



## Tax Alert

A focus on topical tax issues

October 2016

# It's feasible that feasibility expenditure may still be deductible... sometimes

By Robyn Walker

Back in July we reported on the outcome of the Supreme Court decision in [Trustpower v Commissioner of Inland Revenue \[2016\] NZSC 91](#). A first read of the case left many feeling dread about how they were to prepare their tax returns, with the case throwing doubt on what feasibility expenditure might still be deductible.

Following the release of the Supreme Court judgment we were on record saying "All eyes now turn to the Inland Revenue to find out what its next step will be." Late last month, we saw Inland Revenue's next step, with the Office of the Chief Tax Counsel releasing a draft revised interpretation statement on the deductibility of feasibility expenditure (available [here](#)) which seeks to provide practical guidance on how the judgment should be applied. ➔

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Inland Revenue's former guidance hinged on whether a taxpayer had "committed" to a particular asset or course of action. This approach was strongly dismissed by the Supreme Court, and accordingly Inland Revenue has revised its approach to be:

*"Therefore, in the Commissioner's view, expenditure is likely to be deductible in accordance with the Supreme Court decision if it is a normal incident of the taxpayer's business (see [72] of Trustpower (SC)) and it satisfies one of the following:*

- *the expenditure is not directed towards a specific capital project; or*
- *the expenditure is so preliminary as not to be directed towards materially advancing a specific capital project – or, put another way, the expenditure is not directed towards making tangible progress on a specific capital project."*

The draft revised interpretation statement goes on to provide lengthy commentary as to what these two tests mean, but they are most meaningfully explained in plain terms through the use of examples provided by Inland Revenue. We replicate two of the examples here:

#### **Example one:**

##### **Acme Electricity Generation Limited**

Acme Electricity Generation Ltd generates electricity for sale to consumers. Currently, its electricity is predominantly generated by coal-fired power plants. However, it also has some small hydro stations and one wind farm. Acme routinely investigates new generation opportunities and intends to focus its future generation projects on sustainable sources.

Acme sends an employee to Norway on a general fact finding trip to learn about the generation methods that they use and the pros and cons of each of them. Expenditure on the fact finding trip is deductible as it is not linked to a specific capital project or asset.

One of the generation types that Acme learned about in Norway is "blue energy", which uses seawater and fresh water to generate electricity. Acme identifies five potential places in New Zealand that it believes would be suitable for this type of generation plant.

Acme then sends two employees to Norway to talk to the generation company involved. They get general information about "blue energy" including the water conditions that are required for successful generation, the land area required for a plant, the potential generation capacity and ballpark costs for running a plant. This expenditure is also deductible. The expenditure relates to a specific project (a "blue energy" generation plant). However, the expenditure is preliminary and it does not result in any tangible progress of the project or any capital asset or other enduring benefit.

Based on the information that Acme gathered in Norway, it chooses one of the five potential sites that it believes has the best conditions for a viable "blue energy" plant. Acme sends the two employees back to Norway with site plans to get expert advice on the best design for the plant. While there they commission a Norwegian engineer to draw blueprints for the plant. This expenditure is not deductible as having the expert advice and plans for construction materially advances the capital project.

## Example two:

### National restaurant chain

A national restaurant chain is continually looking for new sites on which to build restaurants. It is considering opening a new restaurant in Wellington. To help identify a suitable potential site, the company hires a contractor to survey traffic flows in different areas around Wellington. This expenditure is deductible. The expenditure relates to a specific project (building a new restaurant). However, the expenditure is preliminary and it does not result in any tangible progress of the project or any capital asset or other enduring benefit.

Overall, the draft revised interpretation statement is a good step towards restoring order and giving taxpayers a better idea of how they should determine tax return positions in respect of feasibility expenditure. However, this is only one step of the journey as while there is now guidance, the reality is that a test based on material advancement / tangible progress results in costs being treated as capital earlier than under a commitment test.

