Tax Alert

A focus on topical tax issues – July 2015

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CIR v Trustpower Ltd: Unfeasibility expenditure

By Campbell Rose and Matthew Scoltock

Introduction

Hopes for a turning of the tide may have been high in the wake of Justice Andrews' refreshingly practical and commercially-minded High Court ("HC") judgment for the taxpayer in *Trustpower Ltd v CIR* - not to mention the other recent taxpayer win in *Vector Ltd v CIR*.

Unfortunately, the Court of Appeal (**"**CA**"**) has dashed those hopes in ruling against the taxpayer by allowing the Commissioner's appeal in ***Trustpower***. In delivering judgment for the Court, Justice White has held that $17.7m outlaid by Trustpower in applying for various resource consents relating to four potential electricity generation projects in the South Island was non-deductible capital expenditure.

The commercial setting

Trustpower is a generator and retailer of electricity. It generates (via hydro or wind) roughly half of the electricity it sells. The balance is purchased on the retail market from other electricity generators.

Trustpower has in place a "development pipeline" of approximately 200 hydro and wind generation projects at varying stages of assessment for feasibility. The development pipeline enables Trustpower to decide whether, at any given time, it is best placed to 'build' electricity generation capacity or 'buy' electricity for sale in the retail market. With no guarantee that any given generation project will proceed to a finished product,

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Trustpower's development pipeline provides a means to explore the viability of electricity generation or – as one Trustpower witness put it in the HC – to "invest in a chance".

The legal issues

From 2006 to 2008, Trustpower claimed as deductible $17.7m of expenditure relating to its application for various consents in respect of four potential generation projects in the development pipeline. This was on the basis that:

1. The expenditure did not procure 'stand-alone' assets and was therefore deductible feasibility expenditure. This was indistinguishable from recurring operational expenditure for the purpose of sourcing electricity for resale (i.e. a 'cost of goods sold' characterisation).

2. Even if the consents could be regarded as stand-alone assets, they were held on revenue account and the expenditure incurred in acquiring them was therefore deductible.

Conversely, the Commissioner submitted that:

1. The consents (with the exception of the land-use consents that had unlimited lives) were "depreciable intangible property" in terms of the Income Tax Act 2007 (the "Act") so that the expenditure incurred in acquiring them was on capital account (but depreciation deductions could be claimed once the consents were "available for use" by Trustpower).

2. In any event, the costs were non-deductible capital expenditure.

The CA's judgment – capital vs revenue account

The CA dismissed the Commissioner's first submission as an incorrect interpretation of the Act. Justice White considered the scheme of the Act clearly contemplated that – although the relevant consents were specifically included in the schedule 14 list of "depreciable intangible property" – this did not prevent their cost instead (in appropriate circumstances) being deductible up-front on revenue account.

The CA therefore saw the first question for its consideration not as whether the general permission for deductibility had been satisfied, but, rather, 'whether the expenditure was on account of capital or revenue'. If Trustpower's expenditure was on revenue account, it would be deductible under the general permission and the depreciation regime therefore could not apply.

In considering that first question, the CA traversed well-established case law principles focusing on whether expenditure has created, acquired or enlarged the business structure within which income is earned; or whether it is a cost of earning income or of income-earning operations[1]. The question depended on what the expenditure was intended to achieve from a practical or business point of view, rather than a legalistic examination of the rights involved[2].

Within that framework, the CA held that:

> *"… the expenditure was incurred for the purpose of enabling Trustpower to extend or expand its electricity generation business … The "development pipeline" was a means of determining the viability, feasibility, and costs of building new generation capacity. In the words of Dixon J in Hallstroms, new generation capacity related to the acquisition of the means of production by extending the business organisation. From a practical and business point of view, the expenditure was calculated to effect the extension or expansion of Trustpower's business structure … The fact that Trustpower may not have made its build or buy decision to commit to proceed with the projects before the expenditure was incurred is irrelevant. Like all the expenditure in the development pipeline, it was incurred for the purpose of possible future capital projects … Determined objectively, there was a sufficient connection between the expenditure and capital."*

The CA found that the role of the consents in moving generation projects along the development pipeline – which was central to the HC's view that the expenditure was revenue in nature – confirmed that the expenditure was truly intended to extend or expand Trustpower's business. This meant that the expenditure was therefore capital/non-deductible.

[1] *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 at 960 (PC)
[2] *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 (HCA).

Deloitte comment

Interestingly, the CA appears to have ignored the general permission (nexus with carrying on a business) as a starting point, and has moved directly to the 'capital vs. revenue' inquiry. A finding that the expenditure was capital in nature has then formed the basis of the CA's view that the expenditure also did not satisfy the general permission.

In doing so, it seems the CA has reversed the usual steps of assessing the deductibility of expenditure under the core provisions. Expenditure is deductible if it has the necessary nexus with income unless one of the statutory limitations – including the capital limitation – applies. In other words, if the general permission is not satisfied, the expenditure is not deductible and the capital limitation is never considered.

The CA's decision also implicitly rejects the Commissioner's published guidance on the deductibility of feasibility expenditure (*IS 08/02: Deductibility of feasibility expenditure*). Despite the Commissioner and Trustpower having agreed that feasibility expenditure was deductible (up to the point when a decision was made to proceed with a project), the CA concluded that expenditure with the necessary connection to "a capital purpose" will never be deductible (but is possibly amortised through the depreciation regime).

