Tax Alert

A focus on topical tax issues

December 2016

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Timely revised guidance on deductibility of certain earthquake related costs

By Robyn Walker and Alex Robinson

As much of the country is pulling itself together after being woken in the early hours of 14 November by a strong earthquake, tax is likely to be one of the last things on people's mind, and rightly so.

However, the financial stress of the aftermath of a big earthquake will be slightly reduced with Inland Revenue issuing a revised draft interpretation stating that in most instances the cost of obtaining a detailed seismic assessment

("DSA") will be tax deductible. The updated interpretation follows an earlier draft position released by Inland Revenue, which concluded that the cost of undertaking a DSA on a building was capital in nature and therefore not deductible. For more information on Inland Revenue's original position, please refer to our [February 2016 Tax Alert].

During the consultation period, Deloitte and a number of other submitters strongly opposed Inland Revenue's original position. In Deloitte's submission, we highlighted that there are a number of reasons why businesses could obtain a DSA, many of which would not result in the undertaking of seismic strengthening work. The updated interpretation provides for a number of instances where Inland Revenue consider that DSA expenditure will be deductible, including:

- When a city or district council has identified a building as potentially earthquake prone (i.e. it has been assessed at less than 34% of the new building standard) – in this instance the expenditure will likely be to determine whether any further action needs to be taken;
- When a building consent is required to alter a building;
- To satisfy existing or potential tenants of a building;
- To get insurance or to reduce insurance premiums;
- To identify potential damage after an earthquake; and
- To evaluate the safety of someone else's building where the safety of that building may impact on the taxpayer's business.

The updated interpretation also notes that expenditure on repairs and maintenance on a building, rates and building warrants of fitness are also deductible.

Where a DSA is undertaken as part of a project to seismically strengthen a building or to development or improve a building, Inland Revenue then consider that the DSA expenditure should form part of the project, which would be capital in nature and therefore not deductible.

We consider the conclusions reached in the updated interpretation to be technically correct and are a good result for taxpayers, particularly when many businesses will currently be getting their buildings assessed for damage. Submissions on the revised interpretation closed on 2 December. The statement should be finalised shortly.

However, DSAs are just one small piece in the bigger picture of tax issues a number of businesses will now need to be thinking about, including the following:

- Getting tax payments made on time.
- Whether repairs will be deductible, or whether they improve on what was there before. The inability to claim depreciation on most buildings means it is not possible to claim a deduction for seismic strengthening work.
- The tax treatment of insurance proceeds (including business interruption insurance). Specific tax rules govern when tax needs to be returned on these proceeds.
- If a building is irreparably damaged, whether a loss is available (one of the only instances a loss on disposal of a building is available is if it is rendered useless by a natural disaster).

If you have any questions in relation to the updated interpretation and the deductibility of earthquake related costs, please don't hesitate in contacting your usual Deloitte advisor.

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Closely held companies bill reported back with significant changes

By Veronica Harley

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The Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill ("the Bill") was reported back to Parliament by the Finance and Expenditure Committee (FEC) on 25 November 2016.

As a reminder, the Bill includes over 70 different reforms, including changes in relation to the following areas:

- Review of the tax rules for closely held companies (e.g. look-through companies);
- Non-resident withholding tax (NRWT) and Approved Issuer Levy: related party lending;
- GST - technical issues;
- Related party debt remission relief;
- Interaction of loss grouping and imputation rules;
- Time bar application to ancillary taxes;
- Amending the empowering provision for New Zealand's double tax agreements (DTA) to clarify that anti-avoidance rules still override the effect of a DTA;
- Aircraft overhaul expenses: deductibility and timing; and
- Various other remedial changes.

The FEC received 36 submissions. As a result, a number of amendments have been made in relation to the draft legislation which we previously reported on in our May Tax Alert. Below, we comment on the key changes to be aware of in relation to the main policy issues in the Bill.

Closely held companies

As the title of the Bill would suggest, the Bill includes a number of changes relevant to closely held companies, including look-through companies (LTCs) which will apply from the beginning of the 2018 income year. These are a mixed bag. On the one hand, the deduction limitation rule is being removed which is extremely positive, while on the other, the LTC regime's entry criteria is being tightened which will cause some LTCs to convert to an ordinary company. There are also changes to limit the amount of foreign income that an LTC can earn before losing its LTC status.

Submitters were generally supportive of proposed changes in relation to closely held companies; however concerns were expressed about the proposed tightening of the LTC regime's eligibility criteria and the resulting implications of transitioning to an ordinary company (i.e. that exit tax would be payable). A positive change is the inclusion of a transitional rule (to apply for the 2018 year only) which will allow the tax book values to be rolled over to the ordinary company. There have also been refinements in relation to the grandparenting of charities' LTC holdings, clarifications to the proposed restrictions on an LTC earning foreign income and the rules for counting beneficiaries and trustees as LTC counted owners.

