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Employee Share Schemes – time to revisit loan and bonus arrangements?

By Jayesh Dahya and Varshini Suresh

The Inland Revenue continue to press ahead with reforms to the taxation of employee share schemes with the introduction of the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill (the Bill) last month.

The Bill outlines new rules for the taxation of employee share schemes that are broadly consistent with proposals announced last year.

In this issue:

According to Inland Revenue, the changes are intended to remove "the considerable uncertainty" that has existed in how to apply the current rules which have apparently deterred employers from offering schemes to their employees. Whether that is the case is debatable, however what is certain is that the changes will bring to an end to employee share schemes that deliver non-taxable capital gains to their employees.

What this means is that employers operating employee share schemes that have these benefits will need to consider their options in light of the transitional rules and the proposed application dates for the new rules. This article considers benefits under general employee share schemes; refer to our separate article in this issue on "widely held" or exempt employee share schemes.

Scope of the new rules

The new rules apply to benefits received under an "employee share scheme".

This covers all arrangements involving the provision of shares in a company to past, present or future employees (or their associates). The definitions are cast deliberately wide to cover all types of arrangements such as loans to buy shares, bonuses, put and call options and transfers to employee trusts.

The rules will not apply to:

- Schemes that are eligible for concessions i.e. widely held or exempt schemes– (refer to our separate article on these schemes in this issue of Tax Alert).
- Arrangements where employees pay market value for the shares on the "share scheme taxing date".
- Arrangements that require employees to put at risk shares they acquired for market value with no protection to the person against a fall in share value.

Calculating the taxable benefit

The taxable benefit is broadly the difference between the market value of the shares at the "share scheme taxing date" less the amount paid for them by the employee. Inland Revenue has just released a statement providing guidance on valuation methods; see our seperate article in this issue. Any 'black out periods' where employees are restricted from disposing of shares are not to be taken into account.

The "share scheme taxing date" is the date when:

- There is no real risk that the beneficial ownership (i.e. entitlement) will change, or that the shares will be required to be transferred or cancelled;
- The employee is not compensated for a fall in share value; and
- There is no real risk that there will be a change in the terms of the shares affecting their value

There are ten examples to illustrate how the rules are intended to apply in the Commentary to the Bill. Broadly, if the scheme has any conditions or contingencies that need to be satisfied, the taxing point will be the time that the conditions or contingencies are satisfied. Another way of looking at this is that the taxing point is the time that the employee is exposed to the full economic risk associated with share ownership, as illustrated in the examples on the following page.

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Inland Revenue Examples

Example: Simple vesting period

Facts
A Co transfers shares worth $10,000 to a trustee on trust for an employee. If the employee leaves the company for any reason during the next three years, the shares are forfeited for no consideration. After three years, the shares are transferred to the employee.

Result
The share scheme taxing date is when the three years is up and the employee is still employed.

Analysis
The risk of loss of the shares for the first three years means there is a real risk that the beneficial ownership of the share will change. None of the exceptions applies.

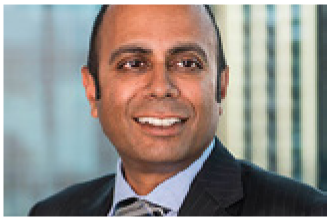
Example: Loan funded scheme

Facts
B Co provides an employee with an interest-free full recourse loan of $10,000 to acquire shares in B Co for market value, on the basis that:

- the shares are held by a trustee for three years;
- dividends are paid to the employee from the time the shares are acquired;
- if the employee leaves within three years, the shares must be sold back to the trustee for $10,000, which must be used to repay the loan;
- if the employee is still employed by B Co after three years, the employee can either sell the shares to the trustee for the loan amount, or choose to continue in the scheme; and
- if the employee chooses to continue, the loan is only repayable when the shares are sold.

Result
The share scheme taxing date will be the earlier of when the employee leaves employment, or the expiry of the three years.

Analysis
Until the three years are up, if the employee leaves B Co for whatever reason, they lose their beneficial ownership of the shares for an amount that is not their market value. So the share scheme taxing date will, on the face of it, be the end of that three-year period. If the employee leaves within that period and is therefore required to transfer their rights, the sale price will be taxed, but since the sale price is the same as the amount contributed, there will be no gain or loss. Once the three-year period is up, the employee will either have no income (if they sell the shares back to the trustee for $10,000) or will pay tax on the difference between the value of the shares at that time and their $10,000 price (if they choose to keep the shares).



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Where an employer opts to pay a bonus under a loan funded scheme, some further complexities arise which are likely to mean that in the future such arrangements will no longer exist.

In the loan funded Inland Revenue example above, if the employer pays the employee a grossed up bonus of $14,925 (at 33%) to repay the $10,000 loan after three years at a time where the value of the shares are now $15,000, the employee will have taxable income equal to the bonus plus the difference between the value of the shares at the taxing point and the amount paid for them (i.e. the bonus after PAYE). In this case, this would be $14,925 plus $5,000 ($15,000-$10,000).

If however, the shares were only worth $2,000, the employee would have taxable income of $14,925 being the bonus and a tax deduction for $8,000 ($2,000-$10,000) that would be claimed in the tax return.

What this illustrates is that employers will have challenges with operating loan and bonus arrangements in the future. There will be difficulties in administration if we overlay the employer share reporting rules and employees are likely to find it difficult to grasp the concepts when it comes time to file their returns.

Deductions for employers

Currently, the general position is that shares issued to employees are not deductible to the employer (as there is no cost which has been incurred on a new share issue). Employers can obtain deductions by structuring employee share arrangements differently, for example by acquiring shares on market or arranging for the purchase of shares from another group entity.

Under the proposed rules employers will be allowed a deduction for:

- Benefits provided under an employee share scheme that is equal to the amount calculated on the "share scheme taxing date" (i.e. the amount of the benefit that is taxable to the employee(s)).
- Costs associated with the administration and managing the scheme, subject to the usual capital/revenue tests.

While this may be good news to those employers who currently do not get a deduction, deductions are of limited benefit to companies who may be in losses, particularly start-up companies that may lose their losses before they become profitable by introducing new shareholders. Unfortunately the suggestion that taxpayers in loss are able to cash up the benefit of deductions in these cases did not have much appeal with Inland Revenue officials.

Application Dates

The Inland Revenue has recognised that employee share schemes are long term arrangements that may have vesting periods of three years or more. Given this, it has been proposed that the new rules do not apply to:

- Shares granted or acquired before 12 May 2016.
- Shares granted or acquired within six months of enactment of the Bill provided the shares were not granted with the purpose of avoiding the application of the new law and the share scheme taxing date (i.e. the date benefits vest) is before 1 April 2022.

As we are in an election year, it is unlikely the new legislation will be enacted until early 2018. This means most schemes should be able to continue to operate under the existing rules until mid-2018.

Where to now?

It is now time for employers with established schemes to start thinking about how their existing schemes would operate under the new rules and whether they need to be updated for the changes that are coming.

For some employers, it may be beneficial to consider whether to make further issues or grants of shares under existing schemes given the transitional rules and likely application dates. Employers would need to ensure that benefits vest before 1 April 2022 and the further issues or grants of shares are not seen as avoidance.

Over time, it may be that employers will move away from the complex and administratively burdensome arrangements that presently exist to more traditional options or share grant schemes that offer an element of simplicity given the new rules will effectively tax all employees share schemes on the same basis as options.

If you have any questions or comments, please contact your usual Deloitte advisor.

The taxable benefit is broadly the difference between the market value of the shares at the "share scheme taxing date" less the amount paid for them by the employee

Gearing up for FBT season...

By Mike Williams and Matthew Ensor

With the fourth quarter Fringe Benefit Tax return for the year ended 31 March 2017 due by 31 May 2017 now is the time to get up to speed with legislative changes and consider the areas that Inland Revenue are currently focussed on.