What the *Trustpower* case has done is shone a spotlight on the existing tax policy settings which can prevent a significant amount of expenditure from ever being deductible for tax purposes. We have seen a number of ad hoc measures to correct problems with software and other intangible assets, but issues still exist. This includes when a taxpayer incurs expenditure to materially advance a tangible asset that ultimately never gets completed (in order to qualify for depreciation deductions), and also when there is unsuccessful expenditure directed at non-depreciable assets (for example undertaking a due diligence on a business ultimately not purchased). There will be a range of options for solving this problem, but perhaps the simplest one may be to look to align the tax treatment with the accounting treatment of such expenditure as we have already done with research and development expenditure.

The Office of the Chief Tax Counsel have played their part, the next move belongs to the Tax Policy team.

Submissions on the draft interpretation statement close on 9 November.

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# Thinking of gifting food and drink for Christmas? Be aware!

By Robyn Walker and Veronica Harley



Does your business commonly send your clients or suppliers a thank you gift of a bottle of wine or some treats to eat at Christmas? Well, Inland Revenue has just spoiled the party with the recent release of an [operational statement](#) declaring that gifts of food and drink are “entertainment” and potentially subject to the 50% deduction limitation rule.

Anyone who has stopped to consider making an entertainment adjustment as part of the tax return process has probably thought to themselves that the rules have some rather unusual distinctions between what is and is not subject to the rules, and therefore taxpayers are more likely to have relied on Inland Revenue guidance on the application of the rules.

When you read Inland Revenue’s guidance, such as the [IR268](#) Guide “Entertainment expenses: What you need to know about making claims”, there is no mention of gifts to clients. All entertainment in the form of food and drink is described in the context of food and drinks which are immediately consumed. Gifts themselves don’t ordinarily fit into what the layperson would consider to be “entertainment”.

It is likely that many businesses have been treating this expenditure as fully deductible to date on the basis of advice previously issued by Inland Revenue in *Business Tax Update* newsletters issued in 2011 and 2012. Initially Inland Revenue said that expenditure incurred in relation to gifts of food and drink provided off-premises are generally 100% deductible, and then in the next publication issued a further clarification stating that they were only fully deductible if “provided or consumed...away from the taxpayer’s business premises, e.g. a business lunch at a restaurant”.

Inland Revenue now accept that this latter statement did not make the position clear and may have lead to some taxpayers treating this expenditure as fully deductible. Accordingly Inland Revenue has, once and for all, clarified the current technical position and issued an operational statement to explain how and from when taxpayers are expected to apply the new rules.

The operational statement contains the following example:

## Example:

Bob is a real estate agent. Each time he arranges the sale of a house, Bob delivers a bottle of champagne to the owner. He also sends a gift basket by courier to the purchaser. The gift basket contains a bottle of wine, some cheese and various household items such as tea towels and soaps.

Bob will only be able to deduct 50% of the cost of the bottle of champagne. This is because he is providing entertainment in the form of drink and doing so off his business premises.

For the gift basket, Bob can deduct the full cost of the tea towels and soap, because an appropriate apportionment should be made for items that are not food and drink. However, he can only deduct 50% of the cost of the wine and cheese (or, if the cost is not separately identifiable, an amount appropriately apportioned as the cost of the wine and cheese).

While some may be exasperated by this outcome, particularly given the likely dollars involved compared with the compliance costs of apportioning the cost of gifts between food and drink and non-food and drink components, Inland Revenue are arguably applying the rules technically correctly in many cases, albeit the rules were probably not drafted originally with gift baskets in mind.

## What do the entertainment rules say?

### Entertainment off premises

The limitation rule applies to deductions for expenditure on food and drink that a person provides off their business premises.

### Entertainment on premises

The limitation rule applies to deductions for expenditure on food and drink that a person provides, other than light refreshments such as a morning tea and whether or not guests are present, —

a. on their business premises at a celebration meal, party, reception, or other similar social function:

b. in an area of the premises that at the time is reserved for senior employees to use and is not open to all the person's employees working in the premises.

Note: the above are subject to a number of exemptions, including for entertainment provided outside of New Zealand, entertainment while travelling on business and entertainment provided at conferences that are at least four hours long.

