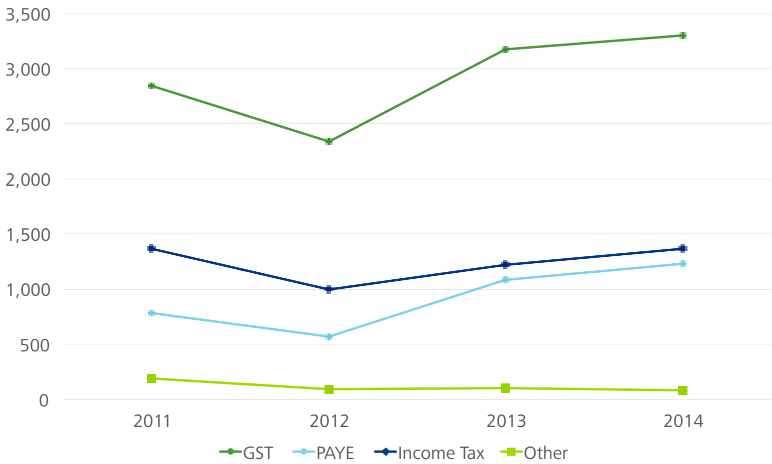
> "… staff may not use the potential of increasing the category of shortfall penalty or the likelihood of prosecution action being taken by the Commissioner, as leverage for finalising tax investigations."

By contrast with the abusive tax position penalty, the promoter penalty has been infrequently applied. While penalties of $12.7 million were charged in FY 11, this was only in relation to two tax shortfalls. No promoter penalties have been applied from FY 12 to FY 14.

Penalties by Tax Type

Perhaps surprisingly, of all tax types, GST is the most common tax for which a shortfall penalty is charged. Of the 5,984 penalties charged in FY 14, 3,300 (55%) of these were in relation to GST. It is difficult to tell whether this is due to higher levels of compliance activity in this area by Inland Revenue,

Incidence of Penalties by Tax Type



taxpayer difficulties with compliance (or outright non-compliance), or both. Regardless, it is clear that a relatively significant number of taxpayers are getting 'caught out' in relation to GST.

We strongly recommend that taxpayers undertake GST reviews on a regular basis and seek specialist GST advice in respect of one-off major transactions.

However, as shown above, the clear winner by dollar value of penalties is income tax. In FY 14, while only being applied in 1,370 instances, income tax penalties were charged in the sum of $48.9 million. This was 85% of penalties by dollar value in that year. The graph above also shows that after dipping around 2012 – 2013, the penalties in respect of income tax are again on the rise.

Conclusion

Unfortunately, while the intention of the reports is clearly to keep Parliament appraised of Inland Revenue's operations in collecting tax revenue through the penalties regime, it is difficult to draw too many conclusions based on the data provided. We are unable to tell, for example, whether an increase in the incidence of gross carelessness is attributable to income tax or GST. It is not clear whether penalties are imposed at an early stage by Inland Revenue, as a result of a protracted disputes process, or following Court action.

We would welcome additional transparency around penalties from Inland Revenue – which could foster taxpayers' perceptions of the integrity of the tax system, voluntary compliance, and provide a 'check and balance' on Inland Revenue's imposition of penalties.

Nevertheless, these reports are a valuable tool to gauge Inland Revenue activity. They also highlight the availability of reductions. Voluntary disclosures can reduce penalties where this is done in advance of an audit or investigation commencing. We therefore encourage clients to talk to us immediately when they are contacted about prior periods by Inland Revenue, or where they are concerned they have not obtained advice to sufficiently justify their tax positions.

It is also interesting to see that GST is an area where taxpayers are more often being charged shortfall penalties – in our experience this is often an area where returns are not reviewed by external advisers as consistently as for income tax.

For advice on mitigating Inland Revenue penalties, what to do when faced with the imposition of shortfall penalties, or any general tax dispute queries, please contact your usual Deloitte tax advisor.

Tax avoidance update: Inland Revenue finalises guidance

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By Campbell Rose and Brad Bowman

On 30 September 2015, Inland Revenue finalised its Question We've Been Asked, Income tax – scenarios on tax avoidance – 2015 (QWBA). The QWBA (QB 15/11) resulted from a panel discussion on the scenarios in question during the 2014 CAANZ Tax Conference. This article focuses on changes from the draft QWBA originally released.

The QWBA's overall conclusions have not changed. However, the facts and analysis in relation to the portfolio investment entity (PIE) scenario have been updated to highlight factors influencing a tax avoidance conclusion. In addition, there are minor changes to the scenarios concerning limited partnerships and discretionary trusts. It is pleasing to see that Inland Revenue has taken into account submissions made on the original draft.

Borrowing funds to invest in a PIE

This scenario has been modified to highlight aspects that are likely to lead to a tax avoidance conclusion. The key factual changes have clarified that Bank A's lending is for a fixed term of two years (the PIE correspondingly invests in 2-year deposits with Bank A), must be applied towards the PIE investment, is secured over the taxpayer's interest in the PIE, and PIE income is retained by Bank A in satisfaction of the taxpayer's interest obligations on the loan from Bank A.

