Tax Alert

A focus on topical tax issues – June 2016

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Capital gains tax on shares? Inland Revenue proposes changes to Employee Share Schemes

By Greg Haddon and Liz Nelson

Late last year Inland Revenue raised some alarm when it issued a Revenue Alert indicating that it had concerns over various employee share schemes, going so far as suggesting they may constitute tax avoidance. They have now released an Officials' issues paper to seek feedback on proposals to significantly change the rules relating to the taxation of employee share schemes. In summary, the paper includes the following proposals:

- Unconditional employee share schemes (shares and options offered to employees free of any further conditions) should be taxed at the time the employee acquires the shares or exercises the option to acquire shares (i.e. no change).
- Conditional employee share schemes (shares or options offered to the employee where retention of the shares is subject to future conditions) should be considered a reward for future work and therefore taxation should not occur until the conditions have been satisfied. This means any movement in share price up until the conditions are satisfied will be subject to tax.

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- Option-like arrangements (being arrangements where shares are acquired at market value and then held on trust for a period before they vest with the employee, including interest-free non-recourse loans and mechanisms to return the shares if conditions are not met) should be similar to conditional employee share schemes, and taxed at the point that the conditions have been satisfied. This is in direct contrast to a product ruling issued by Inland Revenue last year on a commonly used form of share scheme.

- Employers should be allowed a deduction for a deemed cost of the shares provided under an employee share scheme at the same point as the income is taxed in the hands of the employee based on the amount that is taxable for the employee.

- The concessionary regime for widely offered share schemes should either be repealed or modernised (with a preference for the former) on the basis that the rules are antiquated and unfair.

- The paper also considers whether a concession should be offered to start-up companies that would potentially defer taxation of employee share schemes until the shares are sold or listed (based on the value at that time).

The premise of the paper is that a benefit under an employee share scheme should be subject to tax in the same manner as an employment benefit paid in cash. As a cash bonus is not taxable until the cash is received, shares should be taxable when they are granted unconditionally. In the Officials' opinion, options should be taxable on exercise. Where there is the potential for forfeiture, Officials view the arrangement as more akin to an option, so such arrangements should be taxed like an option.

In our view, what the paper fails to recognise is that the value of the benefit received by the employee (as employment income) is the value of the instrument granted, whether it is a share or an option. Any change in the value of the instrument should be considered a capital gain or loss. Neither the employee nor the employer has control over the value of the instrument, as this is a function of capital markets, and the value of a share at vesting is not interchangeable with cash remuneration.

Australia and the U.S. recognise the capital gain element. We understand that Australia will only tax the employee share scheme as employment income where there is a discount on the option or share offered. Where there is no discount, there is no employment income to tax, and any future movement in the value of the share or option is only subject to capital gains tax. Similarly, in the U.S. employees can elect to be taxed upfront on option-like arrangements, and where there is no discount there should be no tax.

The paper uses the difficulty of valuing options as a reason not to tax them upfront and seeks to rationalise this position on the basis that the after-tax outcomes for the employee are equivalent regardless of whether tax is imposed at issue or exercise. However there is no such valuation difficulty in Australia and in our view the after-tax equivalence examples are over simplified. The Australian Taxation Office (ATO) publishes specific tables that give a safe harbour for the valuation of an option. The taxpayer can either use these tables or seek their own valuation. In addition, a share scheme such as the arrangement that was the subject of last year's product ruling is respected as an upfront acquisition of shares in Australia. This leaves New Zealand employees at a significant disadvantage relative to their Australian counterparts and creates complexity within Australasian businesses that offer employee share schemes in both countries.

Officials are also considering offering a "concession" to start-up companies, enabling employees to defer taxation until the shares are sold or listed. Employee share schemes are a popular tool in start-up companies due to the shortage of cash to attract talent and the culture that it creates when employees have skin in the game. This proposal would tax any upward movement in the value of shares until they are ultimately sold or listed in an open market. Again, in our view this is taxing what should be a capital gain on the movement in share price. An argument might exist for imposing a time value of money cost, however taxing the capital gain is neither appropriate nor is it a concession.

Turning to Australia again, there are specific rules for valuing options for start-up companies. Any gain on the shares once they are sold should only be subject to capital gains tax, and potentially gets the benefit of a 50% discount on capital gains tax.

The consideration of start-up companies also fails to look at the wider taxation issues they face, for example, shareholder continuity and tax losses. The benefit of a tax deduction for employee share scheme benefits will be severely limited if a start-up company cannot make use of the tax losses it has available, and is likely to forfeit those tax losses in the event of a significant shareholding change or share listing.