Debt remission

A welcome amendment following the Bill's report back is a re-write of the draft legislation of the debt remission proposals. Broadly, these proposals sought to ensure that the financial arrangement rules do not produce income in circumstances where the debt remission causes no change in the net wealth of the economic group or dilution of ownership. However the first draft was problematic and it's good to see that Officials have acknowledged that the original legislation was "trying to do too much too briefly", was "unnecessarily complicated" and may not work as intended. As such, the rule has been rewritten to deal with each of the following scenarios:

- Where the debtor and creditor are in the same wholly-owned group as the debtor, and the debtor is a New Zealand resident company;
- Where the creditor is a member of the same wholly–owned group of companies as the debtor and, for the debtor, a group of persons who are New Zealand resident companies hold common voting interest which add up to 100%;
- Where the debtor is a company and the creditor is not a member of the same wholly-owned group of companies as the debtor, but the creditor has ownership interests in the debtor;
- If the debtor is a partnership, the creditor has a partner's interest in the income of the debtor; and
- If the debtor is a look-through company, the creditor has an effective look-through interest in the debtor.

A caveat to the above scenarios is that the relief rule will not apply if the creditor and debtor are members of the same wholly owned group of companies and the creditor is a non-resident and the debt has been held by a person that is not a member of the wholly owned group of companies.

The debt remission rule has been backdated to apply from the 2009 income year in order to provide certainty for taxpayers who have essentially taken this filing position in past returns. However if a taxpayer has taken an inconsistent tax position in a past year, then that tax return will stand and will not be able to be reopened.

NRWT and AIL issues

The Bill includes significant changes to strengthen the NRWT rules in relation to interest arising on related party debt. Broadly, the proposals will remove the ability for related taxpayers to benefit from a timing mismatch between when income tax deductions are available for interest expenditure and when the associated NRWT liability arises. Most submitters were generally supportive of the need to have robust policy settings and accepted that some aspects of these rules needed strengthening. However submitters were critical of the overly complex method of achieving this.

Submitters also had concerns about the potential increase in the cost of capital and impact on inbound investment. Although various alternative suggestions were made by submitters, Officials have mostly stuck to their guns, albeit they have refined and clarified some issues within the draft legislation. These rules will apply to existing arrangements from the beginning of the taxpayer's first year after enactment of the Bill and so the exact application date will depend on when the Bill is enacted and the taxpayer's balance date. The rules are still complex and taxpayers with related party cross border debt will need to take advice on the application of these new rules to their situation.

The first draft of the Bill included significant changes to the Approved Issuer Levy (AIL) regime as there was an initial policy concern that parties were structuring around the rules to pay the 2% AIL levy instead of NRWT. It is very pleasing to note that these measures have been removed on the basis that proposals would have imposed compliance costs on already compliant borrowers.

Conclusion

The Bill is likely to be enacted in early 2017 when Parliament resumes in the New Year. There is a need to get the Bill enacted and in force before 1 April 2017 when most of the measures will start to apply for most taxpayers. For further information on these measures or the other issues within the Bill, please contact your usual Deloitte tax advisor.

A welcome amendment following the Bill's report back is a re-write of the draft legislation of the debt remission proposals

Charitable change to the FBT rules? Depends on your facts

By Robyn Walker

One of the perks of being a charitable organisation is the exemption from Fringe Benefit Tax (FBT) for many benefits provided to employees. This can represent a significant tax saving, depending on how employees are remunerated.

However, a tax exemption is seldom straight forward and there are of course in's and out's to the rules which need to be worked through. Most significantly, the tax exemption only applies to the extent an employee is working for the benevolent, charitable, cultural or philanthropic purposes of the organisation. What this means is that if a charity also runs a business, then that business is subject to the FBT rules just like every other business; they should not get a competitive advantage, even if the business applies its profits for the good of the charity.

This has not always been the case, as Inland Revenue have just released a draft public ruling (PUB00229) which will, once finalised, replace an existing public ruling on the application of FBT to charitable and other donee organisations (BR Pub 09/03). BR Pub 09/03 took a pragmatic interpretation of the legislation, whereas PUB00229 applies a more technically correct view of the legislation which may give rise to a few more compliance costs for charities. PUB00229 is now available on Inland Revenue's website.

The legislation

The relevant legislation is section CX 25(1) of the Income Tax Act 2007 which states:

A charitable organisation that provides a benefit to an employee does not provide a fringe benefit except to the extent to which—

a. the employee receives the benefit mainly in connection with their employment; and

b. the employment consists of the carrying on by the organisation of a business whose activity is outside its benevolent, charitable, cultural, or philanthropic purposes.

It is worth noting that the FBT exclusion in section CX 25 applies to a wider category of organisations than simply organisations that are registered under the Charities Act 2005, it also includes donee organisations but specifically excludes local authorities, public authorities and universities.

What has changed?

Under BR Pub 09/03, Inland Revenue placed more emphasis on the use of the word "mainly" rather than the words "to the extent" in section CX 25. What this meant was that Inland Revenue considered that the FBT exemption would not apply if an employee spent more than 50 percent of their time working in a business outside of the organisation's charitable purpose. If an employee was mainly working in a business, FBT needed to be paid in full on any benefit provided to that employee, with no apportionment being undertaken to reflect the employees work in charitable / non-charitable areas.

