Tax Alert

A focus on topical tax issues – May 2015

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Tax depreciation myths debunked

By Iain Bradley and Veronica Harley

There are some particular quirks and rules that apply when it comes to claiming a tax depreciation deduction. In this article we take a look at some of the common myths that prevail and tax rules that apply in this area.

Myth #1 – All depreciable assets with a cost of $500 or less can be written off immediately

Not necessarily. It is true that assets with a cost of $500 or less (low value assets) can be written off; however there is an exception where a number of low value assets are acquired at the same time from the same supplier and which have the same depreciation rate. Under the single supplier rule, if the total cost of the low value assets purchased as a group is greater than $500, an immediate write-off cannot be taken and the assets must be depreciated.

Myth #2 – I need to own the asset before I can claim tax depreciation

This is generally correct, although the meaning of "own" is extended beyond the ordinary meaning in certain cases. For example a lessee is deemed to own and is able to claim depreciation on the cost incurred by the lessee on leasehold improvements for tax depreciation purposes. Taxpayers should note that there are a number of conditions that must be met for leasehold improvements to be able to be depreciated for tax purposes. Depreciable property subject to finance leases is deemed to be owned by the lessee and as such the lessee can claim tax depreciation on that finance lease asset.

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Myth #3 – I can start to claim tax depreciation on an asset from the purchase date

This statement gives rise to two points. The first is that ownership of the asset is not enough. In order to claim depreciation on an item, it must also be used or available for use in deriving assessable income or in carrying on a business to derive assessable income. Therefore tax depreciation can only be claimed from the point a business has commenced and those assets are used or available for use in that business. If an asset is constructed in-house, depreciation can't be claimed until the asset is able to be used.

The other point to note here is that tax depreciation is calculated on a monthly basis. Therefore if an asset is purchased on 31 March being the last day of the tax year, one whole month's depreciation can be claimed. This is because tax depreciation is claimed on a monthly, not daily basis.

Myth #4 – If I forget to claim depreciation in one year, I can claim it in the next year

It's not always that simple unfortunately. The base rule is that an item is deemed to have been depreciated even if a taxpayer neglects to claim a tax depreciation deduction in their tax return. This means the opening balance in the following year is the closing tax adjusted value of the asset as if tax depreciation had been claimed. In this case a taxpayer has the following options.

- If a taxpayer wishes to claim a deduction for tax depreciation missed in the prior year's return, then it can be picked up in the current tax return only if the tax effect of the error is $500 or less.

- If the tax effect of the omitted depreciation claim is greater than $500, then the taxpayer can request that the Commissioner amend the prior year's tax return using section 113 of the Tax Administration Act 1994.
- Finally, a taxpayer may decide not to claim the omitted depreciation and simply start to claim depreciation from the current year on the corrected adjusted tax book value.

Which option is appropriate will depend on the quantum of omitted depreciation and any compliance costs involved. We acknowledge that some taxpayers may have adopted a pragmatic approach to dealing with issue historically but it is important to be aware of what the technically correct options are.

Myth #5 – I should always claim depreciation

Most people do claim tax depreciation in order to legally maximise available deductions and reduce tax payable. However a taxpayer may not wish to claim depreciation in order to provide relief from depreciation recovery income on the eventual sale or deemed disposal of the property. For example, a person may decide to move overseas and rent out their house. While depreciation can't be claimed on the building itself any longer, it could be claimed on the chattels within, for example heat pumps, appliances, blinds, carpets and so forth. It would be necessary to establish a base value of the chattels for this purpose which would generally be market value on the date the person starts to use it for rental purposes. However if that property should revert back to private use or is subsequently sold, depreciation recovery income would arise if the sales proceeds exceed the adjusted tax values of the relevant assets to the extent of the depreciation claimed. There is also quite a lot of compliance involved in a scenario like this, and so some taxpayers may choose to elect that those chattels not be depreciated from the outset. If a taxpayer does not wish to claim depreciation on an asset, the taxpayer must state this in writing and attach it to the relevant tax return.

Myth #6 – I can pick and choose the best tax depreciation rate for my asset

Incorrect! In a recent statement, the Commissioner makes it clear that the Income Tax Act 2007 contemplates only one depreciation rate applying to an item and it is therefore a matter of correctly identifying the item and then matching it to the description in the depreciation rate tables that most accurately describes the item. There is a process that should be followed to identify the correct tax depreciation rate.