In summary, we are concerned that the proposals will result in the over taxation of employees in New Zealand, in exchange for what should only be a small increase in revenue for the Government (assuming companies are ultimately able to utilise their deduction). Effectively, the revenue generated by the proposals should be limited to the tax rate differential between companies and employees (as employers will be able to take a deduction for the employee share scheme benefits); however the cost must be borne by employees. This does little to align the interests of businesses and employees.

In our view the proposals will materially impact the ability of companies to use employee share schemes to attract and retain talent

In our view the proposals will materially impact the ability of companies to use employee share schemes to attract and retain talent. It is likely to be difficult to construct a scheme that delivers the commercial benefits that a number of the existing schemes provide in a form that is manageable from both a company and employee perspective. This cannot be good for New Zealand.

The closing date for submissions is 22 June 2016. If you would like to make a submission, please contact your usual Deloitte tax advisor.

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GST on "remote" services – additional guidance released

By Hana Straight

New Zealand has enacted legislation that requires non-resident businesses providing remote services to private consumers to register for New Zealand GST if their New Zealand supplies exceed the threshold of NZ$60,000 per annum. Details of the new regime can be found in a prior article **here**.

The new rules will apply to supplies made on or after 1 October 2016.

New Zealand's Inland Revenue Department has now released additional **guidance** providing further information in respect of the more practical aspects of the legislation.

Registration and Compliance
GST registration will be available from 1 August 2016 and is likely to require the following information:

- The applicant's name;
- Contact details;
- Country of residence;
- Any existing tax identification numbers;
- A description of the business activity;
- Website address; and
- Whether the applicant will be returning GST or returning and claiming GST.

For the period from 1 October 2016 to 31 March 2017, non-resident suppliers of remote services will have a taxable period of six months (or an optional taxable period of two months). Following these periods (i.e. from 31 March 2017), GST returns will be quarterly with period ends of 30 June, 30 September, 31 December and 31 March.

GST returns are due to be filed, and payments made, on the 28th day of the month following the end of the taxable period, with exceptions being returns and payments otherwise due 28 December (which moves to 15 January) or 28 April (which moves to 7 May).

The Commissioner's Discretion
The legislation requires a non-resident to determine:

- If the customer is a NZ resident
- If the customer is a GST registered business.

The determination of residency is based on a list of commercially available proxies that suppliers may hold. A supplier must hold two non-contradictory pieces of evidence to support their conclusion.
Non-residents are required to assume that a NZ resident customer is not a GST registered business unless the customer has provided their GST registration number, New Zealand Business Number or notified the supplier that they are a GST registered business.

In both situations, the Commissioner of Inland Revenue can agree or prescribe an alternative approach depending on the nature of the supplies.

Non-resident Operators of Marketplaces
One of the key features of the legislation is the requirement for non-resident operators of electronic marketplaces (e.g. app stores) to register and return GST if their supplies exceed NZ$60,000 in a 12 month period (instead of the underlying supplier).

Upon agreement with Inland Revenue, non-resident operators of non-electronic marketplaces can also register and return GST instead of underlying suppliers.

For more information on this area, please contact one of our indirect tax specialists.

Inland Revenue finalise guidance on computer software acquired for use in a taxpayer's business

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By Emma Marr and Brad Bowman

Given the prevalence of computer software in most New Zealand businesses, the deductibility of the cost of this software is a question that almost all businesses will face at one point or another. Inland Revenue have recently updated their guidance on this, issuing Interpretation Statement ("IS 16/01"), **Income Tax – Computer software acquired for use in a taxpayer's business**. IS 16/01 updates and replaces a 1993 Policy Statement on the income tax treatment of computer software.

As a starting point, IS 16/01 only provides guidance in relation to software purchased, leased, licenced, developed or commissioned for use in their business. It is important to note that IS 16/01 does not cover software developed for sale or licence (although we understand that Inland Revenue are currently considering this).

Deloitte made a submission and liaised with Inland Revenue with respect to IS 16/01. A number of Deloitte submission points were incorporated into IS 16/01, including comments in relation to periodic payments for the right to use or access software.

As a general guide, the income tax treatment of the computer software depends on how the business acquires the software. The main types of software expenditure covered by IS 16/01 are as follows:

- Software purchased: Where software is acquired for use in a business, the software purchased will generally be a capital asset and depreciated accordingly (the depreciation rate for software is 50% using the diminishing value method and 40% using the straight line method). Where the cost of the software purchased is less than $500 the software may be fully deductible in the year of acquisition. As with any asset, maintenance costs should be deductible when incurred, whereas upgrades should be capitalised and depreciated.

- Periodic payments for the right to use or access software: Such payments are generally deductible when incurred for tax purposes. This would cover payments for cloud based software services, such as Xero.