In PUB00229, Inland Revenue has revised its interpretation and determined that the inclusion of the words "to the extent" in section CX 25 does mean that an apportionment needs to be undertaken when employees are working across both charitable and non-charitable purposes.

The difference is best illustrated with the following example:

A charitable organisation runs a food bank to relieve poverty but also runs a shop which sells good to the public. The profits from the shop are used to purchase food for the food bank. Peter works for organisation three days per week in the shop and two days in the food bank. Peter receives fringe benefits with a taxable value of $1,000.

BR Pub 09/03 interpretation

The shop is a business which operates outside of the charitable purpose of the organisation. Because Peter works mainly in the shop, FBT is payable on the full $1,000 worth of fringe benefits provided to him.

PUB00229 interpretation

Peter works 60 percent of his time in the shop and 40 percent in the charitable activity of running the food bank. FBT is payable to the extent of his work in the shop. Therefore FBT is payable on $600 worth of fringe benefits.

This seems like a great outcome as less FBT is payable. However, if instead Peter had been working two days per week in

the shop and three days in the food bank, under the BR Pub 09/03 interpretation no FBT would be payable as Peter was not mainly working in the shop, under the PUB00229 interpretation an FBT liability will now arise.

Action to take

Inland Revenue's position is still in draft form and, because the interpretation is in the form of a Public Ruling, there are transitional rules meaning that the old interpretation can apply for a further three years once the new position is finalised.

Charitable organisations that also operate businesses should seek to retest how the FBT exemption applies to them, including undertaking an assessment of what employees work across both charitable and non-charitable areas (particularly management who may be more likely to work across both).

It would also be timely for charitable organisations to ensure they are clear about what does and does not constitute a business which is outside of its benevolent, charitable, cultural, or philanthropic purposes.

Charities will need to develop processes to be able to apportion fringe benefits. PUB00229 does not specify how an apportionment should be undertaken, but states that it needs to be reasonable and reflect the reality

The Inland Revenue is taking submissions on PUB00229 until 23 January 2017. For more information contact your usual Deloitte advisor.

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Charitable organisations that also operate businesses should seek to retest how the FBT exemption applies to them, including undertaking an assessment of what employees work across both charitable and non-charitable areas

Business tax simplification measures are a step closer

By Veronica Harley

The business tax simplification measures recently took a step closer to becoming a reality with the report back to Parliament in late November 2016 by the Finance and Expenditure Committee (FEC) on the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill ("the Bill"). The Bill is expected to be enacted early in 2017.

The FEC received and considered 24 submissions from interested groups and individuals

Our September 2016 Tax Alert outlined the contents of this Bill in some detail. But briefly, this Bill includes changes to increase and expand the current safe harbour threshold regarding use of money interest applying for provisional taxpayers. It also introduces a new method of calculating provisional tax known as AIM (i.e. accounting income method) which is based on accounting income as calculated by accounting software, new withholding tax rules for labour–hire firms, the removal of the 1% incremental late payment penalty, plus various other measures to simplify the tax rules for small to medium businesses.

Some refinements have been made to aspects of the original proposals regarding use of money interest on provisional tax and the AIM provisional tax method. Originally the Bill also included a proposal whereby shareholder-employees and the company can agree that the shareholder-employee's provisional tax payment obligations are attributed to the company. However this proposal has been removed from the Bill for now as the rules were overly complex and the FEC felt that further work was needed to refine the mechanism.

Most of the business tax measures will apply from the beginning of the 2018 income year so will first start to affect those taxpayers making their first provisional tax instalment for the 2018 income year. It should be noted that the AIM measures have a later application date of the 2019 income year. Once the Bill is enacted and the application date is nearer, we'll report more fully on these important changes and any practical or planning issues arising.

This Bill also contains changes to the disclosure requirements for foreign trusts, following the Government inquiry earlier this year. In this regard, most submitters were supportive of the need to strengthen the foreign trust disclosure rules. However, some submitters were critical of the fact that the generic tax policy process had not been followed. The FEC has recommended the development of an Approved Information Sharing Agreement to enable Inland Revenue to disclose information about a foreign trust where requested by the Overseas Investment Office for the purposes of approving investments in sensitive New Zealand assets by overseas investors.

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Other changes include adding an exemption from registration and filing fees in certain cases, measures to ease compliance for trustees who are natural persons who are not in the business of providing trustee services and amendments to narrow the definition of settlor and settlements for the purposes of the foreign trust disclosure rules.

The Bill also proposes to insert a new section allowing the Governor-General to make regulations providing for transitional exemptions as and when necessary to facilitate the smooth transition from Inland Revenue's FIRST to START software platforms as part of the Business Transformation Project without causing undue delay. The FEC has recommended that the transitional regulations provided be amended to ensure that regulations are drafted in the most specific and limited terms possible as there was concern about the broad scope of the original draft.

Finally the Bill also contains Automatic Exchange of Information (AEOI) measures to implement the G20/OECD standard for the automatic exchange of information with applicable jurisdictions. This is designed to counter offshore tax evasion by requiring financial institutions to undertake due diligence to identify offshore accounts and to report information on those accounts to Inland Revenue. For more information on these proposals, see our earlier article.