Myth #7 – If the Commissioner of Inland Revenue issues a new depreciation rate for an item, I don't have to use it

This depends. Several times a year, the Commissioner will insert new asset classes and determine a depreciation rate which will apply prospectively. This mostly occurs for new types of assets. For example, in recent years the Commissioner has added new asset classes for tablets, smart phones, iPods, remote controllers, surveillance gear, gas detectors and shearing sheds. It may be that taxpayers had been using a default rate in lieu of any specific rate. Taxpayers are actually required to commence using the new rate from the beginning of the income year specified in the determination if the new rate is higher. However if the new rate is lower, a savings provision operates so that the taxpayer can continue to use the higher rate as long as the previous rate was a valid choice at the time. We doubt many taxpayers go back and review whether rates could be increased in light of any new determinations issued.

Myth #8 – Tax depreciation is not claimable on any building

Buildings are depreciable assets; however since the 2012 income year, buildings with an estimated useful life of 50 years or more are statutorily depreciated at the rate of 0%. Buildings with an estimated useful life of less than 50 years can still be depreciated. Admittedly there are not many in this category – but it does include barns, portable buildings, fowl houses, hothouses, pighouses, portable huts and shade houses. Further, certain structures which are "grandparented structures" such as barns, car parks, chemical works, fertiliser works, powder drying buildings and site huts which were owned on or before 30 July 2009 can continue to be depreciated at their pre-30 July 2009 depreciation rates.

> An item is deemed to have been depreciated even if a taxpayer neglects to claim a tax depreciation deduction.

Myth #9 – There is no depreciation recovered in relation to buildings because they are not depreciable

Depreciation recovery income will arise on the disposal of any asset where the consideration received is greater than the closing adjusted tax value of the asset to the extent of any tax depreciation previously claimed. Therefore if a building with a useful life of 50 years or more is sold today for greater than tax book value, any depreciation claimed prior to the 2012 income year would still be recoverable.

Myth #10 – Intangible assets are not depreciable

Intangible assets that meet certain criteria are depreciable for tax purposes. Common examples include the right to use software, the right to use a trademark, plant variety rights, the right to use a copyright, patents and the right to use a patent, the right to use land (i.e. a licence), the right to use plant and machinery and the right to use a design, model, plan, secret formula or process. The depreciation rate and method for this type of property is largely driven by the type of property and whether it has a finite life or not.

Conclusion

This is by no means a complete list of the common misconceptions that can arise in relation to depreciation. It can be worthwhile to carry out a periodic review of tax depreciation as it can show up opportunities to make tax savings which can more than pay for any cost involved.

If you would like more information about claiming tax depreciation, please call your usual Deloitte advisor.

New Zealand transfer pricing update

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New Zealand Inland Revenue Transfer Pricing Focus for 2015 and 2016

Inland Revenue has recently **released** its transfer pricing focus areas for 2015 and 2016, encompassing the full range of both inbound and outbound associated party transactions.

Inland Revenue's top priority will be the Significant Enterprises Segment which comprises some 560 taxpayer groups with a reported turnover exceeding NZ$80m, 50% of which are foreign-owned with a further 25% involved in international operations, mainly through controlled foreign companies. Inland Revenue note that these taxpayer groups account for over half of New Zealand's corporate tax base and 10% of overall tax revenue. Inland Revenue has indicated that these companies represent the highest risk of profit shifting due to the extent of their international transactions.

Inland Revenue will continue to refine its risk assessments of all significant enterprises through analysis of annual basic compliance packages (financial statements, tax reconciliations and corporate structures) supplemented by transfer pricing questionnaires.

In regard to issues across all segments of the corporate population, Inland Revenue will maintain a special focus on the following:

- Unexplained tax losses returned by foreign-owned groups;
- Loans in excess of NZ$10m principal and guarantee fees;
- Payment of unsustainable levels of royalties and/or service charges;
- Material associated party transactions with no or low tax jurisdictions;
- Supply chain restructures involving the shifting of any major functions, assets or risks away from New Zealand; and
- Any unusual arrangements or outcomes that may be identified in controlled foreign company disclosures.

Inland Revenue has also advised that it will continue to monitor the profitability of foreign-owned wholesale distributors (i.e. firms that purchase and on-sell goods to other firms without significant transformation), which are the most common multinational business form encountered in New Zealand. For small wholesale distributors (those under $30m in annual turnover), they will seek explanations for any performance resulting in a weighted average profit-before-tax ratio of less than 3%.