The entertainment rules have remained largely unchanged since they were introduced in 1993, and this position illustrates they are well overdue for some modernisation with compliance costs in mind.

Regardless of the merits of the interpretation and current policy position, the Commissioner has stated she will apply this interpretation for tax positions taken on or after 1 September 2016. While Inland Revenue have said they will not seek to actively identify incorrect deductions claimed prior to this date, over-claimed deductions identified in the course of investigation or audit will be disallowed.

If you traditionally send clients or suppliers bottles of wine or gift baskets at Christmas time as a business thank you, please be aware of this change as you compile your list of "entertainment" expenditure for your accountant or tax advisor.

Please don't hesitate in contacting your usual Deloitte advisor to discuss your tax position further.



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Gifts themselves don't ordinarily fit into what the layperson would consider to be "entertainment"

# Further consultation on employee share scheme proposals

By Jayesh Dahya and Brad Bowman

In [June 2016](#), we outlined key proposals included in an Officials' issues paper, entitled *Taxation of employee share schemes* ("original paper") which amongst other things were aimed at ensuring discounted shares received by employees are taxed as employment income when the employee "receives" the shares.

On 1 September 2016, the Policy & Strategy Group released a consultation paper, [Taxation of employee share schemes - further consultation](#) ("further consultation paper"). The further consultation paper sets out Officials' thinking following submissions received in relation to the original paper.

This article provides an update on where Officials have landed on the key proposals included in the original paper.

## Taxation of employees

The further consultation paper does not propose any change to the "general thrust" of proposals relating to unconditional employee share schemes ("ESSs"), conditional ESSs or option-like arrangements. That is:

- Benefits that depend on continued employment will be taxed when the employment conditions are met;
- Benefits that are subject to contingencies will be taxed when all "substantial conditions" relating to the shares have been met (i.e. when the employee holds the shares on the "same basis" as a non-employee shareholder); and
- Benefits from options will be taxed when the option is exercised.

The further consultation paper does not propose any change to the "general thrust" of proposals relating to unconditional and conditional employee share schemes or option-like arrangements

Officials have provided a number of examples to illustrate the concepts that are to be applied in determining when the taxing point will arise and, to put it simply, the proposals will bring to an end the benefits from ESSs that provide employees with protection from the economic risks associated with owning shares.

Despite standing firm, Officials have amended proposals in relation to grandparenting benefits from existing schemes as taxpayers transition to the new rules. Broadly transitional relief will be extended to benefits:

- Granted before the date six months after enactment in accordance with the terms of any ESS in existence before the release of the issues paper on 12 May 2016; and
- Where the taxing point for the benefits under the new law is before 1 April 2022.

## Concessions for widely-offered ESSs

The current rules provide a concessionary regime for widely-offered or "all employee" ESSs. The two primary benefits are:

- Employees are not taxed on the value of benefits received under the widely-offered ESS; and
- The employer is allowed a notional 10% interest deduction on loans made to employees to buy shares.

Among other criteria, the current concessionary regime applies to widely-offered ESSs where the scheme is equally available to all employees and the cost of the shares to the employee do not exceed \$2,340 in a three-year period with no limit on the discount that is offered. While Officials did not include any proposals in relation to the concessionary regime, the original paper sought submissions on whether the rules should be repealed, retained or modernised.



The further consultation paper notes that submissions supported a continued exemption for benefits provided under widely-offered ESSs and criticised various aspects of the current rules. Officials have therefore opted to “modernise” the concessionary rules to make them less restrictive and simpler to operate.

While some aspects of the existing regime would remain unchanged, Officials propose that the cost of shares to the employee would need to satisfy three requirements: 1) the cost can be no more than \$5,000 per annum, 2) the discount can be no more than \$2,000 less than the market value, and 3) the cost can be no more than the market value. Additionally, where there is a cost to the employee in acquiring the shares, the employer must provide an interest-free loan facility to be repaid over the vesting period.