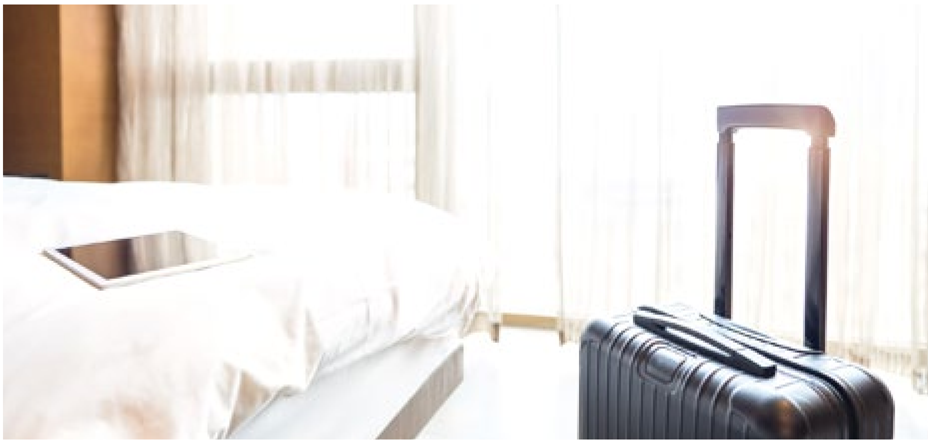
Once the Bill is enacted and the application dates are nearer we will report more fully on these important changes

Calculating 'market rental value' on employee accommodation – guidance finally released

By Jayesh Dahya and Brad Bowman

The Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 included amendments relating to the taxation of employer-provided accommodation that came into effect on 1 April 2015.

Please refer to our July 2014 Tax Alert article for a discussion of these changes.



The market rental value (MRV) of employer provided accommodation is taxable to the employee, if there are no exclusions or exemptions.

Inland Revenue has recently released Commissioner's Statement CS 16/02 – Determining "Market Rental Value" of Employer-Provided Accommodation ("the Statement"), which sets out the Commissioner's approach for working out the MRV of accommodation provided by an employer to employees in New Zealand, in most situations.

Overall, the guidance provided in the statement is sensible and provides taxpayers with a methodology that can be applied to establish a MRV that meets the reasonable care standard.

General principles

If the employer has rented accommodation from a third party on an arm's-length basis, then the market rental value will usually be the rent that is paid by the employer. However, where the accommodation is owned by the employer or is rented on a non-arm's length basis, it will be necessary for the employer to establish a MRV.

When seeking to establish a MRV, Inland Revenue has noted that "absolute accuracy" is not expected. What they expect is that a "reasonable and appropriate process" is followed in determining the MRV. Part of this will include having a documented process that can be made available for review, if requested. Importantly, it is not essential to obtain an assessment from a registered valuer.

Where this process is followed, the value adopted is unlikely to be questioned by Inland Revenue and would not result in shortfall penalties. Any MRV adopted should also be reviewed from time to time and Inland Revenue has suggested that at a minimum, MRVs should be reviewed every three years.

What is not covered?

The Statement only applies to accommodation provided in New Zealand and separate guidelines will be issued for accommodation provided to employees outside New Zealand.

For overseas provided accommodation, the taxable value provided to New Zealand tax resident employees is capped at the average or median rental value for accommodation in the vicinity where the employee would live if in New Zealand. Given this, it is difficult to see what material differences there could be in arriving at a New Zealand dollar equivalent value in these instances.

The Statement does not provide guidance in relation to staff provided accommodation at boarding schools, which is disappointing given that it has been over two years since the enactment of this legislation. The Statement does note that further guidance will be issued but the timeframes for this are not clear.

What is considered reasonable when establishing a MRV?

The Statement notes that the phrase market rental value "refers to the amount that would be arrived at by two non-associated parties, an arm's length basis".

Employers can adopt any reasonable basis for determining the MRV of the accommodation, including a valuation from a registered valuer; an estimate from a real estate agent, property manager, or other suitably experienced person; and a review of comparable properties on internet sites that advertise rental property (for example, TradeMe).

Inland Revenue is silent on the use of Ministry of Business, Innovation and Employment ("MBIE") market rent data to calculate market rental value where the data is available.

In our view, there are no reasons as to why MBIE data cannot be used to establish the initial market rental value of accommodation as a proxy of the market rental value of accommodation in a particular area, which can then be adjusted for unique factors attributable to the property. In reality, this data is already used by landlords to establish rental values, and is commonly referred to by registered valuers and real estate agents.

Factors to be taken into account in assessing a MRV

The Statement notes that the following factors should be considered in arriving at a MRV:

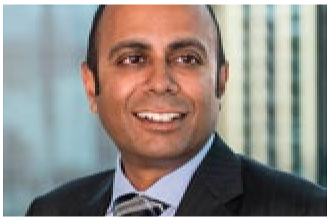
- The location of the accommodation – including desirability, access to amenities, etc;
- The specific functional characteristics of the accommodation – including the number of bedrooms, size, parking, etc;
- The condition of the accommodation;
- Accessibility – i.e. the ease of travel to and from places of work, schools, shopping, public transports, etc; and
- Restrictions of use.