Keep it clean, get it right

Inland Revenue continues to place a strong focus on employment taxes, and we know that Inland Revenue officers are specifically looking at common FBT errors and FBT "risks" in the SME population (real or perceived). Additionally, there have been a number of changes in legislation that may affect how you prepare your FBT return.

To help you get it right we have outlined below relevant changes, common errors and areas of Inland Revenue focus:

Life Insurance

Earlier in the year there was major Inland Revenue focus on employers who take out group life insurance, disablement and trauma insurance policies. A number of employers were contacted and asked to explain their approach to the FBT treatment of such policies. Whilst there are some technical arguments as to why certain life insurance policies are not held for the benefit of the employee and therefore not subject to FBT, Inland Revenue holds a clear view that any policies are subject to FBT where the employee (or the employee's family) will receive directly or indirectly any claim proceeds. In many cases this led to increased FBT liabilities in settling with Inland Revenue (or the prospect of a costly technical and legal argument if the position was to be pursued).

In a further change which applies from 1 April 2017, the FBT treatment of life insurance premiums has been standardised to ensure that all life insurance premiums are treated as specified insurance premiums. Certain life insurance policies previously did not meet the definition of a specified insurance premium and were therefore considered an unclassified benefit such that the de-minimis exemption might apply. This means that going forward the de-minimis exemption will not apply to life insurance policies.

Landing on free parking

Inland Revenue released a public ruling in December 2015 clarifying and updating its operational position for the on premise

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exemption for carparks. Following this there is the potential to reduce FBT liabilities if the right to use employer provided carparks is "in fact or effect substantially exclusive". As a minimum the carparks must be reserved, specific car spaces. Now is a good time to consider your car parking contracts to determine whether the new position will apply to you even if your agreement is stated as a license arrangement. From our experience there is the potential to claim back significant FBT from prior years and real savings to be had going forward by looking more closely at the substance of a car parking agreement rather than just the words used.

Motor Vehicles

Inland Revenue are increasingly focussing on the FBT implications for motor vehicles provided to employees. Motor vehicles often make up the largest portion of an employer's FBT liability and are also one of the main areas where we come across issues. Inland Revenue has issued a draft Interpretation Statement regarding the FBT treatment of motor vehicles, aiming to clarify and consolidate the Inland Revenue's operational positions in a number of areas. With this in mind, we would recommend the below issues are considered leading up to the 31 May deadline:

- **Work-related Vehicles** – We have seen an increased attention by Inland Revenue on work-related vehicles. They have been the subject of recent Inland Revenue activity with the focus on the type of vehicle, availability for private use and the subsequent policing of any non-usage policy. A work-related vehicle will generally not be subject to FBT. However in order to fall under this definition the vehicle must not be designed principally to carry people and cannot in fact be used for private purposes. It must also be permanently sign written with the employer's logo.

- **Travel between home and work** – In the first instance any travel between home and work is considered to be private use of a motor vehicle. Should an employer deem that an exemption to this general principal exists and that there is no private benefit to the travel, the onus of proof will be on the employer to demonstrate and document this position. Some examples of this may be that an employee's home may also be a specified workplace and therefore no FBT attributable where there are sound business reasons for the work to be performed at home (and therefore the need for the travel to home with the vehicle). Alternatively, there may be valid reasons (i.e. security) for a vehicle to be stored at an employee's home.

- **Documentation** – As alluded to above it is important that sufficient documentation and policies are regularly maintained and followed. Specifically, where vehicles are prohibited from being used by employees for private use, this should be clearly documented as the onus of proof will fall on the employer. Suitable documentation could be a provision in the employee's contract or a letter to the employee. If in practice a prohibition on private use is not followed and the employer is aware of the private use, the employer is liable to pay FBT. It is important to review this periodically to make sure what is recorded stacks up, and that appropriate documentation and logs are maintained to support the tax position taken.

- **Motor Vehicle FBT value** – There are a couple of nuances to look out for when calculating the fringe benefit value and the most common error we see is when apportioning the benefit value for the number of days the vehicle is unavailable for private use. If FBT is paid quarterly, the apportionment factor should always be applied over a standard 90 days.

- **Calculation of available days** – Where a vehicle is made available to an employee for their private use, the vehicle is considered available and subject to FBT irrespective of whether the vehicle is actually used. For example, if an employee travels overseas for a holiday, although the vehicle cannot be used by the employee, the vehicle will still be considered available as there are no employment restrictions preventing use. There are some specific exclusions for non-usage days such as the vehicle being used for business travel away from home for a period exceeding 24 hours, emergency call outs, or the employee going overseas for business for more than 24 hours (where no member of the family can use the vehicle in their absence). These can reduce the number of days a vehicle is available for personal use.

Applying the de-minimis exemption for unclassified benefits

There is an exemption from FBT for unclassified benefits provided to

employees provided a de-minimis threshold is not exceeded. The current de-minimis threshold is $300 per quarter per employee or $22,500 per employer over the last 4 quarters for all employees. This calculation is a rolling quarterly calculation. In practice we find this opportunity is missed completely or the rolling quarterly calculation of the threshold is not done correctly.

Further, the de-minimis threshold applies across all associated entities and not on an entity-by-entity basis, regardless of whether or not the entities are providing benefits to the employees of another entity. A risk arises where one group company does not review the availability of the de-minimis exemption in the context of the total value of all unclassified benefits provided across the group. This is a particular risk where there is limited or no information sharing between entities.

Washing up errors in Q4

We are aware of the temptation to correct prior quarter errors in a "wash-up" calculation in the final quarter FBT return. Technically correction of prior quarter errors can only be done in a later quarter where the total adjustment to FBT does not exceed $500 (a recent law change means for quarters beginning after 1 April 2017 this threshold has increased to $1,000).

There is evidence that Inland Revenue is beginning to clamp down on this "wash-up" practice. Therefore when preparing your final quarter returns ahead of 31 May 2017 it is important to ensure that if any errors are corrected that they fall below this threshold. Anything above the relevant threshold should be corrected through a voluntary disclosure.

Annual filing threshold

Small employers have the option of filing FBT returns annually. For the 2017 income year the threshold for filing an annual return is where an employer's total gross PAYE and ESCT contributions for the previous year were less than $500,000. However in order to file annually an election needs to be made with Inland Revenue. A common error we see is that elections are not made or renewed by the 30 June deadline (or the end of the first quarter that fringe benefits arise). If an election has not been made, a small employer will still be required to prepare quarterly returns. From 1 April 2017 the annual filing threshold will increase to employers whose gross PAYE and ESCT contributions do not exceed $1,000,000.

To attribute or not, that is the question

Even if you have chosen to pay FBT at the standard rate of 49.25% per quarter rather than the multi-rate of 43%, all is not lost as employers are still able to replace the fourth quarter calculation with a full year attribution calculation based on FBT rates linked to the total value of cash remuneration and fringe benefits per employer.

Our experience shows employers can and do save material amounts when going through the full attribution exercise. At the very least, rather than perform the full attribution calculation, employers should consider whether it is possible to "pool" eligible benefits at the lower rate of 42.86%.

Software

Now is the perfect opportunity to consider the use of "off the shelf" FBT software. These simple solutions can streamline the FBT process, help reduce errors and ultimately save valuable time and money.

Conclusion

If you require assistance with your final quarter/yearly calculations or wish to explore the benefits of an FBT health check further, please contact your usual Deloitte tax advisor.

Closely held companies – changes to LTC eligibility and tainted capital gains

By Bill Hale and Jamie Hall[1]

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The enactment of the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 ("the Act") has brought into effect a number of legislative changes to the tax rules applying specifically to closely held companies ("CHCs"), being companies which typically have only a few shareholders, for example, look-through companies.

