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Tax Alert

November 2017

When does new building fit-out make the building sale taxable?

By Emma Marr and Brendan Ng

Building owners who undertake a re-fit of the interior of a building might be surprised to find that, in some circumstances, the whole profit made on selling the building is taxable, not just any depreciation recovered on the fit-out. A building owner who is in the business of erecting buildings, or associated with anyone who is, should make sure they are aware of Inland Revenue's draft QWBA PUB00286: *Can a fit-out of an existing building be "improvements" for the purposes of s CB 11?* ("draft QWBA", available here).

The short answer to the question posed by the draft QWBA is yes: if a person who fits out an existing building is in the business of erecting buildings (or is associated with such a person), and later sells that building within 10 years of completing

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the fit-out, they may be required to pay tax on the net proceeds of the sale.

In our view the QWBA could have been more clearly drafted to emphasise that only fit-out which becomes a fixture because it is actually permanently attached to the building would qualify as an improvement. It may also have been helpful if the draft QWBA had discussed how section CB 11 sits alongside the depreciation regime. Many items of building fit-out will be depreciable, and any recovery of depreciation deductions on sale would be taxable. Presumably, Inland Revenue does not expect the proceeds of a building sale to be taxed twice, as both depreciation recovery and an improvement to land under section CB 11.

Section CB 11 of the Income Tax Act 2007 taxes the profit made on the sale of land (which includes buildings) when the land is sold within 10 years of the owner making improvements to the land, if the owner is in the business of constructing buildings, or is associated with someone who is. If someone falls under section CB 11, the main question to consider is whether the fit-out constitutes the level of "improvements" required under that section. That is to say, the improvements must be:

- Improvements to land;
- That are not minor; and
- Are made by a person erecting a building or otherwise.

These factors are commented on further below.

Improvements to land made by a person erecting a building or otherwise

There can be many improvements made to land that would trigger section CB 11, however this draft QWBA focusses specifically on building fit-outs. As an aside, not all taxpayers would necessarily realise that land includes buildings – for legal purposes, land includes anything attached to the land, such as a building. Therefore, building fit-out can be considered an improvement to land depending on its nature.

The draft QWBA does note that fit-out which is not permanently attached to a building would not trigger section CB 11. However this point is not overtly included in the commentary and is only drawn out by way of example. As it stands, building owners who are in the business of constructing buildings and who therefore fall under section CB 11 should evaluate and consider any fit-out work being undertaken, especially where the work involves fit-out that toes the line of being a fixture, as this may be captured by the rules.

Note that improvements may also involve the removal of something previously attached to land (such as the removal of something unsafe to enhance the value of the land), not just additions.

Improvements are not minor

The improvements to land will only be improvements so long as they are "not minor". This will involve an assessment of the particular circumstances which will include consideration of the following four factors:

- The importance of the improvements in relation to the physical nature and character of the land;
- The total cost of the improvements done, in both absolute and relative terms;
- The nature of the professional services required; and
- The nature of the work required for the improvements (if any).

These factors are discussed in detail in [Interpretation Guideline IG0010 "Work of a Minor nature"]().

Taxpayers should be aware that section CB 11 applies whether or not the building in question is part of the building owner's business of erecting buildings. For example, the person might also hold an investment property. Generally section CB 11 has a relatively narrow application and in many cases an exemption for the sale of business premises may apply. However, section CB 11 applies to a sale within 10 years of the building fit-out, and given many commercial leases fall within the range of 6-12 years and fit-outs generally occur with new leases (which usually involve some element of fixtures), the draft QWBA could apply reasonably often, depending on where in the lease cycle the property is disposed of.

Comments on the draft QWBA are due on **17 November 2017**. If you would like to make a submission or would like more information on the draft QWBA, please contact your Deloitte advisor.

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Tax policies of the coalition government

By Robyn Walker

Traditionally the election period is a quiet period from a tax perspective. A period of brief respite from tax policy proposals, announcements, consultation and new legislation. It is clear that the holiday will soon be over, with the new Labour-NZ First Government being sworn in last week.