However, conditions that arise out of, or are particular to the employment relationship itself cannot be taken into account in estimating the MRV; for example, a farm worker who is on-call or a live-in nanny who has a relative lack of privacy. These factors should be addressed in the remuneration provided to the employee.

The Statement also considers the following other points.

- The MRV of multiple dwellings owned by an employer cannot be averaged amongst employees, however the MRV of a shared dwelling can be averaged between employees.
- When an employee contributes to the cost of the accommodation, the income attributed to the employee will be the MRV of the accommodation less any contribution.
- Any contractual conditions requiring an employee to reside at a specific dwelling are not to be taken into account in assessing the MRV.
- The income attributed to the employee in relation to the accommodation will be taken into account for child support, student loans and Working for Families Tax Credits. The employee therefore has an interest in the accommodation being properly and correctly valued.

The Statement includes 13 examples to assist taxpayers and has effect from 1 April 2015 (i.e. when the original amendments were introduced).



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If you are providing employer provided accommodation to your employees, you should ensure that you have a documented process to justify the values that have been adopted as this is an area that Inland Revenue is monitoring.

If you have any questions in relation to the Statement, please don't hesitate to contact your usual Deloitte advisor.

R&D tax credits – our experience to date

By Ian Fay and Harriet Woods

An overview

With the new research and development (R&D) tax credit rules having been in effect since the start of the 2016 income year, a number of our clients have now been through the application process and are reaping the benefits provided by the regime's cash flow injection. Given this we thought it was timely for an update as to how the initial implementation of the regime has been received, as well as a few tips and tricks to look out for as 2016 tax returns are being prepared and the 2017 income year is underway.

In short, the R&D tax credit regime recognises that cash flow is a real problem for many New Zealand start-ups and operates to provide a 'cash out' of an entity's R&D tax losses. The cashed out amount is then required to be repaid from the taxpayer's future income and as such the benefit provided by the regime is solely a timing benefit, effectively being an interest free non-recourse loan.

Further information regarding the finer details of the regime can be found in the March 2016 tax alert article here or Inland Revenue's special report here, however in general a taxpayer will be eligible for the cash out if they satisfy the following criteria.

1. New Zealand tax resident company
2. Tax loss position
3. Must maintain ownership of intellectual property
4. Must have a 'wage intensity' of at least 20% (calculated as total R&D labour expenditure ÷ total labour expenditure).

The practicalities

Overall the response to the regime has been relatively well received and is a benefit for some of our clients where cash is king.

However we have come across a number of issues which can be easily addressed with a bit of forward planning.

IAS 38

The R&D tax credit rules draw on accounting concepts from IAS 38: Intangible Assets. Most businesses applying for the R&D tax credit are not required to prepare financial statements under GAAP so instead prepare financial statements under Inland Revenue minimum financial reporting rules. Many businesses carrying out R&D, however, have already adopted IAS 38 as an accounting policy in order to: ensure deductibility of R&D expenditure that may otherwise be non-deductible; to defer deductions for R&D expenditure; or as a requirement of Callaghan Innovation R&D Growth Grants.

For those businesses that have not adopted IAS 38 previously, this may require changes to existing processes to identify R&D expenditure in accordance with the standard.

An important concept under IAS 38 is determining whether expenditure on R&D can be recognised as an asset. In order to be recognised as an asset the company must be able to demonstrate all of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

d. How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

f. Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

The R&D tax credit regime recognises that cash flow is a real problem for many New Zealand start-ups and operates to provide a 'cash out' of an entity's R&D tax losses

Only expenditure that doesn't meet the threshold to be capitalised as an intangible asset qualifies for the R&D tax credit.

Group structure

Many groups undertaking R&D will structure their operations so that the intellectual property (IP) is held by a separate group company from the one undertaking operations and employing staff – a structure that is often recommended for companies wanting to increase the protection of their IP from business risks.

However this becomes problematic in respect of the R&D Tax Credit rules as they only provide for an R&D Tax Credit where the company that makes the claim both owns the IP and employs the staff carrying out the R&D activities. Where a separate group company employs the staff carrying out the R&D neither the IP owning company nor the company employing the staff can make a claim.

In order to ensure this does not become an issue potential solutions include:

- Amending employment contracts so that the IP owning company is the employer of staff undertaking the IP, which exposes the IP owning company to employee liability risks; or
- Electing for the IP owning company and the employer company to form a consolidated income tax group.

Both of these solutions require forward planning.

Ministry of Business Innovation and Employment (MBIE) forms

Another thing to look out for is ensuring the R&D expense calculation submitted with MBIE in the activity statement and supplementary form matches the IR10 lodged with Inland Revenue.

Obtaining maximum value

The R&D tax credit is in effect an interest free loan. As such value can be maximised by ensuring tax returns and the R&D tax credit claim are filed as quickly as possible after year end. Our experience is that the tax credit is received between 3 – 10 weeks after the claim is made, depending on MBIE / Inland Revenue processing times.