In addition, the Act also includes changes to narrow the scope of the tainted capital gains rule, which applies to all companies but may be of particular interest to CHCs.

While some of the above changes apply from 30 March 2017, being the date of enactment of the Act, most others apply from the 2017/18 income year.

Background

In September 2015 Inland Revenue released the officials issue paper, Closely held company taxation issues ("the Issues Paper"), which sought response to possible changes to deal with concerns about the workability of various tax rules which apply to CHCs. These proposals were covered in a Special Tax Alert publication.

After considering a number of submissions on the proposals, Officials have refined the changes to those included in the Act. We comment on some of the key changes in respect of Look Through Companies ("LTCs") and tainted capital gains below.

LTC Regime

The LTC regime allows companies meeting certain criteria to be treated as transparent entities for income tax purposes. In effect, the rules aim to allow owners of these companies to be taxed as if they owned the underlying investment while still being afforded the protection of limited liability.

As a result of these rules being perceived as difficult to apply, resulting in increased compliance costs and in some instances not working in a manner which was consistent with the policy intent, a number of changes to the regime are included in

[1] The authors would like to acknowledge the contribution of Ashley Barnett in assisting with this article.

the Act. Broadly, Officials have sought to make the LTC regime simpler to apply but have tightened the rules regarding those who are eligible to enjoy the concessions provided by the regime.

LTC entry criteria

In order to ensure that the LTC regime concessions are only available to CHCs, the Act includes a number of changes to the eligibility criteria from the 2017-18 income year. Key changes include:

1. Counting beneficiaries of trusts

The Act has amended the definition of a "look-through counted owner" which provides the mechanism for counting owners when testing whether the entity has met the requirement of having five or fewer counted owners. In particular, where an LTC is owned by a trust, the Act broadens the way beneficiaries are counted to include not only those who receive distributions of LTC income but also any beneficiary who receives any distribution from any source from the trust (whether beneficiary or trustee income, corpus or capital) during the current or preceding three income years. While the regime provides for the aggregation of those holding LTC interests for the purposes of the counted owners test in some situations, this change could significantly expand the number of counted owners a LTC has. This of course will be particularly relevant where the LTC owning trust has other investments from which wealth is earnt and distributed to beneficiaries.

2. Corporate beneficiaries

The definition of an LTC has been amended to expressly prohibit trusts who own LTCs from making distributions to corporate beneficiaries either directly or indirectly. Importantly, current structures involving LTC-owning trusts with corporate beneficiaries are not expressly prohibited by the new rules, provided that the trust does not make further distributions to its corporate beneficiary from the 2017-18 income year.

3. Maori Authorities and Charities

Amendments have been made to effectively preclude direct ownership by charities and direct or indirect ownership by Maori authorities of LTCs subject to the certain exemptions, including:

- The amended definition of "look-through company" allows for LTCs to make charitable distributions to charities which have no influence over the LTC or shareholding trusts of the LTC. This recognises that LTCs may want to make genuine charitable gifts.

- Those Maori authorities and charities who held interests in LTCs as at 3 May 2016 (the date the Act was first introduced into Parliament) are provided with grand-parenting relief meaning they can change the level of shareholding they have in LTCs prior to this date but cannot acquire new interests in LTCs they did not have before that date.

4. Transitional rule for entities losing LTC status

A new transition rule will apply to those entities who are LTCs at the end of the 2016-17 income year but which lose LTC status as a result of the amendments to the eligibility criteria included in the Act. Broadly, these entities will be able to transition to ordinary company status without triggering any potential tax events which can otherwise arise when an entity ceases to be an LTC

A new transition rule will apply to those entities who are LTCs at the end of the 2016-17 income year but which lose LTC status as a result of the amendments to the eligibility criteria included in the Act. Broadly, these entities will be able to transition to ordinary company status without triggering any potential tax events which can otherwise arise when an entity ceases to be an LTC.

Deloitte comment

It is clear that Officials have sought to limit the scenarios in which a taxpayer will be eligible to access the concessionary treatment provided by the LTC regime. By extending the counting of beneficiaries and limiting the ability of Maori authorities and charities to hold LTC interests, Officials have tried to eliminate ownership structures which they consider provide LTC benefits to people outside of the CHC context for which the rules were designed.

Notwithstanding this, it is pleasing to see that Officials have responded positively to some of the concerns raised during the submission process regarding the eligibility changes. For example, the time period over which trust distributions are assessed for the purposes of the counted owners test was not extended to six years as proposed. In addition, a specific four year transition rule has been included, meaning that the more stringent test will only apply to income earned from the beginning of the 2017-18 income year. Likewise, the introduction of the transitional rule for LTCs that lose their eligibility as a result of the changes provides a far more practical outcome for these entities than the proposals included in the Issues Paper.

Going forward, trusts with LTC interests will need to carefully consider the impact of the new rules. In particular, where trusts either have made or intend to make distributions to beneficiaries, trustees will need to consider the impact the distribution(s) could have on the LTC's eligibility. This will be particularly relevant where a trust intends to make a distribution to a beneficiary which is a corporate entity. It may well be that the changes will result in taxpayers considering whether it is appropriate to have LTC interests held in the same trust as other income earning assets given the reduction in flexibility trusts could have in relation to distributions. Further, those establishing trusts for the purpose of holding an LTC interest should consider whether the trust deed has appropriate safe-guards to ensure any distributions are consistent with LTC regime eligibility criteria.

LTC entry tax

As proposed in the Issues Paper, the Act includes an amendment to the LTC entry tax formula. The impact of this change is that where an existing company elects to become an LTC, the retained earnings of the company immediately before becoming a LTC (the amount that would be treated as a dividend should the company have been liquidated) will be taxable to the LTC owner(s) at their marginal tax rate. In calculating their tax liability as a result of this entry tax formula, the owner will be entitled to claim any available imputation credits.

Readers may recall that under the old entry tax formula the company tax rate of 28% was applied, meaning that no further tax was payable by the LTC owners on election into the regime where historic retained earnings were fully imputed. As a result of this creating a perceived tax advantage for shareholders on a 30% or 33% marginal tax rate (and a tax disadvantage for owners on a lower marginal rate), Officials have amended the formula such that each owner must now determine whether or not they have a tax liability on entry into the regime based on their own tax profile.

Deloitte comment

While this change may address a potential tax benefit received by a shareholder(s) of an LTC in situations where their marginal tax rate is higher than 28%, shareholders of companies considering electing into the LTC regime will need to weigh up whether the change will result in them prepaying tax on distributions which they may not receive for some time, or possibly at all. While under the LTC regime shareholders are treated as owning the underlying investment, it is likely that in many instances the LTC could not practically distribute all of the retained earnings which are taxed on entry into the regime to the shareholders (for example due to working capital requirements). As such, it may be that cash tax is required to be paid by LTC shareholders on wealth which they cannot immediately access and which may otherwise not have been payable until the company ceased trading and either a dividend was declared or the company was liquidated. While this change may not adversely impact those entities with negative retained earnings such as highly geared property investment companies, it will likely mean that it is impractical for companies with existing retained earnings balances to enter into the LTC regime.

Other LTC changes

In addition to the above, there are a number of other LTC related amendments included in the Act but not discussed in detail in this article. In particular, the removal of the deduction limitation rule except in limited circumstances is a welcome change due to the complexity and limited benefit that the rule provided. Consequently, it should become easier for loss making LTCs to allocate tax losses to shareholders, including in situations where the deduction limitation rule would have previously prohibited this. Further changes have been made to limit the amount of foreign income that a foreign-controlled LTC can derive, the application of the debt remission rules in the LTC regime as well as the requirement for an LTC to have only one class of share on issue.