In *IS 08/02* – which has been in circulation for seven years – the Commissioner's view is that feasibility expenditure will be deductible under the general permission where it has a sufficient nexus with the taxpayer's business (i.e. where it is part of the taxpayer's "ordinary business operations"). The usual tests will then indicate whether feasibility expenditure is capital or revenue in nature. Significantly in Trustpower's context, the statement notes that where feasibility expenditure is part of a taxpayer's "normal business operations (*i.e., part of the constant demands on the enterprise*)", the expenditure will more likely be deductible. While the statement suggests that certain types of feasibility expenditure might be capital in nature, it does not state that expenditure which might ultimately procure a capital asset will never be deductible.

At first blush the outcome here may appeal to 'purists'. However, it arguably establishes a concerning principle: if expenditure is subjectively intended to increase sales (say, a new marketing strategy), but objectively from a practical and business point of view it must ultimately have been intended to increase production/capacity to generate those increased sales (which would involve a structural/capital asset being created or acquired), then on the CA's approach it is non-deductible capital expenditure given that "connection". This is despite the marketing spend being part of "normal business operations" (which Trustpower's development pipeline was, on the evidence before the HC). Or was the CA simply influenced, significantly, by the fact that Trustpower actually acquired and held consents themselves? On the CA's reasoning, however, that did not matter: as the baseline shift in enquiry is to whether the taxpayer's expenditure ultimately has "a capital purpose".

Putting the CA's reasoning to one side, the result for the tax system runs counter to recent legislative amendments allowing deductions for specific 'black hole' expenditure, where the underlying policy objectives have focused on helping businesses grow and make meaningful contributions to New Zealand's economy. Against that backdrop, unless it is overturned on an appeal to the Supreme Court, the CA's view adds fuel to the fire in terms of the need for a legislative solution to allow general deductibility of business-related black hole expenditure (such as in Australia, where it is deductible over five years on a straight-line basis if not otherwise deductible and certain other conditions are met).

Nexus with income

The CA also found that Trustpower's expenditure did not even satisfy the general permission:

> *"… the disputed expenditure was not incurred "in carrying on" Trustpower's business or in earning the income of the existing business or in performing the income-earning operations of the existing business. Trustpower's profit-making enterprise is the generation and retailing of electricity, not the development of its pipeline of possible new projects or the investigations of, and applications for, resource consents for those projects.* ***Possible future projects in its development pipeline are for the purpose of extending, expanding or altering its business structure in the future, not part of the carrying on of Trustpower's ordinary business activities or the taking of steps within that framework, being the generation and retailing of electricity. In terms of s DA 1 the requisite nexus between the incurring of the expenditure and the deriving of the income is not established."***

Deloitte comment

In our view, this is arguably an even more curious aspect of the CA's judgment. "Carrying on" a business is a well-established concept, which has been interpreted widely as including "abnormal" expenditure in the course of business that is not incurred in deriving assessable income (and is therefore not deductible under the first limb of the general permission), as well as expenditure incurred in the course of carrying on "ordinary business operations".[3]

By contrast, in the CA's view, expenditure aimed at growing an existing business – the goal, surely, of every business – is not incurred in carrying on that business. Taken to its logical conclusion, this means that only expenditure directly incurred in relation to the income-earning aspect of a business will ever be deductible (i.e. cost of goods sold).

Given the scheme of the Act as described above, this would mean that the capital limitation effectively serves no purpose – as any structural or 'expansion' related expenditure falls at the first "general permission" hurdle – well before the second "capital" hurdle is in sight.

If the decision is appealed, it is hoped that the Supreme Court will clarify the application of these fundamental building blocks in our tax system.

Used or available for use?

Briefly, for completeness, it is worth noting the CA's conclusion that the consents were available for Trustpower's use (for depreciation purposes) once they were granted – despite Trustpower not having decided to use them and not being able to obtain land access at that point. "Available" here simply meant "capable of being used" (even if not actually used).

Applying the CA's approach, the consents should have been depreciated by Trustpower as soon as they were acquired.

Given the recent clarification by the HC in *Westpac*[4] (another taxpayer win) regarding the breadth of the Commissioner's discretion in considering requests to amend previous assessments, one assumes that Trustpower's section 113 application will be looked upon favourably if it does not pursue a Supreme Court appeal.

[3] See *Income Tax in New Zealand* at 414-415.

[4] [2014] NZHC 3377.

Bright-line test for sale of residential property – issues paper released

By Jenny Liu and John Wang

On 17 May 2015 the Government announced as part of the Budget 2015, proposals to bolster the existing tax rules and improve compliance in respect of property transactions. Amongst the compliance measures announced is a "bright-line" test which will tax residential property sold within two years of purchase.

On 29 June 2015 Inland Revenue released a consultation paper detailing the design proposals for the new "bright-line" test.

The consultation paper seeks public feedback on the suggested details of the bright-line test. Once Ministers have considered public feedback on the proposed changes, the new rules will be included in a tax bill to be introduced in September this year. The closing date for submissions is 24 July 2015.

The new rules will apply to residential properties for which an agreement to purchase was entered into on or after 1 October 2015. The critical date for the application of the new rules is the agreement date rather than settlement date. Where a property is acquired other than by way of sale, the rules will apply if the registration of title occurs after 1 October 2015.