Intercompany Service Charges: Administrative Practice and Checklist

Administrative Practice

To further minimise compliance costs for multinational enterprises and to align with the administrative practice of the Australian Tax Office (ATO) for intercompany service charges, Inland Revenue has raised the de minimus threshold for services from NZ$600,000 to NZ$1m. The higher threshold applies from 1 January 2015.

The administrative practice allows taxpayers to apply a mark-up of 7.5% to the cost of certain non-core services and services with costs below the de minimus threshold of NZ$1m, in the absence of a detailed transfer pricing analysis or benchmarking study. For further detail on Inland Revenue's administrative practice for services,

including the criteria for application of the administrative practice, refer to paragraphs 557 – 570 of the **Transfer Pricing Guidelines**, noting that the de minimus threshold has not been updated in this document.

Service Charge Checklist

To assist companies operating internationally, including in particular a large number of New Zealand small to medium enterprises, Inland Revenue has compiled a checklist based on its experience in reviewing international service charges.

The message is to understand the charge, go behind the label and document it (the actual services provided, the benefits arising, the basis of the charge, etc).

The cost plus method is generally best, but never rule out the possibility of internal comparables (where similar services are being provided to third parties by the provider).

1. Watch out for "duplicated services" - in particular, does the enterprise have an infrastructure in New Zealand which can and does provide the type of services for which charges are also being made from overseas?

2. Be wary of charges for directors/chief executives (doing no more than investment monitoring), and overseas regulatory costs (for instance, Sarbanes Oxley compliance costs) - these are most probably non-chargeable "shareholder services".

3. Get the cost base right (including New Zealand tax deductibility of items included in cost sharing arrangements) and apply a sanity check - does it make sense, especially in relation to the bottom line?

4. Mark-ups must be fair and reasonable in relation to the nature of the service and the risks assumed – for example:

    - No mark-up for simply on-charging third party costs;

    - Minimal mark-ups for low risk supporting services;

    - Higher mark-ups where specialist knowhow or expertise is involved.

5. An allocation key should result in a charge proportionate to expected benefits - in this regard, turnover can be too simplistic and arbitrary (don't just assume a close relationship between services provided and sales without further analysis).

6. For outbound direct investment/New Zealand exporters, management and other support services provided to offshore associates (including controlled foreign companies) must be identified and fully charged.

7. A branch is not legally distinct from the rest of the enterprise - service charges should therefore be allocated on an actual cost basis only (i.e. no mark-ups).

8. Keep in mind other tax obligations such as withholding on services performed in New Zealand by offshore associates and royalties (e.g. know-how and connected services).

If you require further guidance or for more information please contact a member of the Deloitte transfer pricing team.

High Court awards increased costs and criticises Inland Revenue

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In the **December 2013 Tax Alert**, we commented on Trustpower securing a rare taxpayer win in the High Court, with the outcome that feasibility expenditure was deductible. The High Court has now ruled on the level of costs payable by Inland Revenue, with Trustpower again coming out on top. Justice Andrews considered that both the nature of the proceedings and the Commissioner of Inland Revenue's (Commissioner) conduct had contributed to increased costs of the dispute and ordered the Commissioner to pay further costs of over $750,000 to Trustpower.

Background

The underlying tax dispute centred on expenditure of $17.7 million incurred by Trustpower in applying for, and obtaining, resource consents in respect of four potential projects that never proceeded. The High Court agreed with Trustpower's position that these expenses were ordinary operating costs in the nature of feasibility expenditure and were therefore deductible. The Commissioner's position was that the consents were stand-alone/separate assets of a capital nature and that associated costs were non-deductible.

The two parties then squared-off over costs.

While Inland Revenue accepted liability for costs and disbursements of $639,967, the parties could not agree on:

- Increased costs for listing documents on discovery, preparing an agreed statement of facts, preparation of briefs of evidence and preparation for trial; and
- Payment of various disbursements in respect of expert witnesses, litigation support services and travel/accommodation of senior counsel.

Increased costs

The costs payable by the unsuccessful party to a court case are largely prescribed by the High Court Rules. However there is some discretion for the court to order a party to pay "increased costs" in certain situations, such as where the nature of the proceedings means that the time required substantially exceeds that allocated under the rules, or where a party has contributed unnecessarily to the time or expense of the proceedings.