Tainted capital gains

One of the more welcome changes included in the Act is the narrowing of the "tainted capital gains" rule. This rule has historically applied to limit the amount of capital gain that could be distributed tax free to shareholders on liquidation of a company, in particular where a capital gain had arisen as a result of a transaction with an associated party. The policy rationale behind this rule was to prevent companies from generating and then distributing capital profits in lieu of dividends, which would have been regarded as taxable income. While acknowledging this concern, the ambit of the rule was far reaching and often resulted in companies deriving tainted capital gains from transactions which were genuine in nature and which occurred at a market value (and were not tax driven).

The new tainted gains rule

Effective from 30 March 2017 (the date the Act was enacted), the tainted capital gains rule will only apply to asset sales between companies that have at least 85% common ownership, with the original owners still retaining at least 85% interest in the asset at the time of liquidation.

In particular, a tainted capital gain will arise if:

- Company A makes a gain on the sale of property to another company (Company B); and
- At the time of the sale there is 85% common shareholding between Company A and Company B; and
- At the time Company A is liquidated the property is still either owned by Company A, Company B or another company with 85% or more common shareholding with Company A.

Helpfully, the new rule applies to all distributions made after 30 March 2017, even if the gain was made before that date. Further, to the extent that the transferred asset ceases to exist on the liquidation of Company A, any gain arising from the earlier transaction will not be tainted.

Officials have suggested that the threshold of 85% was chosen on the basis that a change of ownership to an unrelated third party of more than 15% is sufficient evidence that the transaction is genuine and involves a real transfer of the underlying assets, rather than a transfer in lieu of a dividend.

Deloitte comment

The loosening of the tainted capital gain rule is a positive change. The scope of the legislation as it previously stood was difficult to justify in many circumstances, particularly as it often resulted in genuine commercial transactions either being subject to the rule or worse yet not proceeding because of the potential tax implications only. By limiting the ambit of the rule to transactions between companies (only) and in situations where there is at least 85% common ownership, the rule now strikes a better balance between protecting the policy intent and ensuring genuine commercial transactions are not caught. It is however unfortunate that the Act does not adopt submissions suggesting CHC be allowed to distribute non-tainted capital gains to shareholders prior to liquidation.

Practically, we suggest that companies may wish to re-calculate their available capital distribution amount if they have previously considered that a non-taxable capital gain was tainted and therefore not eligible to be included. As noted above, even where the transaction giving rise to the gain occurred prior to 30 March 2017, provided the company deriving the gain has not yet been liquidated the new rule will apply to determine whether or not the gain is "tainted".

For more information on the above changes, please contact your usual Deloitte advisor.

One of the more welcome changes included in the Act is the narrowing of the "tainted capital gains" rule

Start preparing for changes to investment income

By Alex Kingston and Jenny Green

As reported in the April Tax Alert, significant changes to the tax administration of investment income are a step closer to enactment following the introduction of the Taxation (Annual Rates for 2017-18, Emplyment and Investment Income, and Remedial Matters Bill) (the Bill) that was released on 6 April 2017 – the latest development in the Government's business transformation program to modernise New Zealand's tax administration system.

Broadly, the Bill includes new rules that would result in more comprehensive and more frequent reporting of taxpayers' investment income, allowing Inland Revenue to pre-populate individual's tax returns with dividend and interest information, and to monitor and adjust social policy entitlements or tax rates during the year.

Whilst the new rules should reduce compliance costs for some investors, there will be a significant increase in the administrative and compliance burden on payers of the investment income. Questions have been raised as to whether this shift in the administrative and compliance burden from taxpayers and the Government to payers of investment income is appropriate. Nevertheless, changes are coming, so anyone who makes payments of investment income should begin preparing themselves for what is the next wave of tax reporting requirements.

Overview of rules

Investment income information

Investment income information includes:

- the customer's name, contact details, IRD number and date of birth (if held);
- the customer's tax rate / prescribed investor rate;
- the amount and type of income paid;
- the amount and date of tax withheld (if any), and any imputation or Maori authority credits attached to payments;
- for PIE funds, whether the fund the payer is invested in is a retirement savings scheme or not.

The most significant (and onerous) change is the requirement for payers of interest (on domestically issued debt), dividends and taxable Maori authority distributions to provide investment income information to Inland Revenue monthly (or annually for recipients of those payments that are exempt from RWT). Multi-rate PIEs will also have to report investors' prescribed investor rates (PIRs) every six months. These changes apply from 1 April 2020 onwards.

From 1 April 2018, the date that multi-rate PIEs (that are not superannuation funds or retirement savings schemes) must provide investment income information to Inland Revenue annually will be brought forward to 15 May from 31 May.

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Comment

These proposals represent a substantial increase in detail and frequency of reporting from the current requirements, where only summaries of total income paid and RWT, NRWT, AIL and PIE tax deducted are required monthly, with the more detailed information (i.e. for each recipient) only required at the end of the year.

For payers of dividend and interest income, in particular those payers with a large quantity of recipients (such as banks and other financial institutions), the increase in customer information detail and frequency of reporting will require both upfront costs of building changes into existing systems, and additional ongoing compliance costs associated with the review and validation of monthly reporting information. This comes at a time when a number of entities have already had to invest in systems to cope with FATCA and CRS reporting requirements.

These changes are not just limited to banks and financial institutions; Inland Revenue data shows there were over 30,000 payers of resident withholding tax in 2014, indicating that a range of types of entities will be affected by the changes.

The application date of 1 April 2020 (for the bulk of the changes) seems a reasonable timeframe to enable business systems to be adapted for these changes, however time can be eroded quickly as the parliamentary process plays out, so payers of interest income should start planning for what changes may be required for implementation.

Other measures

Joint account holders

Payers of investment income to joint accounts will be required to provide information for all account holders if they hold such information. This is welcomed as it would be extremely difficult to obtain information for all joint account holders in many circumstances. Where information is provided to Inland Revenue but joint account holders are not entitled to an even share of income, it is expected they would need to make a manual adjustment in their personal income tax return to correct their tax positions, as Inland Revenue would assume an even split of income and tax credits.

Provision of IRD numbers

In order to incentivise taxpayers to provide IRD numbers to payers of investment income, the non-declaration rate will increase from 33% to 45% for interest payments. No similar non-declaration rate has been introduced for investors in multi-rate PIEs (as was floated in the investment income discussion document). Rather, investors in multi-rate PIEs will be deemed to have exited from the fund unless an IRD number is provided within six weeks of opening their account.

Interest payers and PIEs would be encouraged to ensure IRD numbers are requested as part of on-boarding procedures to ensure no unexpected tax consequences for customers / investors.

E-filing

To enable the provision of more frequent information, investment income payers will generally be required to file investment income electronically, which is a positive shift from the current requirement to paper-file returns.

RWT-exempt status

Payers of investment income will be able to confirm if recipients have "RWT-exempt status" via an electronic register maintained by Inland Revenue (replacing the need for RWT exemption certificates). This should be a more reliable approach for confirming RWT-exempt status than the current position but may shift the responsibility from the recipient taxpayer to the investment income payer to confirm the RWT-exempt status.

Year-end withholding tax certificates

Due to the pre-population of individual tax returns with dividend and interest information, end of year RWT withholding tax certificates will only need to be provided to taxpayers who have not supplied their IRD number, so whilst there will be a reduction in the number of certificates required, there will still be a need for payers of investment income to be able to produce these.

Correcting errors

Errors in the amount of withholding tax deducted can be corrected if made and corrected in the same year. Errors of less than $2,000 or 5% of the payer's annual withholding tax liability can be corrected without the imposition of penalties or interest if discovered in following years.

Conclusion

The changes result in a major shift in the compliance burden from investors to payers of investment income. There are a number of complexities that still need to be worked through, which will be particularly important for those payers of investment income with a large amount of investors, such as banks, financial institutions and other wealth management participants.