Property gains that are subject to the new rules will need to be included in an income tax return and will be taxed at ordinary marginal tax rates.

Why is the bright-line test introduced?

The purpose of the bright-line test is to supplement the "intention test" in the current land sale rules that makes gains from the sale of property purchased with the intention of resale, taxable. Due to its inherent subjectivity the intention test can be difficult for Inland Revenue to enforce in practice.

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The bright-line test supplements the intention test with an unambiguous objective test.

When is the start and end of the two year period?

The two-year period will run from the date of acquisition to the date of disposal, however the date of acquisition and the date of disposal are proposed to be defined differently to minimise opportunities to avoid the new rules.

It is proposed that the date of acquisition will generally be the date the title is registered with Land Information New Zealand (LINZ), whereas the date of disposal is proposed to be the date a sale and purchase agreement is entered into. Although the date of disposal is the date an agreement for sale is entered into, it is likely that Inland Revenue will use the LINZ system to identify properties transferred within 2 years, or just outside the 2 year period, for further investigation.

Where there is a sale of the right to buy a property,including sales "off the plan", the bright-line period will run from the day that a person enters into an agreement to purchase the property, to the date that a person enters into an agreement for the sale of the right to buy the property.

What type of properties will the bright-line test cover?

The bright-line test will only apply to "residential land".

Under the suggested changes, residential land will mean:

- Land that has a dwelling on it; or
- Land for which there is an arrangement to build a dwelling on it;
- But does not include land that is used predominantly as business premises or as farmland.

The definition of dwelling means that hotels, motels, rest home or retirement villages will not be considered residential land but amendments will be made to the definition to ensure that serviced apartments will be caught within the new rules other than where operated as a business.

Farmland is land where the area and nature of the land disposed of means that it is then capable of being worked as an economic unit as a farming or agricultural business. Capable of being worked as an economic unit as a farming or agricultural business means land capable of producing revenue sufficient to cover all costs of holding and operating the land, including the cost of capital employed and a reasonable recompense for the proprietor's labour. This is likely to rule out lifestyle blocks from any exception. Further, small farms with dwellings may therefore still be subject to the bright-line test even if they are leased to farmers and are used for farming activities.

Are there any exceptions to the bright-line test?

The primary exception to the proposed bright-line test is the main home exception. This exception will apply when:

- The land has a dwelling on it;
- The dwelling is occupied mainly as a residence by the owner; and
- The dwelling is the main home of the owner.

If the property is owned by a trust, then the exception will apply when the dwelling is occupied mainly as a residence by, and is the main home of, a beneficiary of the trust. If a settlor of a trust has a main home that is not owned by the trust, the main home exception cannot apply to any property owned by the trust.

The requirement that the dwelling is occupied mainly as a residence is the key test for the residential exclusion in the current land sale rules and is intended to ensure that properties used mainly for investment or other purposes are not covered by the exception. It is determined based on actual use rather than intention. The requirement that the dwelling is the main home of the owner is intended to ensure that the main home exception can only be used for one property at a time. This is determined by the degree of use and the personal connection.

Other proposed exceptions include inherited property, which is not subject to the bright-line test. The transfer of property under a relationship property agreement would also not be subject to tax under the bright-line test. However, any subsequent sale of property transferred under a relationship property agreement may be subject to the bright-line test if the disposal is within two years of the original acquisition and the property was not the transferee's main home.

Officials are seeking submissions on how the bright-line test should apply to disposals as result of individual or corporate insolvency.

Are taxpayers allowed a deduction of expenditure?

Under the proposed rules, taxpayers would be allowed deductions for property subject to the bright-line test according to ordinary tax rules. A deduction will be allowed for the cost of the property which includes:

- The initial acquisition price of the property;
- Any expenditure related to the acquisition, e.g. costs to lawyers, valuers, surveyors and real estate agents;
- Incidental costs of disposing of the property;
- Any capital improvements to the property made after acquisition, such as renovations.

Certain holding costs such as interest, insurance, rates and repairs and maintenance may also be deductible subject to normal deductibility requirements (e.g. sufficient nexus to income, not being capital or private in nature, etc).

It may therefore be prudent to retain documentation in relation to the various expenses incurred in relation to a property such that deductions can be supported in the event that a property is ultimately caught within the rules.

What if you sell a property at a loss?

Losses arising only as a result of a sale of property being caught by the bright-line test are proposed to be ring-fenced so that they can only be used to offset taxable gains arising under the land sale rules.

A person would not be able to recognise a loss under the bright-line test arising from a transfer of property to an associated person.

Any other relevant rules you should be aware?

Inland Revenue is proposing a specific anti-avoidance rule for land rich companies and trusts to prevent people from avoiding the bright-line test through the use of trusts and companies rather than direct transfers of residential property.

What about any GST implications?

The current issues paper is silent on GST implications. We would welcome further clarification on this matter especially where subdivision is involved.

How strictly will these rules be enforced?

Inland Revenue has been provided an extra $29 million in Budget 2015 to chase property investors. The extra $29 million of spending brings the department's total spending on chasing property investors over the next five years to $62 million and is forecast to generate about $420 million of extra tax in that period.

To support its efforts, Inland Revenue currently uses a sophisticated computer software that identifies and 'tags' individuals and properties that have been involved in regular buying and selling activities. Inland Revenue will likely utilise similar software for identifying taxpayers that are subject to the bright-line test.