Tax featured heavily in the 2017 election campaign and, as such, we are also likely to see tax being a focus for the new government. Not only to make its mark on the tax landscape, but also to ensure that the revenue coming into the Inland Revenue is sufficient to pay for new spending promises.

There will be a number of priorities for the new government, however the 100 day plan specifically includes establishing the Tax Working Group. Other 100 day plan actions such as the introduction of a new families package, changes to student loans and changing minimum wages will also require tax intervention as these changes all touch the social policy systems administered by Inland Revenue. The new Minister of Revenue Stuart Nash will be in for a busy time.

In addition to the 100 day plan, there will be a bunch of "Business as usual" activities that will require proper attention. Inland Revenue is part-way through a major transformation which will require detailed oversight, as well as legislative reform. In addition, the last National-led Government proposed comprehensive changes to address Base Erosion and Profit Shifting (BEPS) concerns, with new rules intended to apply from 1 July 2018. The expected revenue from these measures has already been banked in forecasts and therefore we are unlikely to see any slowdown in these reforms. In order to have legislation enacted in time for a 1 July 2018 start date, we would ordinarily expect legislation to have been introduced into parliament by mid-2017, so it will be imperative for the new government to make its decisions and get legislation into Parliament as soon as possible.

The previous government was also in the process of implementing a number of tax changes, including changing employee share scheme rules and implementing a number of measures needed for Inland Revenue's Business Transformation project (see our April 2017 Tax Alert for more details on this). The contents of this Tax Bill will need to be evaluated and a decision made as to whether to reinstate and progress the Bill in its current form.

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The Labour Party included the following items in its election tax policy which we would expect to see progressed over the next parliamentary term:

- Reverse National's proposed tax cuts and re-invest that money in a fairer package of support for families and in core public services such as health, education, housing and police
- Crack down on housing speculation by extending the bright line test to five years. This taxes the sale of properties other than the family home
- Create a level playing field for families to buy their first home by removing a tax loophole that speculators use to avoid paying tax – as recommended by both the IMF and the Reserve Bank
- Set up a Tax Working Group, to ensure that there is a better and fairer balance between the taxation of income and assets, in particular the capital gain associated with property speculation. The outcomes of this Working Group – if any – will not take effect until the 2021 tax year
- Introduce tax incentives to encourage research and development
- Eliminate Secondary Tax as part of IRD's Business Transformation Programme
- Take strong action to ensure that multi-national companies pay their fair share of tax, including consulting on the introduction of a Diverted Profits Tax.

Tax Working Group

There is nothing like a good review of the tax system to get tax advisors excited to get out of bed each day, and 2018 seems likely to keep the tax community inundated with plenty of reading material. While we may have to wait another 100 days for the finer details, here is some of what we already know about the Tax Working Group:

- The terms of reference will be to consider possible options for further improvement in the structure, fairness and balance of the tax system.
- The Working Group will have a primary focus on measures that will address the imbalance in taxation on gains from speculation in property and income from other sources.
- The Working Group will consider options that are forward looking, not retrospective.
- Increases in personal income or corporate taxes or GST rates will not be considered, nor will any inheritance taxes or other changes that could apply to the family home.
- The Working Group will be comprised of tax experts, academics, economists and those with knowledge of the impact of the tax system on individuals, communities and businesses. Members will be appointed by Cabinet and will be supported by recommendations by Treasury, MBIE, the Reserve Bank and Inland Revenue.

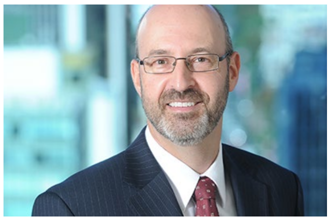
It is expected that the Working Group will be established before Christmas and convene in the New Year. The Working Group will be working during 2018 with an aim of reporting to the government in early 2019. Further consultation would then occur on recommendations being pursued, and parliamentary processes undertaken to have legislation in place before the next election in 2020.

It is an ambitious project to get completed within three years. Let's do this.