The Commissioner accepted that the nature of the proceedings required an award of costs above the normal allocation, and the only dispute was as to quantum. The Court agreed that the nature of the proceeding was such that "the scale does not begin to approach being a reasonable time allocation for discovery in this proceeding" – a comment that applied equally to each category of cost considered by the Court. As a result, substantial increases in costs were awarded.

The second issue was whether increased costs were justified on the basis that the Commissioner contributed unnecessarily to the time or expense of the proceedings. On this issue the Court found for Trustpower, awarding a 10% uplift on costs. This was based on two main factors:

- The discovery (i.e. production of documents) required by the Commissioner was 'considerably greater than necessary'. The Commissioner requested a broad range of categories of documents be discovered (back to the early 2000's), and discovery extended beyond the categories agreed between the parties. Trustpower's solicitors calculated that they spent 1,612.7 hours (being 201.6 working days) on the discovery process. The majority of the "common bundle" of discovered documents, which comprised 60 Eastlight folders, was never referred to.
- The Commissioner's statement of defence directly contradicted evidence expressly or implicitly accepted by the Commissioner in the report produced by Inland Revenue's Adjudication Unit during the pre-litigation disputes process. The Commissioner denied or asserted no knowledge of factual matters which had

been accepted in that report, which meant Trustpower was then required to call expert witnesses to provide extensive evidence to deal with those matters.

The High Court found that the awards for increased costs made due to the nature of the proceeding had to some extent addressed the Commissioner's conduct, but that a further uplift of 10% was warranted to recognise the contribution of that conduct to the costs.

Disbursements

Inland Revenue also disputed, for various reasons, disbursements claimed by Trustpower for fees charged by expert witnesses, litigation support services and travel/accommodation of senior counsel. The High Court confirmed that the costs satisfied the criteria set out in the High Court Rules, therefore Trustpower was entitled to recover all of the fees, travel and accommodation costs, and a portion of the litigation support expenses.

Deloitte comment

- The High Court was critical of how Inland Revenue and Crown Law managed the dispute and legal proceedings. Justice Andrews found that Inland Revenue and Crown Law caused the breadth and extent of discovery to be considerably greater than necessary. We hope that the Commissioner takes on board this criticism in the conduct of future disputes, with the awareness that seeking detailed discovery could lead to a higher award of costs for the taxpayer if the Commissioner is ultimately unsuccessful. It may potentially also inform the Commissioner's approach to the exercise of her statutory information gathering powers (i.e. section 17 notices).
- Of particular concern is the divergent approach taken in the report prepared by Inland Revenue's Adjudication Unit during the pre-litigation disputes process and the statement of defence prepared by Crown Law during the legal proceedings. Although Crown Law is not strictly obliged to follow arguments, facts or conclusions drawn by Inland Revenue in the adjudication report, it is disappointing to see the Commissioner willing to put a taxpayer to significant time and expense in disputing facts that another arm of Inland Revenue has already accepted (particularly given the unit functions in an independent review / quality control manner). On this point, as with other aspects, the disputes process does appear to be unfairly stacked in Inland Revenue's favour.
- Where Crown Law diverges from a position previously accepted by Inland Revenue's Adjudication Unit, and additional costs are incurred as a result, taxpayers can take solace that the High Court has the discretion to order Inland Revenue to pay increased costs to compensate the taxpayer. However, as it is not the function of the costs regime, the taxpayer is unlikely to ever be fully reimbursed for the additional work required.

The High Court was critical of how Inland Revenue and Crown Law managed the dispute and legal proceedings.

Upcoming Dbrief - M&A Tax

Debt Push Down: Focus on Australia and New Zealand
Tuesday, 12 May, 11:00 AM – 12:00 PM HKT (GMT +8)

It has always been a challenge for investors to obtain tax deductions on financing costs incurred in connection with M&A. In the previous quarters, we illustrated case studies in China, Hong Kong, India, Japan, Korea, and various regions of Southeast Asia. In this quarter, we will continue the discussion of this topic with a focus on Australia and New Zealand. We'll discuss:

- Basic and special debt push down techniques in Australia and New Zealand.
- Illustrative case studies in Australia and New Zealand applying these techniques; considering how to align interest expense with taxable operating income, taking into account cross-border transfer pricing considerations and beneficial ownership requirements.
- Other local country specific tax structuring issues / opportunities in relation to debt structuring.
- Understand the techniques and challenges on debt push down that might affect your M&A deals.

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