Compliance measures

Further to the above, also announced in Budget 2015 the Government also introduced a bill to Parliament last week to enable Inland Revenue to collect more information about people who are dealing in land. The Taxation (Land Information and Offshore Persons Information) Bill will see LINZ and Inland Revenue collaborating on information collection. Broadly:

- All parties to a property transaction will be required to obtain an IRD number and provide that number to LINZ as part of the transaction process. Those who are tax residents in another country will also have to provide their Tax Identification Number from their home jurisdiction. There will be an exemption for New Zealand residents' main home (which is consistent with the issues paper).
- Overseas buyers and sellers will need to have a New Zealand bank account to get a New Zealand IRD number. This rule will also apply to New Zealanders who have been out of the country for three or more years.

This Bill had its first reading last week and has been referred to the select committee. The government proposes the legislation will take effect from 1 October 2015. These measures alone may prove a deterrent to some offshore investors.

The Government has toughened up its approach on this issue such that it will soon become much harder for those that buy and sell property in the hope of making quick gains to avoid being identified and taxed appropriately.

Currency conversions for branches – draft released

By Stephen Walker

On the 10 June 2015, Inland Revenue released for consultation an exposure draft outlining the Commissioner's proposed approved methods for converting foreign currency amounts into New Zealand Dollars ("NZD") for tax returns involving branches.

Historically, many taxpayers have been required to perform detailed, time consuming and often complex calculations in order to comply with the technically correct requirements of the New Zealand tax legislation and convert their foreign currency amounts into NZD based on the close of trading spot exchange rate. In many cases, the effort required to perform such calculations is disproportionate to the amount of tax at stake, leading the vast majority of taxpayers to adopt more simplified pragmatic methods in practice.

The subject matter of the exposure draft is therefore a welcome one in that it signals Inland Revenue's acceptance of some of those simplified methods currently used by taxpayers. However, the proposed approved methods, as they are currently drafted, do leave a number of questions unanswered and raise a few new ones. In addition, there are some New Zealand companies, not just branches, who have non-NZD presentational currencies, for whom these proposals may also be useful. However, as it currently stands, these proposals would not apply to them.

What's covered?

The proposed acceptable conversion methods outlined in the exposure draft for determining the NZD equivalent of profit before tax are the IFRS method, the annual methods, the monthly methods and the close of trading spot exchange rate method, which is the default method that is currently outlined in the legislation.

The exposure draft also covers the limitations for using each method, how certain tax adjustments should be converted, acceptable foreign exchange rate sources to use, and the notification requirements for a taxpayer choosing or changing to a particular method and/or exchange rate source. Inland Revenue is keen to hear of any other methods adopted by taxpayers as they may seek to approve these too. In addition, the exposure draft reiterates that taxpayers can still seek their own taxpayer specific approved methods if they so wish and these new proposals would not override existing or new methods, agreed directly with Inland Revenue.

IFRS method

The good news is that, under the proposed IFRS method, if you already prepare financial statements for a New Zealand branch or a New Zealand parent entity of an overseas branch, these are prepared under the New Zealand equivalent to IFRS ("NZ IFRS"), and they are already in NZD, then the conversion method adopted under NZ IFRS will be acceptable to the Commissioner. This would likely be in line with the current practice of the majority of New Zealand taxpayers operating branches.

If you do not, or are no longer required to prepare financial statements under NZ IFRS, a scenario which many taxpayers may soon find themselves in following the recent changes to the financial reporting requirements for branches of small overseas companies, then you may need to consider one of the annual, monthly or the existing default conversion methods instead.

Annual and monthly methods

Under current proposals, choosing one of the annual methods would require you to aggregate the branch's income and expenditure for the year, converting them into NZD at the end of the year using either the annual average of the end-of-month exchange rates, or the annual average of the mid-month exchange rates (based on the 15th of the month). The monthly conversion methods are similarly applied to each month's aggregated income and expenditure, but using either the exchange rate on the 15th day of that month, the exchange rate on the last day of that month, or the average exchange rate for that month.

The annual methods would appear to be the simplest of the methods to apply, however, under the current proposals, the annual methods will only be available for use by those taxpayers who are members of a group whose annual worldwide turnover is less than NZD10m.

The comments included in the exposure draft suggest that as the annual methods represent a significant departure from the default close of trading spot exchange rate method, the Commissioner is keen to limit the use of the annual methods to small taxpayers, hence the NZD10m limitation. However, the worldwide turnover threshold is likely to rule out the annual methods for those taxpayers who may be large globally, but have a small New Zealand presence and ultimately a low New Zealand tax liability.

In the interests of trying to simplify and reduce the compliance burden for such taxpayers, it would perhaps make more sense to apply the turnover limitation to the New Zealand group turnover (including any foreign branches) in order to balance addressing the Commissioner's concerns and simplifying the calculation methods for many taxpayers.