Although the detail on what format the investment income information will need to be provided to Inland Revenue in has been relatively light, payers of investment income should start considering what changes may be needed to systems and processes so they are ready to act once the rules are finalised.

Please contact your usual Deloitte tax advisor should you have any questions.

These changes are not just limited to banks and financial institutions; Inland Revenue data shows there were over 30,000 payers of resident withholding tax in 2014, indicating that a range of types of entities will be affected by the changes

Widely held share schemes – proposed changes announced

By Jayesh Dahya and Blake Hawes

Outdated and inflexible rules governing widely held share schemes are about to get an overhaul, under changes announced in April 2017 as part of the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill (the Bill).

The Bill outlines new rules for the taxation of widely held employee share schemes (known as Inland Revenue approved exempt share schemes) that are in line with those proposed last year. Separate rules for other employee share schemes (ESS) are covered in a separate article in this edition of Tax Alert.

Benefits under the current regime

Broadly under the current regime, the concessions for widely held schemes allow:

- Employees to receive benefits from an employee share scheme tax free.
- Employers, a notional 10% interest deduction on loans made to employees to acquire shares (in addition to actual interest incurred on money borrowed), and no FBT is payable on loans provided to employees to acquire shares.

Despite these benefits, the current regime is seen as outdated and inflexible. The low limits imposed on the cost of the shares that could be purchased by an employee are seen as a barrier to employers offering these schemes given the costs to set up and administer a scheme. Further, concerns have also been raised that under the current regime, there is no limit to the discount that can be offered to employees.

What are the proposed changes?

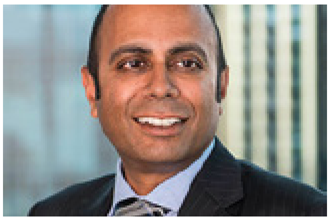
The changes retain many of the features of the current regime and are framed around two policy objectives: first, to ensure that the scheme is available to all employees (not just executives or senior management); and second, to ensure that employees can afford to participate in a scheme (not just those employees on high salaries).

A share purchase scheme will be one that:

- Has been approved by the Inland Revenue under section DC 12, which means that existing schemes should be able to continue under the proposed regime; and
- Meets the specified criteria, and has been notified to the Inland Revenue.

The table summarises the key requirements to qualify a share purchase scheme.

Purchase of shares	• The cost of the shares must not exceed their market value (but may be less). • The maximum value of shares that can be provided to an employee is **$5,000** per annum. • The maximum discount that can be offered to an employee is **$2,000** per annum.
Who is eligible to participate?	• 90% or more of full-time permanent employees must be eligible to participate in the scheme. If part-time (or seasonal) employees are also eligible to participate all part time employees (or seasonal employees) must be eligible to participate on the same basis.
Employee contributions	• If the scheme requires an employee to buy a minimum amount of shares before they can participate, the amount can be no more than $1,000 per annum.
Minimum Period of service	• Any minimum period of service required before an employee can participate cannot exceed three years for full time employees
Loan requirements	• If employees are required to pay for shares, a loan must be made available to the employee or the employee may pay for the shares in instalments. • Loans must be interest free. • Loans are to have a minimum term of 36 months and a maximum term of 60 months. • Employees will repay loans by regular equal instalments at intervals of not more than one month
Restrictive period	• Generally, shares have to be held for three years (either by the employee or by a trustee of a trust on behalf of the employee)



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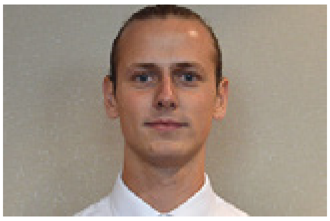

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The not so good

It comes as no surprise that no deductions will be available to employers other than for the costs associated with the administration and running of the scheme (subject to all the other limitations, e.g. capital/revenue).

This means from the date of enactment employers will no longer be entitled to claim the notional 10% interest deduction.

What is surprising is that from the date of the introduction of the Bill (6 April 2017), employers who have been claiming deductions for the cost of acquiring shares provided under an exempt scheme will no longer be able to claim a deduction for these costs. These deductions are seen as contrary to policy and were never intended. It seems that the Inland Revenue did not appreciate that employers may have been claiming these costs under general principles.

A lost opportunity?

The proposed changes provide an ability for employers to deliver up to $5,000 worth of shares at a discount of up to $2,000, potentially for no cash cost if shares are issued by an employer. However, the removal of the employer deduction has 'soured' these proposals in Inland Revenue's strive for perfect symmetry. The question we have to ask is whether we have lost an opportunity?

ESS can be used as a tool to recruit, grow and retain talent and are commonly used by multinational companies overseas.

ESS also facilitate employee engagement, inspire loyalty and provide an opportunity for employees to invest in shares. While concessional schemes may offer tax benefits, there are also other non-tax benefits.

Widely held ESS can assist employees better understand the markets and increase financial literacy, and internationally employee share acquisition schemes are a common feature of many organisations remuneration and retention strategies. Participation also encourages employees to save.

It remains to be seen whether the proposals are enough to encourage employers to set up and establish widely held ESS in the New Zealand market. ESS can be expensive to set up and administer and it is disappointing to see the Inland Revenue removing incentives for employers to offer these schemes

Have we lost an opportunity, only time will tell?

If you have any questions or comments, please contact your usual Deloitte advisor.

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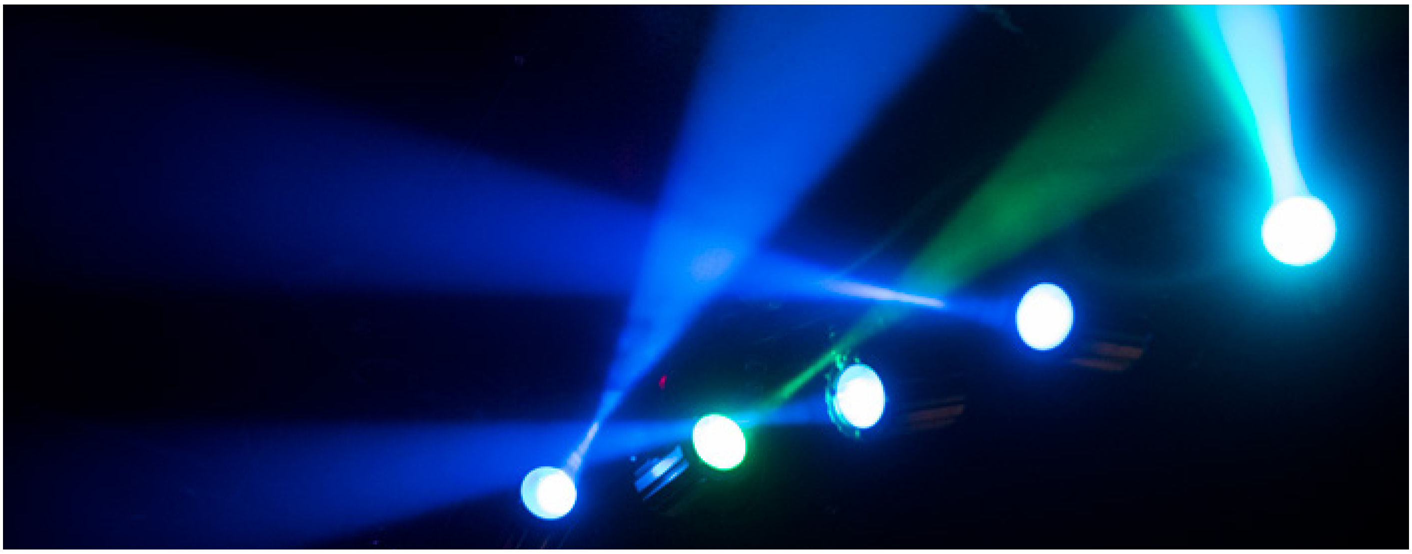


Determining the "value" of shares received by an employee under a share purchase agreement

By Jayesh Dahya and Evon Storey

Hot on the heels of the new share reporting rules, which came into force on 1 April 2017, and the recent tax bill introducing proposed changes to the taxation of employee share schemes, Inland Revenue has released a Commissioner's Statement CS17/01 providing guidance on how to determine the value of shares received under a share purchase agreement ("SPA").