If, after surrendering the tax loss, a company is going to be tax paying the benefit may be minimal. For the 2015-16 income year, if the tax credit is received (for example 6 months after year end) this could be after the first instalment of provisional tax is due for the following year, such that voluntary provisional tax payments may be advisable to reduce exposure to use of money interest. From 2016-17 onwards this will be a less significant issue as changes to the provisional tax rules should result in no exposure to use of money interest in the year following a tax loss. Even if the following year has a tax liability depending on timing of the tax credit being received there should be at least a full year's use of the R&D tax credit before it is "repaid" through increased tax payments.

Conclusion

The R&D tax credit rules provide a potentially very valuable source of additional funding for companies undertaking R&D. With some careful planning, the R&D tax credit is reasonably simple to claim and the potential benefit is set to increase over coming years as the cap increases from $500,000 ($140,000 Tax Credit) for 2015-16 by $300,000 per year to a maximum of $2,000,000 for 2020-21.

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IR's Operational Guidelines: Pre-Litigation Settlements

By Campbell Rose and Vyshi Hariharan

Thankfully, plenty of water has passed under the bridge since the days when there was a question as to whether, and on what basis, the Commissioner of Inland Revenue (Commissioner) could "settle" disputes with taxpayers.

In a welcome development, Inland Revenue has recently released guidelines on its operational approach to settling tax disputes prior to litigation commencing, "Operational Guidelines: Section 6A Settlements" (Guidelines) – for a copy of the guidelines, click here. The Guidelines set out the internal approach taken in exercising the Commissioner's discretion under sections 6 and 6A of the Tax Administration Act 1994 to settle disputes at any stage up to filing challenge proceedings: this can include prior to the disputes process formally commencing with the issuance of a notice of proposed adjustment.

We commend Inland Revenue for publishing the Guidelines, which in one form or another have been operating (unpublished) for the last nearly four years in practice. Tax disputes take a very heavy toll on the precious human, financial and other resources of taxpayers, as well as on the Commissioner's limited resources. Where there are tenable arguments and taxpayer/Commissioner "agree to disagree", it is comforting to know that there is some structure around Inland Revenue's internal decision-making processes in terms of whether a dispute is most sensibly dealt with by resolution on a mutually acceptable basis.

Helpfully, the Guidelines confirm which Inland Revenue staff are authorised to accept or reject a settlement proposal in different circumstances. Knowing upfront whether you are dealing with the decision-maker is obviously critical for taxpayers seeking to achieve a reasonable resolution of their dispute with the Commissioner.

The Guidelines also note that the Commissioner should withdraw from the dispute where it is considered that the taxpayer's position clearly represents the better view of the law. In practice, we have recently seen Inland Revenue make sensible decisions to "walk away", for both legal/merits and procedure-related reasons. Again, this is to be commended: although in our experience it has usually taken the involvement of Inland Revenue staff independent from the investigation team to achieve this.

As a starting point, the Guidelines state that the law should be applied correctly and Inland Revenue should seek to recover all of the tax which is due in those circumstances. However, it is recognised that this will not always be the case, and so the Guidelines detail the key factors to be evaluated when a settlement is being considered:

Inland Revenue's resources: The focus here is on the resources necessary to develop the dispute, against the revenue to be gained. In the Guidelines' examples, this factor is described as potentially being more relevant where "a historic dispute involving a single taxpayer with little tax at stake and no precedent value is still

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The Guidelines also note that the Commissioner should withdraw from the dispute where it is considered that the taxpayer's position clearly represents the better view of the law. In practice, we have recently seen Inland Revenue make sensible decisions to "walk away", for both legal/merits and procedure-related reasons

likely to require significant Inland Revenue resources"; whereas if may be "a more neutral factor where the dispute will not require significant additional resources (e.g. the dispute builds on work previously done by the Commissioner)".

Likelihood of success in the dispute: Inland Revenue weighs the likelihood of succeeding where there is uncertainty as to the law or facts relevant to a case. A number of factors are considered, including issues surrounding factual or expert opinion evidence. The Guidelines note that "there may be uncertainty where the taxpayer's expert is at odds with (Inland Revenue's)". As with any litigation, there is often not a great deal to be gained for either party where matters descend into a 'battle of the experts', assuming that both parties' experts' positions are credible (valuation being an obvious example).

Promoting voluntary compliance: Essentially, "a settlement that is too low does not encourage voluntary disclosure". Probably unsurprisingly, the Guidelines note that the past compliance record and the future compliance of those involved in the dispute can be considered. Other factors taken into account include whether the dispute relates to alleged tax avoidance or evasion, and whether the decision to settle may affect the behaviour of other taxpayers. In relation to assertions of tax avoidance, our observation is that these can themselves sit in a "spectrum", and so merely because the Commissioner considers that general anti-avoidance is in issue should not necessarily adversely influence a decision on whether to settle.

The integrity of the tax system: The overarching principle here is the public's perception about the tax system's integrity, i.e. whether taxpayers will view the Commissioner's approach to settlement as reasonable, overly lenient or unduly harsh. The Guidelines acknowledge that where a settlement is rejected which is comparable to another that was accepted in relation to a materially similar dispute, in order to maintain integrity, appropriate reasons would need to be provided. Of course, however, Inland Revenue will keep terms of specific settlements confidential in the interests of taxpayer secrecy.