Tax adjustments

The exposure draft also provides some guidelines as to how to calculate annual tax adjustments when using either one of the annual or monthly methods. The base requirement is that the adjustments should be consistent with the nature of the item being adjusted. Examples given include;

- Adding back non-deductible legal fees, the value of which would be the NZD amount in the profit and loss, converted using the relevant method.
- For items such as depreciation (both accounting and tax) the document suggests that using an average annual rate for converting the amounts would be acceptable. Note that the annual conversion rate for such adjustments appears to be applicable under both the annual and monthly conversion methods. This helpfully negates the need to carry out monthly tax calculations under the monthly method.
- For balance sheet adjustments, which would include items such as general accruals, holiday pay, bonuses etc, the amount to be adjusted could be calculated by reference to the balance date spot rate.

Foreign tax credits

Where a branch has paid foreign income tax, the amount being claimed as a foreign tax credit in an entity's New Zealand income tax return should be the

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amount in NZD converted at the exchange rate on the date the foreign tax was paid.

Foreign exchange rate sources

The exposure draft proposes five approved sources of exchange rates for use by both foreign and New Zealand branches. The first, not surprisingly, is the Inland Revenue's own rates, as published on their website. Others include those rates published on the website of the Reserve Bank of New Zealand ("RBNZ"), foreign exchange rates from one of New Zealand's registered banks (as registered on the RBNZ website), and any reputable externally-sourced exchange rate.

The proposals do not state any particular order in which the above should be considered which is helpful in that it allows a taxpayer some flexibility in terms of choosing whichever source is more practical given their specific circumstances. For example, the RBNZ rates are available in excel format, which can make them easier to use if you are performing manual calculations. Alternatively, if you are a registered bank looking to use your own rates for conversion, you would be able to do so.

There are no comments or examples as to which external rate sources Inland Revenue would consider reputable. Presumably, Inland Revenue are looking to include widely available public sources of exchange rate information from the internet, but it would be helpful if this was clarified and some examples of reputable sources given by Inland Revenue in their final document.

The fifth approved exchange rate source is the effective exchange rate applied by a bank to those branches that operate a NZD bank account. As the exposure draft is currently worded, if a foreign currency amount has been directly credited to a New Zealand bank account, and the bank has converted that amount to NZD, the NZD amount received is the amount that must be used for tax purposes and the other methods will not apply.

From a practical perspective, the use of the words "must be used" in this context suggests that, whatever your particular circumstances, and despite the preferred and most practical conversion method you may have chosen for other transactions, if you operate a NZD bank account for your branch, then you will need to identify and split out those transactions already converted in

the NZD bank account from your annual, monthly or transaction spot-rate conversion calculations.

Whilst not all branches may operate both a foreign currency and a NZD bank account, if these proposals stay in the final document, operators of such branches will really need to think about whether they need to use one or the other rather than both currency accounts if they want currency conversion to be simpler.

Consistency requirements

There will not be any requirement to notify the Commissioner that you will be using either one of the conversion methods or one of the foreign exchange rate sources outlined above. However, once a method or exchange rate source is adopted, you will need to continue using that method and source consistently for future periods, and if you want to change to another method and/or rate source, then you will need to apply to the Commissioner for approval to do so. There are also some specific consistency proposals around the use of one of the annual methods.

Limitations

As well as the annual methods' specific turnover limitation outlined above, if the current tax legislation currently prescribes a method to be used for a particular transaction, then under the currently worded exposure draft, you would not be able to use any of the annual or monthly methods for that particular transaction. Examples given include calculating income or loss for foreign investment funds and financial arrangements under the financial arrangement rules. This latter exclusion may make these provisions difficult to apply in practice.

Take the example of a New Zealand branch, with an Australian Dollar ("AUD") presentational currency looking to file its New Zealand income tax return. In this context there are likely to be some transactions that are financial arrangements. These will require you to go through the balance sheet, identifying and carving out the financial arrangements from your annual or monthly calculation and calculating them on a spot-rate basis. If you also have an NZD bank account, then as outlined previously, you will also be required to split out and exclude those transactions from your chosen conversion method. Suddenly, under the currently worded exposure draft, we seem to be moving away from simplifying the foreign exchange calculations, and moving towards something that is potentially more complex than the current close of trading spot exchange default method. Also linked with foreign exchange gains, the exposure draft makes no reference to the appropriate treatment of any gains and losses already included in the AUD profit and loss account. Such balances could be made up of both existing NZD and other third currency denominated transactions. What should taxpayers do to convert such items to NZD?

Submissions

The exposure draft can be found here: **https://www.ird.govt.nz/resources/a/d/ad7b640c-7746.../pub00184.rtf** and if you would like to provide your comments on the items raised in the document, either directly or through Deloitte, the deadline for them to be submitted to Inland Revenue is 22 July 2015. Please feel free to contact your usual Deloitte Tax advisor for further information.

Tax avoidance: Inland Revenue sheds further light on their approach in practice

By Campbell Rose and Brad Bowman

Inland Revenue has released a draft **Question We've Been Asked**, *Income tax: scenarios on tax avoidance – 2015*. The draft QWBA has resulted from a panel discussion on the scenarios in question during the 2014 CAANZ Tax Conference.

The draft QWBA concludes that:

- Structuring an investment into an existing business using a limited partnership is not tax avoidance;
- Borrowing funds from, and investing in a portfolio investment entity (PIE) sponsored by the same bank constitutes tax avoidance; and
- Taking into account the tax profile of a beneficiary when distributing income from a discretionary trust on its own is not tax avoidance (but factual variations may alter this view).