While employees will not be taxed on any benefits from widely-offered schemes, Officials have stated that employers will not be entitled to a deduction for the cost of providing the shares and intend on removing the notional 10% interest deduction on the loans made to employees (although loans made before the effective date of the new legislation would be grandparented).

It will no longer be a requirement for employees to seek Inland Revenue approval for widely-offered schemes, rather that taxpayers will simply need to register the scheme with Inland Revenue.

#### Start-up companies

The original paper considered offering a “concession” for start-up companies, which would have enabled employees to defer taxation until the shares are either sold or listed. In the further consultation paper, Officials note that there was little support for the concession and any benefits would likely be outweighed by the concession’s resulting complexity. Officials therefore do not propose any special rules for start-up companies.

#### Deduction for cost of shares provided under an ESS

The original paper proposed that employers should be allowed a deduction for a deemed cost of the shares provided under an ESS. This deduction would occur at the same point as the income is taxed in the hands of the employee and would be based on the amount that is taxable for the employee. The further consultation paper notes that submissions were largely in favour of the proposal and that there is no change to this proposal.

If you have any questions or comments in relation to the further consultation paper, please don’t hesitate in contacting your usual Deloitte advisor.



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# Tax residency: Life after Diamond – the new era begins

By Jayesh Dahya



In September 2016, Inland Revenue released an [updated interpretation statement](#) on tax residence.

The statement has been updated for the Court of Appeal's decision *Commissioner of Inland Revenue v Diamond* [2015] NZCA 613.

Tax residence is an important tax concept as it determines whether a person is assessable for New Zealand tax on their worldwide income or only on New Zealand-sourced income. Tax residence is often overlooked when a New Zealand tax resident leaves New Zealand to work or live overseas as it is generally assumed that by leaving New Zealand, there is no longer a requirement to pay tax in New Zealand. This is not the case. If a person remains New Zealand tax resident during their absence, they have a requirement to pay New Zealand tax on their overseas income and New Zealand sourced income.

Fundamental to the concept of tax residence is the permanent place of abode ("PPOA") test. A person will be tax resident in New Zealand if they have a PPOA in New Zealand, regardless of the time spent out of the country. As there is no definition in the Income Tax Act 2007 of what a PPOA means, tax advisors must refer to principles established by case law when determining what it means. As an individual's particular circumstances must be considered on a case by case basis in making this assessment, often the position is not clear cut.

The concept of a PPOA was most recently tested in the Court of Appeal's decision in *Diamond* (for the background on this, see our [February 2016 Tax Alert article](#)) where Inland Revenue asserted the taxpayer retained their PPOA in New Zealand. In a rare taxpayer win, the Court dismissed Inland Revenue's approach to determining whether a PPOA existed and the decision set out the principles to be applied in

assessing whether a taxpayer has a PPOA in New Zealand.

Inland Revenue has now updated its interpretation statement to reflect the principles provided by the Court of Appeal. In summary, for a PPOA to exist in New Zealand:

- A person must have a place of abode (i.e. a dwelling) in New Zealand to have a permanent place of abode here. An "abode" means a "habitual residence, house or home or place in which the person stays, remains or dwells."
- Deciding if a dwelling is a taxpayer's PPOA requires an assessment of the taxpayer's circumstances and how the taxpayer has used that dwelling. This requires an assessment of:
  - the continuity and duration of the person's presence in New Zealand; and





– the durability of the person’s association with the place of abode and how close their connection with it is.

- A property used as a personal residence can be contrasted with one that is an investment property. Simply renting out your personal residence in itself may not be sufficient, as you would also need to consider the use of the property before and after a period of absence. The existence of a dwelling as a habitual abode is fundamental to the PPOA test, *“it does not matter how strong a person’s ties to New Zealand are if those ties do not indicate that the particular dwelling in question is the person’s permanent place of abode. For example, if a person has strong connections to New Zealand, but the only dwelling **they have here is a property that they have never lived in and never intend to live in, that property could not be their permanent place of abode**”*.