With employers now required to report share benefits received by employees to Inland Revenue, questions have arisen on which methods are considered acceptable in valuing the benefit that is reported.

It is pleasing to see that if one of the methods outlined in the statement is adopted and documentation is retained to support the valuation, Inland Revenue will accept that valuation. Importantly, it is noted that "absolute accuracy is not expected in all scenarios".

Value of the Share Benefit

A share benefit arises under a SPA when shares are acquired by the employee for an amount less than market value.

The value of the benefit is the difference between the market value of the shares and the amount paid or payable on the date of acquisition.

The statement notes that the Income Tax Act does not define "value" and does not prescribe methods to determine value. The value of the shares is the "market value of the shares" being the value that the shares would be exchanged for between two non-associated third parties, on an arm's length basis.

Listed Shares

For listed shares on a recognised exchange (under YA 1), the following methods of share valuation are acceptable:

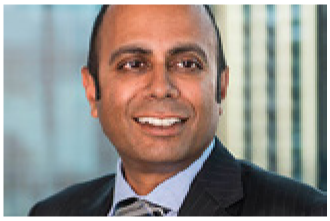
1. Volume Weighted Average Price (VWAP) which is calculated using the price of the last five trading days, inclusive of the acquisition date. The price of the share is multiplied by the number of shares traded and then this is divided by the total shares traded for the day. The VWAP calculation and listed price data needs to be retained to support the value and method; or

2. Closing price of the listed share on the acquisition date. The closing market listed price data is required to support this method; or

3. If the employee disposes of the shares on the date of acquisition on a recognised exchange, the actual proceeds of sale on that date.

For shares that are listed on an overseas recognised exchange, conversions to New Zealand dollars are to be undertaken using the close of trading spot exchange rate on the acquisition date.

For companies listed on several exchanges, conversions should be undertaken based on the listed price on the recognised exchange in the employee's country of



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residence. If this is not applicable, the listed price will be the average of all the listed prices converted to New Zealand dollars.

In all cases, documentation is required to support the method that is used.

Newly Listed Companies

Shares issued to employees as part of an Initial Public Offering ("IPO") are to be valued using the published offer price included in the retail offer documentation.

If the shares are only available to non-retail investors, the VWAP price of the investors should be used.

Unlisted Shares

For unlisted shares (not start-up company shares), the following methods of share valuation are considered acceptable by the Commissioner.

1. An arm's length value determined by a qualified valuer that conforms with generally accepted practice; or

2. A valuation based on an arm's length transaction (e.g. capital raising) undertaken in the last six months involving the issue or sale of the same class of shares. If this method is used, the company is required to retain documentation that supports the value of the shares at the time of the arm's length transaction and also a written statement from either a member of the Board of Directors, the Chief Executive Officer or the Chief Financial Officer of the company that the value reflects the market value of the shares at the acquisition date; or

3. A valuation prepared by an appropriate person within the company. To support the share value, the company should retain the following information:

a. A copy of the valuation, details of the valuation method (discounted cash flow and capitalisation of earnings methods are considered to appropriate) and all underlying workings and assumptions.

b. Evidence that the person preparing the valuation has the necessary financial skills, qualifications and experience to make this valuation

c. Written approval of the valuation from either a member of the Board of Directors, Chief Executive Officer or Chief Financial Officer of the company. Alternatively, approval from a suitably qualified valuer appointed by the Board of Directors will also be sufficient.

The Commissioner will accept a previous valuation to determine the value of a share provided under a SPA if the valuation relates to the same class of shares and is not more than six months old.

Start-up Companies

For a start-up company the valuation methods are broadly the same as an unlisted company except that a valuation based:

1. On a recent transaction (e.g. capital raise) can be used as a proxy for market value if the transaction has occurred within the last 12 months.

2. On a value determined by an appropriate person in the company will require the use of the discounted cash flow method as this is the only method considered appropriate by the Commissioner.

The Commissioner will accept a previous valuation to determine the value of a share provided under a SPA, if the valuation relates to the same class of shares and is not more than 12 months old for a start-up company. However, given the complexities associated with share valuations for venture capital funding rounds, this Statement will not apply to a company with a current or proposed (i.e. is intended to take place within six months of acquisition date of shares by employee) venture capital funding round, i.e. funding by a venture capital fund or firm (including Series A funding rounds) but not a seed funding round.

Overall it is good to see guidance from the Inland Revenue to help employers with valuing shares provided to employees under a SPA. However, one does have to question the subtle differences between start-up companies and other unlisted companies and the somewhat vague definition of a start-up. An unlisted company (not a start-up) can only use a previous valuation to determine the value of a share acquired under a SPA if it is within six months of acquisition whereas a start-up company can use a valuation that is up to twelve months old. Why not just allow twelve months for all unlisted companies? The distinction seems to be arbitrary, particularly when the values of a start-up company are likely to change far more rapidly than the value of more established companies.

If you have any questions or comments, please contact your usual Deloitte advisor.

The new related party debt remission rules

By Iain Bradley and Veronica Harley

Forgiving debt between related parties has very much been a regular topic in our Tax Alert over the past three years. It's great to finally be able to report that the issue has been brought to a conclusion with the enactment of The Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017 on 30 March 2017. We know a lot of readers have been awaiting the final version of these rules in order to tidy up intercompany loans once and for all. In fact in some cases action may be required sooner than later because of an amendment that takes effect from 1 July 2017.

Background

The whole debt remission issue was triggered back in 2014, when Inland Revenue released a draft Question We've Been Asked which considered a particular debt capitalisation arrangement which involved a shareholder subscribing for shares in company as partial repayment of a loan. The Commissioner concluded that capitalising the debt was potentially tax avoidance as it avoided tax that would otherwise be payable (because income would have arisen under the financial arrangement rules if the debt had been forgiven).

Historically, group companies were in fact often resorting to capitalising the debt instead of forgiving it because of the outcome under the financial arrangement rules. If the debt was instead forgiven, the financial arrangement rules resulted in an asymmetrical outcome because under the base price adjustment mechanism, debt remission income arose for the borrower, while the related-party lender was denied a deduction for the principal amount under the bad debt write-off rules (the interest may have been accrued and returned as income but a subsequent write off was allowed as a bad debt deduction). Officials accepted that the debt remission income arising and the asymmetrical outcome in the context of a wholly-owned group of companies was not appropriate and set about determining what the correct policy outcome should be in this context. An issues paper and various versions of draft legislation have since followed in order to find a workable solution.

As a result, the financial arrangement rules have been amended to ensure that debt remission income does not arise in the context of an "economic group". The first thing to note is that the rule has been backdated to apply from the 2007 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 prior year, then that position will stand and the taxpayer will not be able to reopen the return to apply this new rule.

The core rule

New section EW 46C has been inserted into the Income Tax Act 2007 and operates in the context of an economic group (as defined) to determine what "consideration" has been paid or received when performing the base price adjustment when debt has been forgiven. Broadly a debtor is treated as having "paid" the amount of debt on the date on which the creditor forgives it and the creditor is treated is having "been paid" the amount of debt on the date the creditor forgives it. This means that the result of the BPA should be nil.

It should be noted that for this rule to apply, debt must be "forgiven". This requires overt action on the part of the lender.