Although the draft QWBA leaves some important questions unanswered, Inland Revenue are to be commended both for participating at the Conference and for committing resources to produce (and consult on) the draft QWBA. This latest guidance adds to the other recent QWBAs that also addressed tax avoidance in practice: *QB 14/11* and *QB 15/01*.

Structuring using a limited partnership

The first scenario involves a company with available tax losses (Loss Co), which wholly owns a profitable operating subsidiary (Op Co). Loss Co wishes to introduce a new 50% investor (Investor Co). The investment is structured by Op Co selling its business to a limited partnership with Loss Co and Investor Co as 50:50 investors.

The effect is to enable Loss Co to continue to offset its losses against its 50% share of Op Co's income.

If Investor Co had simply purchased 50% of Loss Co's shares in Op Co (an economically equivalent transaction), that tax outcome would not have arisen. It is clear that tax considerations significantly influenced the manner in which the investment was structured.

The draft QWBA importantly reconfirms that, in undertaking the avoidance analysis, the economic effects of the structuring must not be confused with comparing the transaction actually undertaken with one that is economically equivalent (but which produces different, and perhaps less optimal, tax outcomes). This is consistent with the Supreme Court's observation in Ben Nevis that in commerce there are different means of producing the same economic outcome which have different tax consequences.

Of equal significance is the draft QWBA's confirmation that taxpayers are not obliged to elect a structure that requires them to pay the highest amount of tax: *"… there is no general requirement for the parties in this scenario to adopt an alternative, less tax-favourable, arrangement"*. As the Supreme Court stated in Ben Nevis and in Penny & Hooper, *"… taxpayers have the freedom to structure transactions to their best advantage"* (assuming that provisions are used in a way intended by Parliament).

Determining the commercial and economic reality of the arrangement therefore should be based on what actually happened, not what could have happened in the alternative. We are seeing Inland Revenue investigators postulate hypothetical (and less tax efficient) alternatives as part of their tax avoidance analysis, and so it is hoped that the principles reaffirmed in the draft QWBA will be respected in practice.

This principle has parallels with Sir Ivor Richardson's observations in *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (at paragraph [40]), that *"commerce is legitimately carried out through a range of entities and in a variety of ways; that* ***tax is an important and proper factor in business decision making and family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another*** *is required to justify attributing a greater tax liability"* [emphasis added].

The draft QWBA concludes that all of the facts, features and attributes Parliament would expect to see present in the arrangement to give effect to Parliament's purposes for the specific provisions are present – the tax outcomes are therefore within Parliament's contemplation, and accordingly do not fall foul of the general anti-avoidance provision.

We agree with this conclusion. Our final observation is that the tax effects of the arrangements listed in the draft QWBA should also include the tax consequences of the business sale itself (e.g. income may arise from the sale of trading stock or fixed assets) – supporting the commercial and economic reality of what has been implemented.

Borrowing funds to invest in a PIE

The second scenario involves an individual on the top marginal tax rate of 33% who borrows funds from Bank A (incurring interest at 5.0% p.a.) and invests the funds in a multi-rate portfolio investment entity (PIE) sponsored by Bank A. The PIE's asset is deposits with Bank A which earn a fixed pre-tax return of 4.9% p.a. The individual notifies the PIE to apply a prescribed investor rate of 28% and deducts their interest expenditure.

The arrangement is pre-tax negative (a loss of 0.1% p.a.), but post-tax positive (net return of 0.178% p.a.). According to Inland Revenue's general anti-avoidance interpretation statement, this is an indicator that suggests tax avoidance, however it is not determinative in itself (refer paragraph [349] of IS 13/01). The draft QWBA reiterates that a strong tax influence in structuring does not automatically give rise to tax avoidance (refer paragraphs [56] and [87]).

In addition, the arrangement involves a circular movement of funds from Bank A to the investor, and then back to Bank A via the PIE. Circularity of funds is another indicator of tax avoidance, but similarly it is not conclusive (refer paragraph [24] of *IS 13/01*).

The QWBA finds that the arrangement has no investment or savings element as a matter of commercial and economic reality, which is contrary to how Parliament contemplated the PIE rules should be used (as compared with, say, a taxpayer who withdraws funds off deposit and invests them in a similar cash PIE – which *IS 13/01* concludes is not tax avoidance). Inland Revenue has also reiterated its view that a general purpose of the arrangement (the generation of investment income) is not sufficient to displace a tax avoidance purpose or effect as being merely incidental; the purpose must explain the particular structure adopted.

The purpose or effect of this arrangement could be described as the generation of investment income. For this arrangement, the general purpose of generating investment income could have been achieved in multiple different ways. It does not explain the specific structure of the arrangement. The draft QWBA therefore concludes that the tax avoidance purpose or effect was not merely incidental to the general purpose of generating investment income.

Ultimately, the draft QWBA concludes that borrowing funds from a bank and investing them in a PIE sponsored by the same bank is tax avoidance. Although a number of factors are relied upon in reaching this view, we believe the most influential factors are likely to be the lack of real risk assumed by the taxpayer in making the investment, and the circularity: would the same conclusion be reached if the taxpayer borrowed from Bank A and invested in a PIE sponsored by Bank B? This was briefly canvassed at the Conference panel session, but has not found its way into the draft QWBA.