The decision of the Court of Appeal and the revised interpretation statement hopefully put an end to the uncertainty that has existed over the last few years where Inland Revenue have asserted that the mere existence of a dwelling (irrespective of how it has been used) is sufficient for a PPOA to exist in New Zealand. We now head into an era that will hopefully see greater certainty for taxpayers and a more consistent application of the law.

For those that have relied on the earlier interpretation statement and taken a tax position that would be different under the revised interpretation statement, Inland Revenue has released an [operational statement](#) which states that taxpayers can ask Inland Revenue to apply the new analysis to their circumstances and request amendments to previous tax positions in accordance with the principles set out in *Standard Practice Statement SPS 16/01 – Requests to amend assessments*.

If you have any questions in relation to the above, please don’t hesitate in contacting your usual Deloitte advisor.



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# Government releases significant and complex proposals to tackle hybrid mismatch arrangements

On 6 September 2016, the New Zealand Government announced the release of a discussion document (“Paper”) that contains proposals for addressing hybrid mismatch arrangements.

A hybrid mismatch arrangement is an arrangement which exploits the differences in the tax treatment of a legal entity or a financial instrument by two or more countries. Such arrangements would provide a “mismatch” in tax outcomes with the effect of reducing the total worldwide tax that should have been paid by the parties involved.

Hybrid mismatches include situations where there is a double deduction in two different countries for the same expense, or a deduction is allowed in one country without income being recognised in another country. Inland Revenue cite the recent case of *Alesco New Zealand v Commissioner of Inland Revenue* [2013] NZCA 40 as an example on point, whereby the New Zealand taxpayer had issued optional convertible notes to its Australian parent, which were treated as part debt and part equity in New Zealand, but exclusively equity in Australia. The tax outcome meant expenditure in relation to the instrument was deductible in New Zealand; however, the income was not assessable in Australia.

The Paper proposes that New Zealand should adopt the OECD recommendations on hybrid mismatch arrangements, as proposed under Action 2 of the BEPS action plan, and seeks input on how the OECD recommendations could be implemented in New Zealand.

Hybrid mismatches include situations where there is a double deduction in two different countries for the same expense, or a deduction is allowed in one country without income being recognised in another country

The recommendations seek to prevent the misalignment of domestic rules resulting in unintended tax advantages, which is primarily achieved through the use of “linking rules” that change the usual tax treatment of cross-border transactions to ensure that there is no hybrid mismatch in such cases.

The Paper is divided into two parts. Part I describes the problem of hybrid mismatch arrangements, the case for responding to the problem and a summary of the OECD recommendations. Part II explains the OECD recommendations in greater detail and discusses how they could be incorporated into New Zealand tax law.

The Paper considers each of the OECD’s recommendations and proposes a number of changes to New Zealand’s tax law to implement them. There are a significant number of proposals included in the Paper, many of which are complex. The proposals appear ominous with the following statement made in page 1: “It is expected that most hybrid arrangements would be replaced by more straightforward (non-BEPS) cross-border financing instruments and arrangements following the implementation of the OECD recommendations in New Zealand.”

There is recognition that the rules will result in complexity for foreign branches of New Zealand companies, so submissions are requested on whether there should be an active branch income exemption.

There is also a proposal to treat companies that are resident in another country under a Double Tax Agreement as non-resident for New Zealand tax purposes.

The proposals are expected to apply to payments made after a taxpayer’s first tax balance date following enactment.

The Paper makes it clear that the final decision in relation to the proposed implementation of the OECD’s recommendations in New Zealand will be made after the consultation phase. The date for submissions has been extended from 17 October to 28 October 2016.

# A snapshot of recent developments



## **GST turns 30 and celebrates with the introduction of the Netflix tax**

Goods and services tax (“GST”) turned 30 on 1 October 2016. GST was introduced on 1 October 1986 by the third Labour Government at a rate of 10%. It was increased to 12.5% on 1 July 1989 and more recently to 15% on 1 October 2010.