Precedential value of the dispute: The Guidelines note that where Inland Revenue consider that a "dispute will formally or indirectly determine the Commissioner's position in relation to either a number or category of taxpayers or of the issue generically, then it is often not desirable that such a dispute should be settled". Further the Guidelines state that where the law is unclear and obtaining clarity on the law will promote voluntary compliance, Inland Revenue may pursue a dispute. While in principle it is understandable, and probably quite laudable, that Inland Revenue may pursue a dispute in the interests of clarifying the law for the general body of taxpayers, this would be more acceptable if New Zealand had a funded test case system, and the litigation process was quicker. The tax disputes process is not for the faint-hearted, be they individuals, privately-owned businesses or multi-national corporates: it is expensive, time-consuming and materially disruptive. This means that falling into the category of a case with "precedential value" (sometimes quite by accident) more often than not results in burn-off and taxpayer-adverse settlements, rather than a principled development of the law.

Quantum of tax in dispute: Predictably, the amount of tax involved is also considered, and the greater amount of revenue at stake the more compelling the other reasons for settlement need to be. This factor often feeds into the other criteria, such as "Inland Revenue's resources" above.

Taxpayer's capacity to pay: It is relevant to consider whether Inland Revenue would eventually recover the full tax where a settlement with the taxpayer for a reduced assessment and the payment of that assessment now may increase the revenue collected - compared with an assessment and payment in the future without the settlement in place.

The Guidelines also confirm Inland Revenue's general policy to not accept the use of income tax losses to settle disputes (i.e. only in limited circumstances). While the commentary on this area is insightful, anecdotally we have not seen Inland Revenue acting consistently in this area.

Nor have we seen consistently sensible approaches taken to settlement discussions more generally. In one case, Inland Revenue's Disputes Review Unit (DRU) found that no unacceptable tax position penalty should apply (i.e. the taxpayer's position was "about as likely as not to be correct") – but Inland Revenue inflexibly insisted in settlement discussions that only 10% of a GST refund should be paid out. In another case, Inland Revenue's representative in settlement discussions sought to revisit the DRU's findings, and even suggested (once challenge proceedings were on foot) that a section 17 notice should be issued to gather further information. So it does appear that some focus on adopting principled and consistent approaches in settlement negotiations is an area that could be improved upon within Inland Revenue.

There is also discussion in the Guidelines surrounding the role of Facilitators in the conference phase of a dispute. Although Facilitators are trained in mediation techniques, and thereby seek to help the participants understand their respective positions, in our experience this rarely assists in moving disputes towards what in many cases should be principled settlement discussions. We do wonder whether more use could be made of this valuable independent insight, where there are obvious candidates for settlement.

The Guidelines also confirm Inland Revenue's general policy to not accept the use of income tax losses to settle disputes

What's on the Tax Policy Agenda?

In November, the Government released the latest version of the Tax Policy Work Programme (TPWP) and details of the expected timing of projects. The three main categories under which work programme projects are classified are:

- Improvements and enhancements to tax policy within New Zealand's broad-base low-rate framework;
- International tax and Base Erosion and Profit Shifting (BEPS); and
- BusinessTransformation and better public services initiatives.

In recent times there has been some criticism of the extent of tax policy reform taking place and the latest TPWP doesn't really show any signs of slowing down. That said, the TPWP is always an ambitious list and it is never the case that all the items on the list actually get started let alone completed.

There are a few new items on the list and also a couple of significant omissions from the last TPWP.

Starting with the omissions:

1. Feasibility expenditure – the outcome of the *Trustpower case* has left taxpayers facing a painful process of analysing expenditure to determine if it is deductible under the new legal interpretation. While this issue has not made the official work programme we understand some work is underway and it is expected that there will be consultation in early 2017, but the lack of formal acknowledgement of it will be concerning for taxpayers who want the law fixed;
2. Mutual recognition of imputation credits – this chestnut had been on the work programme for so long without any movement. Does its omission signal that New Zealand has finally given up on Australia coming to the party? We understand that no decision has been made to abandon this pursuit, but the expectations of progress are slim given the extent of tax reform already underway in Australia; and
3. GST on low-value goods – we've seen the introduction of the "Netflix tax" to counter online purchases of services but there has been silence from both Inland Revenue and Customs on the work on low-value imports of goods. The removal of GST on low value goods from the work programme seems unusual, particularly given just last week Australia announced they would be requiring non-residents selling low value goods into Australia to register for Australian GST (you can get a few more details about this change from our article here).

What are the new or otherwise interesting items:

1. Deductibility of holding costs for revenue account property – the Finance and Expenditure Committee has asked officials to look into the deductibility of holding costs for revenue account property (e.g. if land is being held for resale, what costs can be deducted in the interim). Also related to property, changes were introduced last year to require non-residents to have New Zealand bank accounts in order to get an IRD number (required before purchasing land). This requirement has proved problematic and resolving issues in this area features as an additional new item on the work programme;
2. Demergers – our tax rules do not cope well with company restructures, so it is good to see this work progressing. We understand this matter is being fast tracked and will introduce an exemption from the dividend rules for certain demergers by Australian listed companies;

3. Employee share schemes – while this isn't a new item, the previous consultation on changes has been widely criticised. The work programme now notes that the reform will seek "appropriate and balanced outcomes". We expect to next see these reforms in a tax bill in early 2017; and

4. Business Taxation – we've seen the first wave of business tax changes related to provisional tax and withholding taxes come through, it is great to see the work programme still committing resources to "researching additional measures that have potential to deliver further benefits to business, reduce compliance costs and make the tax system simpler."