Tax featured heavily in the 2017 election campaign and, as such, we are also likely to see tax being a focus for the new government

Dealing with uncertain tax positions in your financial statements

By Iain Bradley and Belinda Spreeuwenberg



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The External Reporting Board has issued a new interpretation NZ IFRIC 23 *Uncertainty over Income Tax Treatments* to clarify how to reflect uncertainties relating to income taxes in financial statements. This occurs when there is uncertainty over whether the relevant tax authority will accept a tax treatment under tax law.

NZ IFRIC 23 applies to for-profit entities that report under Tier 1 or Tier 2 and will take effect from annual reporting periods beginning on or after 1 January 2019, with early adoption permitted.

The interpretation is limited to income taxes and addresses how to recognise and measure current or deferred tax assets or liabilities in accordance with NZ IAS 12 *Income Taxes* where there is uncertainty over income tax treatments.

The interpretation provides that:

1. An entity is required to use judgement to determine whether it should consider each uncertain tax treatment independently or together.

2. An entity should assume that the tax authority will examine amounts it has a right to examine and will have full knowledge of all related information when considering uncertain tax treatments.

3. If the entity concludes that it is not probable that a tax authority will accept an uncertain tax treatment, an entity must reflect the effect of the uncertainty in their financial statements using the most likely amount or the expected value of the uncertain tax treatment when determining the taxable profit or loss, tax bases, unused tax losses, unused tax credits and tax rates. Where the uncertain tax

treatment affects both current tax and deferred tax, consistent judgement and estimates are necessary.

4. Where there is a change in facts and circumstances on which an earlier judgement or estimate of an uncertain tax treatment is based, the change should be reflected as a change in accounting estimate applying NZ IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Examples include changes that can arise upon release of an Inland Revenue ruling or interpretation statement, judgement from a court, knowledge of a similar tax treatment used by the entity or another entity that the tax authority has agreed or disagreed with, and the expiry of a tax authority's right to examine or re-examine a tax treatment.

Implications of uncertain tax treatments

Where an entity concludes it is probable that a tax authority will accept an uncertain tax treatment, the recognition and measurement of current tax and deferred tax assets or liabilities should be consistent with the tax treatment the entity has used or plans to use in tax return filings.

If an entity concludes it is not probable that the tax authority will accept an uncertain tax treatment, it should reflect the effect of uncertain tax treatments using either of the following methods:

a. The most likely amount. This is the single most likely amount in a range of possible outcomes and is a better predictor of the uncertainty where the outcome could be binary or concentrated on one outcome.

b. The expected value. This is the sum of the probability-weighted amounts in a range of possible outcomes.

To illustrate the expected value method of determining the taxable income, consider a New Zealand company (NZ Co) that has taken tax deductions relating to transfer pricing. The entity has concluded that it is not probable that Inland Revenue will accept the tax treatment and that the possible outcomes are illustrated in the table above.

	Estimated additional taxable income	Probability	Estimate of expected value
Outcome One	$0	40%	$0
Outcome Two	$100	50%	$50
Outcome Three	$150	10%	$15
			$65

While outcome two is the most likely outcome, NZ Co determines that the uncertainty of the tax treatment is not concentrated on one outcome. NZ Co would therefore use the expected value of $65, and accordingly recognise and measure their current tax liability based on this value. The estimate would be updated in each subsequent period until the uncertainty is resolved.

If an entity applies NZ IAS 12 to account for interest and penalties on income tax, the interest and penalties will fall within the scope of the interpretation.

NZ IFRIC 23 does not introduce new disclosure requirements. Instead the interpretation highlights disclosures that should be considered under other existing accounting standards. For example, an entity considers whether it needs to disclose judgements made and information about the assumptions and estimates in accordance with NZ IAS 1 *Presentation of Financial Statements*.

Specific guidance has been included in the interpretation on the transition to applying the interpretation. As retrospective application of the new interpretation may be difficult without the use of hindsight, there are two transition approaches allowed. An entity can either re-state the comparatives if possible to do so without the use of hindsight, or adjust the cumulative effect of initially applying the interpretation in opening equity.

Entities may find that an ongoing obligation to consider court decisions, Inland Revenue positions, or other changes to facts and circumstances that may create uncertainty over tax treatment under tax law, for tax positions taken in prior years, is an onerous burden. While there is some time before NZ IFRIC 23 takes effect, it may be worthwhile to start recording material tax positions and monitoring any development that may create an uncertain tax treatment, so that entities are ready to comply with the interpretation from 1 January 2019.