- Software developed in-house: Expenditure incurred in developing software in-house will likely be capital in nature and capitalised as a software asset. Amounts capitalised would be depreciated in the same manner as software purchased (that is, once the software is available for use). Despite that, expenditure incurred prior to the commencement of the software project may be deductible immediately as "feasibility expenditure". There are also special deductibility rules regarding expenditure incurred in software developments which are ultimately abandoned.

IS 16/01 also considers expenditure on software commissioned by a taxpayer for use in its business (which is treated in the same way as software developed in-house) and the lease of software where the lease is a finance lease for tax purposes (in which case the normal finance lease rules apply).

Computer software which a taxpayer uses in their business can be leased, purchased outright, developed in-house or commissioned. The software may even be a service provided by cloud based software service providers. It is important for taxpayers using computer software in their business to fully understand the tax treatment that may follow as a result of the way in which it is acquired.

If you have any questions in relation to the deductibility of computer software expenditure, please contact your usual Deloitte advisor.

Given the prevalence of computer software in most New Zealand businesses, the tax treatment thereof is a question that most businesses will face at one point

A snapshot of recent developments

Below is a summary of the key tax developments which have occurred since our last Tax Alert.

OS 16/01: Filing an IR 10 and section 108 of the Tax Administration Act 1994

On 31 May 2016, Inland Revenue released the finalised operational statement **OS 16/01**, which outlines Inland Revenue's operational approach for applying section 108 of the Tax Administration Act 1994 ("the time bar") when an IR 10 has been filed. Our article in **March** covered the draft. The conclusions reached are broadly consistent with the earlier draft with some of the discussion and explanations updated.

Taxation (Resident Land Withholding Tax, GST on Online Services, and Student Loans) Act 2016

Also known as the 'Netflix tax' Bill, this bill passed its third reading on 3 May 2016 and received royal asset on 13 May 2016. This Act imposes a range of new rules including the Residential Land Withholding Tax ("RLWT"), GST on remote services and intangibles supplied by offshore suppliers, and a remedial change regarding recently introduced bank account requirements.

Taxation (Transformation: First Phase Simplification and Other Measures) Bill

The Taxation (Transformation: First Phase Simplification and Other Measures) Bill passed its third reading on 31 May 2016 and received royal assent on 2 June 2016. The Bill includes the first proposals relating to business transformation, changes to the collection of tax from employee share schemes and a simpler FIF exemption for ASX companies.

Commissioner's mileage rates for 2016

The Commissioner of Inland Revenue completed her review for 2016 of the **mileage rate** for expenditure incurred for the business use of a motor vehicle and concluded that rate should be reduced to 72 cents per kilometre (from 74 cents in 2015) for both petrol and diesel fuel vehicles for the 2016 income year.

Customs and Excise Act amendments released

On 19 May 2016, Customs Minister Nicky Wagner **announced** a set of proposals to reform the Customs and Excise Act 1996. The proposals include plans for Customs NZ and Inland Revenue to co-ordinate on the streamlining of GST payment at the border and a focus on reducing compliance costs. The proposals also include changes to address a range of issues for New Zealand businesses, including:

- An allowance for alcohol manufacturers to use off-site storage without incurring excise tax when the goods enter storage;
- An internal process for appeals over the assessment of duty;
- Importers will be able to declare a provisional value for goods in specific circumstances and declare a final value later; and
- Customs will be able to issue binding valuation rulings.

Draft SPS on using losses to pay shortfall penalties

On 24 May 2016, Inland Revenue released a draft standard practice statement ("the draft SPS") concerning section IW 1 of the Income Tax Act 2007. Section IW 1 allows taxpayers to use tax losses to pay shortfall penalties imposed on income tax liabilities. The draft SPS confirms that losses can only be applied to penalties on income tax. It also discusses the conditions for using losses, how losses can be used for group penalties and the correct value of an individual or company's losses when paying a penalty.

CS 16/01: OECD information sharing requirements for taxpayer rulings and determinations

On 17 May 2016, Inland Revenue released **Commissioner's Statement 16/01** ("CS 16/01") CS 16/01. The statement details the Commissioner's obligation to share certain taxpayer rulings or determinations with tax authorities in other OECD countries as a part of Action 5 of the OECD's BEPS Action Plan.

Multilateral Competent Authority agreement for the automatic exchange of Country-by-Country reports

On 12 May 2016, Revenue Minister Michael Woodhouse **announced** that New Zealand has signed the **Multilateral Competent Authority agreement for the automatic exchange of Country-by-Country reports**. This agreement "allows all signatories to bilaterally and automatically exchange Country-by-Country Reports with each other, as contemplated by Action 13 of the BEPS Action Plan".

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