Tax-influenced distributions from a discretionary trust

The third scenario involves the trustee of a discretionary trust distributing income to a taxpayer who is either:

- An individual adult beneficiary on a marginal tax rate lower than the trustee tax rate; or
- A corporate beneficiary with tax losses available that are equal to, or greater than, the income distributed; or
- A corporate beneficiary, where the income is a dividend from a foreign company and exempt under section CW 9.

As a starting point, the draft QWBA notes Parliament would contemplate that the facts, features and

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attributes present in an arrangement involving beneficiary income would include the existence of a valid trust (including satisfying the necessary prerequisites in the formation of the trust), and the trustees of the trust acting in accordance with the trust deed and general trust law.

The draft QWBA effectively goes on to observe that if the recipient beneficiary is validly entitled to a distribution, the distribution is properly effected and the recipient does actually benefit from the distribution, then the commercial and economic reality of the arrangement is the same as its legal form (i.e. a distribution of income to a beneficiary as beneficiary income). Again, this is what Parliament contemplates for the trust rules. On this basis, the arrangement's tax outcomes are not tax avoidance.

We agree with the draft QWBA's conclusion. This is welcome guidance given that the distribution of income by trustees of discretionary trusts to a variety of beneficiaries, including by reference to their tax profile, is widespread and common-place in New Zealand – which is notorious for its proliferation of trusts.

However, we do not agree with all aspects of the draft QWBA's analysis, and it does leave open some significant questions:

- The draft QWBA contemplates a "solvent" corporate beneficiary with tax losses available to it. The scenario discussed at the CAANZ Tax Conference did not involve a solvent beneficiary and, in practice, a beneficiary with tax losses is quite likely to be insolvent (or barely solvent). If the corporate beneficiary is owned by a beneficiary or beneficiaries of the trust, it is quite plausible that the trustee would consider it entirely appropriate to distribute funds to the corporate in order to bolster its balance sheet – to put it in a better position to continue to trade, or assist it to satisfy bank covenants, or to enable it to repay debt (etc). It is difficult to see how this additional factual feature should make any difference to the anti-avoidance analysis. Indeed, it seems axiomatic that the beneficiary in such circumstances clearly is "benefiting" from the distribution. This should be revisited in the finalised QWBA.

- The QWBA refers to distributions within six months of the income year-end constituting beneficiary income. A relatively recent law change extended the six month time limit 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: in practice it is often greater than six months.

- The draft QWBA correctly states that a valid declaration or resolution by a trustee allocating income to a beneficiary will be sufficient for an amount to be "paid" (see [77] – at [78] it is confirmed that physical payment is not required). Despite this, in the context of its avoidance analysis the draft QWBA appears to place significance on whether distributions are actually received by beneficiaries (see [82], [91] and [92]). In our view actual cash payment/receipt is not a fact, feature and attribute that Parliament contemplated to be present in an arrangement involving beneficiary income. Given that a valid and binding trustee resolution creates a receivable/sub-trust in the beneficiary's favour, which can be dealt with by them for their benefit, we consider that this aspect of the draft QWBA needs to be modified when it is finalised.

- Linked to the "paid" point, the draft QWBA suggests that journal entries may function to "pay" or otherwise effect a distribution (refer [91] and [92]). This is not correct, and appears to implicitly (and, we consider, wrongly) suggest that a journal entry 'in combination' with other features may lead to a tax avoidance conclusion. A journal entry is simply an accounting entry recording a transaction that has already occurred. The journal entry is not the "payment" of the distribution; it simply records that the beneficiary has a beneficial interest in an amount equal to the distribution that has already occurred by virtue of the trustee's declaration or resolution. This should be corrected in the finalised QWBA.

- Disappointingly, the draft QWBA is silent on what factual variations in this scenario would give rise to tax avoidance (or, at least, Inland Revenue scrutiny). It would not be difficult to non-exhaustively list some of these in terms of what Inland Revenue have encountered in practice. If Inland Revenue published anonymised Disputes Review Unit reports (whether taxpayer favourable or unfavourable), then this would go a long way to inform taxpayers and their advisers of broadly what factual features of arrangements are likely to be considered problematic (or not) in the avoidance analysis.

Inland Revenue's deadline for comment on the draft QWBA is 23 July 2015. If you have any comments or if you wish to discuss the draft QWBA, please contact your usual Deloitte advisor.

Take care when transferring funds from a UK pension plan

By Andrea Scatchard

Have you lived and worked in the UK? If so then you probably have funds sitting in a UK pension plan.

Historically foreign pension plans caused numerous, often very costly, headaches for individuals in New Zealand as the tax rules often taxed unrealised increases in the plan's value even if the funds were locked in and unable to be accessed to pay the New Zealand tax. The rules were changed from 1 April 2014 to simplify the New Zealand tax treatment and encourage a higher level of compliance. From that date, individuals are taxed only at the point that they withdraw from their foreign pension plan, including transferring the interest to a New Zealand or Australian scheme.

The amount that is taxable in New Zealand depends on how long the individual has been present in New Zealand at the time of withdrawal or transfer, with the added bonus that new migrants (or returning residents who accrued their rights in the foreign scheme whilst a non-resident) are generally able to utilise a four year window and move their pension plans into New Zealand tax free within that initial period. This tax free New Zealand treatment can be very attractive, but there is a catch, and it's a big one. Individuals must be very careful where they transfer their funds to in New Zealand otherwise they could face a UK tax liability of up to 55% of the value transferred. UK pension plans can only be transferred to QROPS (qualifying recognised overseas pension schemes) and these must be approved by Her Majesty's Revenue and Customs (HMRC).