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Broadly the new section operates for the following scenarios:

a. Where the creditor is a member of the same wholly-owned group of companies as the debtor and the debtor is a New Zealand resident company:

b. 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 (the NZ group) hold, before section YC 4 (Look-through rule for corporate shareholders) is applied to the NZ group in relation to their interests,—

   – common voting interests that add up to 100%; and

   – if a market value circumstance exists for a company that is part of a group of companies to which the debtor belongs, common market value interests that add up to 100%:

c. If the debtor is a company, where the creditor is not a member of the same wholly-owned group of companies as the debtor and the creditor has ownership interests or, as applicable, market value interests in the debtor:

d. If the debtor is a partnership, where the creditor has a partner's interest in the income of the debtor:

e. If the debtor is a look-through company, where the creditor has an effective look-through interest in the debtor.

Note that the relief provision does 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.

It should be noted that for the scenarios above (c) to (e) (i.e. other than in the context of a wholly owned group), the debtor is treated as having paid the amount of debt on the date on which the creditor forgives it only if the "proportional debt ratio" for the amount equals the "proportional ownership ratio".

The "proportional debt ratio" is defined to mean the percentage that the creditor's amount bears to the total amounts of debt to which section EW 46C applies at the time the creditor's debt is forgiven. The "proportional ownership ratio" is defined to mean the percentage of ownership interests, or as applicable market value interests, total partner's interests or total effective look-through interests for the debtor, ignoring nominal shares. Essentially this mechanism is seeking to ensure that debt remission is made in proportion to ownership so that the debt remission will not cause a dilution of ownership.

In a related change, applying from 1 July 2017, the ability of the creditor to claim a bad debt deduction for interest accrued but not received is being turned off in certain situations. A creditor will only be able to claim a bad debt deduction for interest income previously returned which will not be received where the creditor is either:

- Not associated with the debtor, or
- Is associated with the debtor but the debtor has no deductions for the financial arrangement.

The deemed payment of interest accrued

With effect from 1 July 2017, a further change will take effect in that "debt" forgiven under this new rule will be deemed to include amounts accrued, but unpaid at the time of forgiveness (i.e. interest). Thus when performing the base price adjustment, consideration paid to the creditor will also include accrued interest.

The sting in the tail is that Officials consider that section CG 3 (re repayment of bad debts) would then apply to deem income to arise to the extent the creditor has previously been allowed a bad debt deduction for the interest. This means that a creditor may be subject to tax on accrued interest income that will never be physically received.

Readers will note a delayed implementation date of 1 July 2017 for this particular change. Officials have intentionally given taxpayers a little time to tidy up loans of this sort by either repaying or forgiving them to avoid the lender being treated as having been "paid" the accrued interest.

Conclusion

Whether debt capitalisation is now back on the table as an option to tidy up group loans remains to be seen. There may be some instances where debt capitalisation may still be preferable to forgiving the debt. It is hopeful that Inland Revenue will clarify how QB 15/01 (Income tax: tax avoidance and debt capitalisation) applies post the introduction of these rules, if at all. The argument being that if no debt remission income arises under the new rules, capitalising debt instead of forgiving it cannot be seen to be tax avoidance, although the statement may still be relevant for situations that are not covered by the scope of the new debt remission rules.

What is clear, is that it is important for taxpayers to take advice now with a view to tidying up group loans, particularly before 1 July 2017. For more information, please contact your usual Deloitte tax advisor.

Tax-free capital gain, or taxable land sale?

By Ian Fay and Fraser Chapman

Did you know the sale of your main home may be subject to tax?

Taxpayers who have bought and sold their personal residence a number of times should be aware that their activity has the potential to be subject to the land sale provisions. This will be the case regardless of whether they had an intention to make a profit. Inland Revenue commentary released late last year will help taxpayers understand if that activity will be caught within the rules.

As part of Inland Revenue's continued compliance focus on land transactions, QB 16/07: Income tax land sale rules – main home and residential exclusions (QB 16/07) was released late last year. This commentary will help taxpayers to decide if they are able to rely on the "main home" exemption from the bright line rule, or the residual exemption from the general land transaction provisions.

Where a taxpayer is caught by the bright line rule, if the relevant property is their main home they will generally not be taxed on the capital gain. Similarly, if a taxpayer is caught by the general land transaction provisions, they will generally not be taxed on any gain if the relevant property is their personal residence. However, taxpayers need to be aware that if they have established a "regular pattern" of land transactions, they will be unable to rely on these exclusions.

QB 16/07: Income tax land sale rules – main home and residential exclusions

Legislation does not define "regular pattern" for the purposes of the land transaction rules. Given this, it can be difficult for a taxpayer to understand when their activity will mean that they will no longer be able to rely on the main home or residential exemption.

Taxpayers who have bought and sold their personal residence a number of times should be aware that their activity has the potential to be subject to the land sale provisions

QB 16/07 provides further detail on what the Commissioner considers to be relevant when assessing if a "regular pattern" arises. The commentary also lists useful examples that illustrate when a pattern of transactions will become regular. This provides taxpayers with a useful benchmark to assess their activity.

While there is no hard and fast rule on the number of transactions that will amount to a "regular pattern", it is accepted by Inland Revenue that generally at least three prior transactions will be required.

Establishing a pattern

In order for a pattern to emerge from a taxpayer's activity, there must be similarity or likeness between the transactions. The relevant factors to consider when assessing this similarity include:

- the type and location of each of the sections of land;
- the type of dwelling houses;
- the method of erection;
- the use to which the dwelling houses were put; and
- any other relevant characteristics of the transactions.

It is important to remember that the reason or purpose for each transaction should be disregarded when looking at these factors. It will be irrelevant that a taxpayer is forced to sell their personal residence a number of times because of events that are outside their control. In these instances, it is plausible that taxpayers may not give the land sales provisions a second thought as the potential to make a capital gain played no part in the decision to sell the property.

There is no set number of transactions that are required for a pattern to occur. However, the greater the number of similar transactions, the more likely there is a pattern.

Taxpayers should be aware that Inland Revenue has recently placed an increased compliance focus on land transactions. In this regard, Inland Revenue's property compliance budget has increased to $62 million for the 2015 -2020 period. In addition, increased information sharing between LINZ and Inland Revenue will assist Inland Revenue to identify those taxpayers engaging in regular land transactions.

The 'land transfer tax statement' prepared alongside the registration of a land transfer asks specific questions around seller identity and the nature of the property being sold. It is now easier for Inland Revenue to identify when a pattern begins to arise and we expect to see increased audit activity in this area.

Establishing Regularity

For a pattern of transactions to be regular they must occur at consistent intervals. The factors that help to establish regularity include both the number of similar transactions and the intervals of time between them.

Inland Revenue has provided a useful benchmark for taxpayers by indicating that generally at least three prior transactions would be needed for there to be a regular pattern. Taxpayers should bear in mind that this is only a guideline as there may be some instances where two prior transactions are enough to establish regularity. Again, this assessment is one of "fact and degree".

What land transactions are relevant?

The pattern for consideration must relate to the taxpayer's "main home" or personal residence.

This clarifies the position for those taxpayers who are engaging in land transactions that do not involve their own residential property. For example, if a taxpayer has a pattern of speculative buying and selling of land they do not live on or do so as part of their business, these transactions are taxed under a different rule.

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When deciding if the main home exemption from the 2 year bright-line rule is able to be used, taxpayers should remember that the regular pattern of land transactions is not the only hurdle. If the main home exemption has been used twice in the last two years, it is unable to be used again. Therefore, this should be considered before under-going an analysis of whether a "regular pattern" has been established.

Example of a regular pattern

Given the fact that there is no hard and fast rule, taxpayers should refer to the various examples set out in QB 16/07. These provide insight into how Inland Revenue would apply the test in practice. The example below is a direct extract from QB 16/07.