In addition to the above items, it can be certain that we will continue to see a number of workstreams addressing BEPS. In early 2017 we expect to see a package of BEPS reforms out for consultation which will consider interest limitation rules, hybrid mismatch arrangements, transfer pricing and permanent establishment definitions.

For more information contact your usual Deloitte advisor.

The tax policy work programme is always an ambitious list and it is never the case that all the items actually get started, let alone completed

A snapshot of recent developments

OECD releases text of multilateral instrument to counter base erosion and profit shifting

The OECD has released the text of the Multilateral Convention that will swiftly implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises. The new Convention will essentially transpose results from the OECD/G20 BEPS Project into more than 2,000 tax treaties worldwide. The New Zealand Government is one of more than 100 jurisdictions that have participated in the negotiation of this document. Officials intend to consult on the implementation of the Convention in the coming months. The Convention will be open for signature from 31 December 2016 and a signing ceremony in Paris is planned for 5 June 2017. After signing, individual signatories will need to ratify the Convention in line with their domestic constitutional arrangements. For more Deloitte analysis, please refer to this tax@hand article.

Tax measures to help those affected by the earthquakes

Minister of Revenue Michael Woodhouse has announced tax measures to help those affected by November's earthquakes in Kaikoura and surrounding areas. Inland Revenue will provide the following relief:

- Use of money interest will be waived, until 31 January 2017, when a taxpayer is prevented from paying on time as a result of the earthquakes;
- Late filing and late payment penalties will be remitted for all affected taxpayers; and
- Discretion as to income equalisation for farmers and fishers who are significantly affected by the earthquakes.

Customs and Excise Bill

On 23 November 2016, the Government announced the introduction of a new Customs and Excise Bill ("the Bill"). The Bill modernises but does not substantially change the Customs and Excise Act 1996. Proposals support the movement of travellers and goods across the border, protect New Zealand from harm and support the collection of Crown revenue.

Trusts Bill

On 10 November 2016, the Government released the Trusts Bill and accompanying exposure draft. This Bill adopts 48 of the Law Commission's 51 recommendations in replacing the Trustee Act 1956. The Bill largely restates the existing law, which means that existing trust deeds will not need to be changed. Submissions are due 21 December 2016.

Consultation paper on electric vehicles

Inland Revenue has released a consultation paper ("the Paper") on electric vehicles, which considers whether the current tax depreciation rates that apply to conventional vehicles are appropriate for electric cars (i.e. whether the depreciation rate for electric cars should be accelerated) and whether the current FBT calculation method is overvaluing the private benefit of being able to use a company owned electric car.

The Government's Electric Vehicles Programme provides an overview of the Government's target of 64,000 electric vehicles by 2021. Also relevant to this Paper is the Energy Innovation (Electric Vehicles and Other Matters) Amendment Bill, which is currently with the Select Committee (submissions are due 1 February 2017).

ACC levy recommendations for 2017-2019 period

On November 2016, ACC announced that it is making levy recommendations to the Minister for the 2017-2019 period. Recommendations include a 13% reduction in the average Motor Vehicle levy for car owners, a 10% reduction in the average Work levy, changes to workplace safety incentive products for businesses, and a 3% increase in the Earners' levy for employees due to an increase in claims volumes and costs.

CRS for AEOI – Low risk entities or accounts

The Common Reporting Standard for Automatic Exchange of Financial Information provides for an exclusion to due diligence and reporting obligations for "low risk" excluded entities and accounts. Inland Revenue has requested submissions from financial institutions who consider they are a low risk entity or have low risk accounts. The financial institution will need to meet the technical criteria set out in Inland Revenue's fact sheet, which also provides a list of information required for a submission. Submissions are due 31 January 2017.

Draft QWBA: Income tax and Goods and Services Tax — Treatment of bloodstock breeding partnership

On 17 November 2016, Inland Revenue released a draft QWBA on Income tax and Goods and Services Tax — treatment of bloodstock breeding partnership. The draft QWBA clarifies the Commissioner's view on income tax and GST treatment for a partnership formed to carry on a bloodstock breeding business. In particular, it covers a new partnership's purchase of its first horse in order to race the horse for a number of years before using it for breeding. Submissions are due 23 December 2016.

Merry Christmas

This is the last Tax Alert issue for 2016, a year that has once again been extremely busy on the tax policy front.

We would like to wish all our readers a merry Christmas and hope you have a relaxing holiday break over the new year.

Tax Alert will return in February 2017.

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We are introducing a new entity to our client facing structure, Deloitte Limited. From 1 June 2016, we will transition to having Deloitte Limited be the party responsible for providing our services. More information here www.deloitte.com/nz/aboutus