From April 2015 the list of New Zealand QROPS has been significantly reduced. Kiwisaver schemes no longer qualify as QROPS because they allow withdrawals before the age of 55 for first home purchasers and in certain financial hardship situations, which are not allowed by HMRC. The relevant list of New Zealand approved QROPS is generally available on the UK HM Revenue & Customs Website, however, the list of available QROPS schemes is currently undergoing further review by the UK HM Revenue & Customs and is due to be re-published shortly. It is therefore important that you check carefully with any NZ QROPS provider to ensure that they are still able to facilitate a pension transfer; otherwise you face the risk of your funds being returned to your UK scheme. This is particularly relevant if you currently have a transfer underway.

If you have a UK pension plan and are looking to transfer it to New Zealand, make sure you do your homework and seek professional tax and financial advice before proceeding. Also be aware that the transfer process can take some months to implement so if you qualify for the transitional resident four year exemption and are considering transferring your pension plan within the four year period you should start talking to your advisers at least six months before your exemption period expires.

For more information please contact your usual Deloitte adviser.

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New tax bill – the start of the business transformation process

Earlier this week, a new tax bill *(the Taxation (Transformation: First Phase Simplification and other Measures) Bill)* was introduced which paves the way for the Business Transformation and modernisation of the tax system project. The bill includes measures that will make communication easier with Inland Revenue, simplify some tax rules and allow the Inland Revenue to share information with other government departments in certain situations.

The key measure is a new communications framework in the Tax Administration Act 1994 which provides for varying levels of communication ranging from informal telephone conversations to electronic communication or delivery (via website, email or other means) to more formal notification methods requiring paper or original documents.

Currently most communication under tax legislation is paper-based (i.e. must be in writing) or must be delivered by post which has become outmoded in today's electronic age. As a consequence, much of the bill replaces outmoded language throughout the various tax acts.

The new rules allow for new modes of communication so that as new technologies emerge, the legislation can be future proofed to a degree. An amendment will also allow for documents to be signed with a digital or electronic signature.

These rules will apply from the date of enactment (likely to be later in 2015).

Collection of tax on employee share schemes

The bill also slips in a key change regarding the collection of tax on employee share schemes. Readers will recall that earlier this year, the Government consulted on this issue **(see our April 2015 Tax Alert).** Employee share schemes, where employers offer shares in the company to employees, are often used to encourage staff retention and motivation. The value of the benefit from these schemes is treated as an income substitute under the current tax rules, but unlike most employment income, is not currently subject to PAYE. Instead, employees who receive share scheme benefits must file a tax return and account for the tax on the value of the benefit themselves which can be problematic.

Following consultation, the bill proposes to allow an employer to choose to withhold tax on any employment income an employee receives under a share purchase agreement using the PAYE system. Submitters generally preferred the PAYE option and submitted that an elective approach was preferred.

However, all employers will be required to disclose the value of any benefits an employee receives under a share employee agreement via the employer monthly schedule (whether or not PAYE is withheld). In other words, where the employer decides to leave it up to the employee to pay their own tax on any benefit, this must be disclosed and Inland Revenue will be on notice to ensure the employee has included this in his or her own tax return.

These changes will apply from 1 April 2017 to employment income received on or after this date.

KiwiSaver

Rules are being amended to improve the service provided to members when transferring from one scheme to another by expanding the current information sharing provision. The bill also proposes that minors, who have been incorrectly enrolled into KiwiSaver, be allowed to opt out before their 19th birthday.

FIF exemption simplification for ASX

The bill amends the FIF exemption for certain share investments listed on the Australian Stock exchange (ASX) for attribution under the foreign investment fund regime. The bill removes the requirement that shares must be listed on an approved index under the ASX operating rules and replaces it with a requirement that the shares are in a company listed on the ASX. This will remove the considerable uncertainty and administrative issues in practice as companies move on and off this list each year. Taxpayers should be able to better self-assess their compliance as it will be easier to check whether they are simply listed on the ASX given this is publicly available.

Once the bill has had its first reading, it will be referred to a select committee and at that time a submission date will be set.

Increase in pooling value threshold for depreciation purposes

On 4 June 2015, the **Income Tax (Maximum Pooling Value) Order 2015 (LI 2015/141)** was released which increases the maximum allowed pooling value to $5,000 (previously $2,000).

The pool method is one of the three available methods for calculating a depreciation loss for an income year. The method allows a taxpayer to group a number of assets together and depreciate the pooled assets as if they were a single asset, thereby reducing compliance costs. A pool is depreciated using the diminishing value method, at the lowest rate applying to any asset in the pool.

"Poolable property" is property acquired during the income year for no more than the maximum pooling value threshold.

The order came into force on 1 July 2015 and applies for the 2015/16 and later income years. This is the first increase in the pooling value threshold since the rules were introduced back in 1993 and is therefore a long overdue measure which will assist depreciation compliance in certain situations.

Some may also argue it's about time to increase the low value asset threshold for immediate write-off from $500 as well. The New Zealand threshold pales into significance with respect to the recent Australian budget announcements whereby small businesses meeting certain turnover thresholds can immediately deduct assets with a cost of less than A$20,000.

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