The birthday celebrations coincide with the commencement date of the new “Netflix tax”. From 1 October, any offshore business providing remote and online services and supplies of intangibles to a New Zealand private consumer will need to collect and pay GST if the cumulative amount of supplies provided to New Zealand private consumers within a 12-month period is expected to exceed NZD 60,000. See our earlier [article](#) on this topic.

## **Public Rulings Unit Work Programme**

On 5 September 2016, Inland Revenue released an updated 2016-17 Public Rulings Unit Work Programme. Noteworthy items added to the work programme included the following.

- Income tax – Deductibility of feasibility expenditure, which is an update and review of IS 08/02 following Trustpower (see our main [article](#) on this).
- Income tax – Income – Amounts derived from land use, which considers the impact of the Vector decision on existing

public statements, in particular Pub BR 05/ 02-10 and Pub BR 09/06.

- GST – Credit card charges, which seeks to provide guidance on the GST treatment of fees charged in respect of credit cards.
- GST – Grouping rules, which seeks to resolve uncertainties around GST grouping issues.
- Income tax – Associated persons – Corporate trustees, which addresses uncertainty around the capacity of a trustee when the trustee is a corporate following the decisions in *Concepts 124 Ltd v CIR* [2014] NZHC 2140 and *Staithe Drive Development Limited v CIR* [2015] NZHC 2,593.
- Income tax – Land – Improvements becoming part of land, which seeks to address whether building fit-out is an improvement to land for the purposes of section CB 11 and as to which party owns various improvements to land and buildings.
- Income tax – Research & Development, which seeks to provide guidance on the R&D rules, including the application of the new loss tax credit rules.

## **Operational guidelines: Section 6A settlements**

On 1 September 2016, Inland Revenue released Operational Guidelines: Section 6A settlements (“the Guidelines”) to outline its internal approach to settling disputes prior to the filing of a challenge in the Taxation Review Authority or the High Court. By way of background, Interpretation Statement IS 10/07 confirms that Inland Revenue can “settle” disputes prior to litigation, pursuant to section 6A of the Tax Administration Act 1994. The Guidelines confirm that the starting point for Inland Revenue is to apply the law correctly and to seek to recover all of the tax which is due. However, where a dispute is commenced, the Guidelines provide a set of criteria which can be taken into account and some guiding principles around how much weight should be given to each criterion. For each settlement, Inland Revenue will consider whether it is consistent with the dual duties of collecting the highest net revenue practicable over time and protecting the integrity of the tax system.

## **QB 16/07: Income tax – land sale rules – main home and residential exclusions – regular pattern of acquiring and disposing, or building and disposing**

On 31 August 2016, Inland Revenue released QB 16/07. The QWBA provides guidance on when someone will have a “regular pattern” of transactions that means they cannot use the residential exclusion from sections CB 6 to CB 11 of the Income Tax Act 2007 and when someone will have a “regular pattern” of transactions that means they cannot use the main home exclusion from the 2-year bright-line test. While there is no hard and fast rule, at least three prior transactions would be needed for there to be a regular pattern of acquiring or building and then disposing of property. We also note that a flowchart has been inserted which outlines

the taxing provisions and exclusions that may apply when taxpayers sell land and property.

### IRD: Depreciation rates guidance

Inland Revenue has published an updated depreciation rates guide. This guide sets out the general and provisional depreciation rates for both diminishing value and straight line methods for assets acquired in the 2006 and future tax years. Several times a year, the Commissioner releases determinations to insert new asset classes and corresponding depreciation rates which apply going forward. This is most common for new types of assets (for example, we have recently seen the addition of depreciation rates for drones, smart phones and tablet computers). Often taxpayers use a default rate where

a specific rate does not exist. In this case, if the new rate is higher, they are required to commence using the new rate from the beginning of the income year specified in the determination. However, if the new rate is lower, as long as the previous rate was correct at the time, taxpayers are not required to change to the less favourable rate and can continue to use the higher rate. See QB 15/03 – Changing to a different depreciation rate for an item of depreciable property for more information. Setting depreciation rates is not necessarily a set and forget task. It pays to periodically check that you are using correct depreciation rates, particularly for new classes of asset types where a default rate may have been used.



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