Inland Revenue has (still) concluded that this should constitute a tax avoidance arrangement, but has updated the QWBA to include the following:

- With respect to the PIE rules, Parliament would have intended that investors receive an after-tax economic return resembling what they would receive if they had personally made similar investments to those made by the PIE – but Parliament intends that some investors could pay less tax if investing through a PIE given the capped 28% PIE rate.

- The circularity features have been expanded and emphasised more, such that the commercial and economic reality of the arrangement is that the usual risk associated with borrowing is absent. The circular elements mean that typical commercial constraints do not apply, and that the arrangement could be scaled-up to any level of borrowing and investing. This therefore suggests that, as a matter of commercial and economic reality, the investment in the PIE is not part of the taxpayer's savings and investment activities, and may have been motivated by tax outcomes: the financial consequences of the arrangement are "neutralised" or "distorted" and are "unlike those expected of an arrangement involving borrowing and investing".

- The arrangement being pre-tax negative and post-tax positive is not determinative in itself in terms of any tax avoidance analysis. However, that feature is relevant for this scenario because the duration and interest rates of the arrangement are fixed. Inland Revenue observes that this is likely to preclude any other economic gains arising from the arrangement, which suggests that there is no real borrowing or application of funds in connection with an income-earning activity. In addition, the taxpayer's interest obligations not satisfied by the PIE income are "funded by the tax system". This suggests that any net investment return "arises from the tax system and not the investment itself", so that there is "no real savings or investment activity" as contemplated by Parliament.

Tax-influenced distributions from a discretionary trust

Inland Revenue's view remains that this should not constitute a tax avoidance arrangement.

It is pleasing to see that Inland Revenue has taken on board submissions made on this aspect of the QWBA.

The QWBA has been updated to remove references to the solvency of the corporate beneficiary. This makes sense given that a beneficiary with tax losses is unlikely to be solvent. It is also quite conceivable that a trustee would distribute income to an insolvent beneficiary, to bolster their financial position.

Factors relevant to the avoidance analysis have been slightly modified to include whether authorised distributions are paid in cash or credited to beneficiaries' current accounts (rather than referring to distributions "by journal entry", which in our view is not a correct or valid concept).

The QWBA originally referred to distributions of beneficiary income within six months of the income year-end, which was not technically correct. The QWBA now reflects the relatively recent law change which extends the beneficiary income period to the earlier of (a) the date on which the trustee actually files the return of income or (b) the date by which the trustee must file the return (which in practice could be up to 12 months following income year-end).

Inland Revenue's view remains that this should not constitute a tax avoidance arrangement.

Finally, Inland Revenue has clarified aspects of the "factual variations" that could lead to a tax avoidance conclusion. The QWBA now states that there is a risk of tax avoidance where, in commercial and economic reality, there is no realistic prospect of the beneficiaries ever benefiting from the income allocated to them. Although the QWBA confirms there is nothing inherently wrong with (say) resolving to credit a distribution to account and retain the funds for use within the trust, a reference to *Krukziener v CIR (No 3)* (2010) 24 NZTC 24,563 has also been added – where the use and benefit of income distributed by trustees was enjoyed by a person other than the beneficiary nominated to receive the distributions, and this was a factor suggesting tax avoidance.

It is still disappointing that other examples have not been included. Given that we understand Inland Revenue is looking at a number of trust distribution cases at present, the QWBA could have usefully outlined other factual variants that Inland Revenue has seen in practice, which are considered to involve a risk of tax avoidance (or, at least, would invite more detailed scrutiny).

Structuring using a limited partnership
Inland Revenue still considers that this scenario should not constitute a tax avoidance arrangement.

The only change of note in relation to this scenario is that the tax effects of the arrangement listed in the QWBA should also include the tax consequences of the business sale itself (for example, income may arise from the sale of trading stock or fixed assets).

Inland Revenue has included a comment that recognises there may be tax effects arising from the sale of the business, but notes however that these tax effects "are not of significance" to the general anti-avoidance analysis. It seems surprising that Inland Revenue does not accord much weight to the fact that steps undertaken as part of an arrangement give rise to real, and entirely expected, tax consequences (and, indeed, potential tax cost), in addition to other tax outcomes arising. When enquiring about whether those outcomes could have been contemplated by Parliament, all of the other tax consequences of the arrangement would seem to be important in having regard to the arrangement as a whole.

Concluding remarks
We commend Inland Revenue for their continued participation in (relatively) public tax avoidance related discussions. Given the Government sees it as important that the tax rules are as clear and certain as is feasible, seeking to clarify Inland Revenue's approach on general anti-avoidance matters is clearly consistent with that aim. Publishing appropriately redacted copies of Disputes Review Unit reports on avoidance issues would constitute an even more helpful step in the same direction, but current indications are that this is unlikely to be palatable to Inland Revenue.

If you have any questions in relation to the finalised QWBA, please do not hesitate to contact your usual Deloitte advisor.

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