Melody and David are keen house renovators and have purchased a number of properties to improve and sell at a profit. These purchases and sales are shown in the following table:

Property	Date acquired	Land/activity	Date sold
1 (N Road)	June 2006	Cottage in inner-city Wellington suburb purchased. Renovations undertaken over the period of ownership, while Melody and David lived in the house.	May 2008
2 (P Street)	May 2008	Bungalow in Wellington suburb purchased. Renovations and landscaping undertaken over the period of ownership, while Melody and David lived in the house.	July 2010
3 (E Place)	July 2010	House in Wellington suburb purchased. Off-street parking built during the period of ownership, while Melody and David lived in the house.	February 2011
4 (J Avenue)	January 2011	Larger family home in Wellington suburb purchased, as Melody and David had started a family. Some minor redecorating undertaken during the period of ownership, while Melody and David lived in the house.	March 2013

Melody and David purchased the properties for a purpose and with an intention of selling them after they had completed some improvements. Their aim was to renovate the properties while they lived in them and sell them at a profit, enabling them to move up the property ladder. As such, the proceeds from the sales may be subject to tax under s CB 6 – the purpose or intention provision. This depends on whether Melody and David can rely on the residential exclusion in s CB 16.

Melody and David acquired the properties with houses on them, and it is assumed that they occupied the houses mainly as their residences. It is also assumed that the area of each property was 4,500 square metres or less. Therefore, the only issue is whether Melody and David are precluded from using the residential exclusion, which they will be if they have engaged in a regular pattern of acquiring and disposing of houses that they occupied mainly as residences.

When the first three properties (N Road, P Street and E Place) were sold, Melody and David did not yet have a regular pattern of acquiring and disposing of houses. A regular pattern has to exist independently of the transaction being considered. By the time E Place was sold, there had only been two prior acquisitions and sales. The Commissioner accepts that generally at least three transactions would be needed for there to be a regular pattern.

By the time the J Avenue property was sold, Melody and David had previously acquired and disposed of three houses that they had lived in. The question is whether those three transactions amount to a regular pattern of acquiring and disposing of houses that were occupied by the couple mainly as residences. If they do amount to such a regular pattern, Melody and David will not be able to rely on the residential exclusion for the sale of the J Avenue property.

For there to be a pattern, there has to be a similarity or likeness between the transactions. In this case, there is. The N Road, P Street and E Place properties were all residential properties in Wellington acquired, occupied, renovated and sold by Melody and David. It does not matter that the nature of the renovations done to each property was different. The pattern only needs to involve acquiring and disposing of houses that have been occupied mainly as residences.

For a pattern of acquisition and disposal to be regular, the transactions need to occur at sufficiently uniform or consistent intervals. In this case, the properties were held for 1 year 11 months, 2 years 2 months, and 7 months, respectively. Three properties were acquired and disposed of in a period of 4 years 8 months. The Commissioner considers that the intervals between the transactions are consistent enough for this to be a regular pattern. The intervals between the transactions do not need to be identical.

Because Melody and David have engaged in a regular pattern of acquiring and disposing of houses that they occupied mainly as residences, they cannot use the residential exclusion in s CB 16. Therefore, the proceeds from the sale of the J Avenue property will be income to Melody and David under s CB 6. Melody and David can deduct the costs of the property and the redecorating, to the extent that those costs are not private in nature.

Conclusion

The ability of taxpayer to rely on the 'main home' and residential exemption does not solely rely on whether the taxpayer has occupied the relevant property. Careful consideration of the rules is required when a pattern of transactions begins to emerge.

For more information on the application of these rules please contact your usual Deloitte advisor.

Taxpayers should be aware that Inland Revenue has recently placed an increased compliance focus on land transactions. In this regard, Inland Revenue's property compliance budget has increased to $62 million for the 2015 -2020 period

A snapshot of recent developments

2017 Deloitte Asia Pacific Tax Complexity Survey

The 2017 Deloitte Asia Pacific Tax Complexity Survey (Survey) has been published. The Survey received over 330 responses from tax and finance executives across the region. The Survey showed that predictability about the future development of tax law is the most important factor for businesses deciding to enter or exit a market within the region. With the recent political developments in the US and across Europe, businesses will adopt a generally conservative approach in their tax management strategies, and will devote more time and resources to managing their tax liabilities in complex tax jurisdictions like China and India in the coming years. In contrast to China and India, respondents to the Survey considered New Zealand to have one of the most stable and predictable tax systems across the Asia Pacific region.

IS 17/04: Income tax – computer software acquired for use in a taxpayer's business

Inland Revenue has finalised IS 17/04, which considers the income tax treatment of software acquired for use in a taxpayer's business. The statement outlines the income tax implications for software purchases, periodic payments for the right to use or access software, software developed in-house, commissioned software and the lease of software under a finance lease.

IS 17/03: Goods and services tax – single supply or multiple supplies

On 11 April 2017, Inland Revenue finalised interpretation statement IS 17/03: Goods and services tax – single supply or multiple supplies. IS 17/03 explains how to determine whether the different elements contained in a transaction should be treated as a single composite supply or multiple separate supplies. To assist with this determination, the statement suggests considering the true and substantial nature of what is supplied to the recipient, the relationship between the supplied elements and whether it is reasonable to sever the elements into separate supplies.

Draft guidance on key-person insurance released

On 13 April 2017, Inland Revenue released a draft QWBA, entitled Income Tax: Insurance – key-person insurance policies. The draft QWBA considers what a key-person insurance policy is and the income tax treatment of key-person insurance policies. It concludes that proceeds and premiums in relation to the insurance policy should be taxable and deductible respectively to the extent the insurance is based on estimated loss of business profits. Alternatively, proceeds and premiums should not be taxable and deductible respectively where the insurance policy relates to the replacement of capital. Finally, the draft QWBA notes that amounts may need to be apportioned where the insurance policy is for a mixture of loss of business profits and replacement of capital.

The deadline for comment is 23 May 2017.

Draft QWBA on RWT and NRWT on non-cash dividends

On 10 April 2017, Inland Revenue released a draft QWBA, entitled Resident and non-resident withholding taxes: Non-cash dividends. The draft QWBA considers whether the income of a person receiving a non-cash dividend includes withholding taxes. It concludes the amount of income in this situation would include the non-cash dividend as well as any withholding taxes paid in relation to the dividend.

The deadline for comment is 23 May 2017.

Special Reports released following the CHC Bill's enactment

After the enactment of Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017, Inland Revenue released two Special Reports. The first special report considers NRWT and AIL changes and provides early information and worked examples on the changes to the taxation of interest payments for non-residents. The second special report considers a number of significant changes to the taxation of closely-held companies.

Tax response to the April Flood Events

On 19 April 2017, the Tax Administration (April Flood Events) Order 2017 (LI 2017/66) came into force. The Order allows Inland Revenue to waive all use of money interest payments on late tax payments for taxpayers who have been affected by the floods in Edgecumbe and the Bay of Plenty. Inland Revenue will allow taxpayers to make late deposits from the 2016 income year and to apply for early refunds on income equalisation, which will allow farmers and fishers to average their taxable income over several years more easily in light of the recent April Flood Events.

QWBA on the period for which a private or product ruling applies now finalised

On 21 April 2017, Inland Revenue finalised QB 17/03, which considers the period for which a private or product ruling applies. QB 17/03 concludes that the Commissioner has discretion to decide on the period for which a private or product ruling applies. Despite this, Inland Revenue note that the period will generally be three years from the date of issue of the final ruling or five years where a ruling is re-issued.

Two Draft General Determinations released

Inland Revenue has recently released two draft depreciation determinations on campervans/motorhomes and "rapid DC car charging stations". The deadlines for comment are 19 May and 10 June 2017 respectively.

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