Where an entity concludes it is probable that a tax authority will accept an uncertain tax treatment, the recognition and measurement of current tax and deferred tax assets or liabilities should be consistent with the tax treatment the entity has used or plans to use in tax return filings

A snapshot of recent developments

Business Transformation receives praise at the OECD Forum on Tax Administration

Inland Revenue's Business Transformation program has been mentioned in the OECD's Tax Administration 2017 report released at a recent OECD Forum on Tax Administration (FTA) in Oslo, Norway. To read more see IRD a global leader in shift to digital unobtrusive tax administration by NBR or see full OECD report here.

Donee organisations – meaning of wholly or mainly applying funds to specified purposes within New Zealand

Inland Revenue has released a draft Interpretation Statement (PUB00295) on the meaning of the "wholly or mainly" test in section LD 3(2)(a) of the Income Tax Act 2007. If an organisation "wholly or mainly" applies their funds to charitable, benevolent, philanthropic or cultural purposes within New Zealand, they will be classified as a donee organisation for income tax purposes and can obtain a tax credit or deduction for the gift (dependent on the type of taxpayer making the gift).

Before this draft statement, the Commissioner considered that a bare majority of 50% or more of funds applied to charitable, benevolent, philanthropic or cultural purposes within New Zealand was sufficient to meet the "wholly or mainly" test. The draft statement proposes, with effect from the year ended 31 March 2019, that *the minimum threshold be increased to "75% or more*". It will also be necessary for organisations to monitor their compliance with the threshold at least annually and the draft statement briefly outlines two monitoring methods to work out how to apply the 75% minimum threshold.

The draft interpretation statement also confirms Inland Revenue's view that applying funds to specified purposes within New Zealand does not limit an organisation to spending funds within New Zealand.

The deadline for comment is 30 November 2017.

Six-monthly GST return filing

Inland Revenue has released a statement (SPS 17/02) setting out how the Commissioner will exercise her discretion to allow GST-registered persons to become, or remain, six-monthly return filers for GST purposes when the taxable supplies threshold ($500,000 in a 12-month period) has been breached. A person with taxable supplies greater than $500,000 in a 12-month period may apply for six-monthly filing where they:

- Make seasonal supplies – that is, 80% or more of their taxable supplies within an income year within a six-month period that ends at any day within the last month of the person's income year; and
- have not had a six-month filing frequency under the seasonal criterion in the 24-month period before the application.

A person will not have to cease using 6-monthly filing if the breach of the taxable supplies threshold is a one-off.

Group insurance policy taken out by employer for the benefit of an employee

On 18 October 2017, Inland Revenue released a draft QWBA for public consultation (PUB00293). This item considers the income tax treatment of group insurance policies taken out by an employer for the benefit of its employees. The draft item replaces two out-of-date *Public Information Bulletin* items: "Staff insurance schemes" PIB No 70 (December 1972) and "Life and accident insurance policies" (PIB No 106 July 1980).

The draft item concludes that the employer will generally be entitled to a deduction for the premiums paid because in most cases the payment of a premium for a group insurance policy that is paid in connection with employment will constitute a business expense, just like salary or wages. The payment of a premium by an employer will be a fringe benefit, and any amounts paid out under the group insurance policy will not be income of the employer. Whether a payment made to employees is income or not will also depend on whether the payment is intended to compensate an insured person for lost income.

The deadline for comment is 29 November 2017.

Draft public rulings on Australian limited partnership and foreign tax credits

On 27 September 2017, Inland Revenue released several draft public rulings in relation to Australian limited partnerships for consultation, which are reissues of BR Pub 14/01 to 14/05. The rulings will apply from the beginning of the first day of the 2017-18 income year, i.e. the date of expiry of the previous rulings. We note that the draft rulings do not substantially differ from the existing rulings.

These draft rulings concern the ability of a NZ resident partner of an Australian limited partnership to claim foreign tax credits for Australian income tax and dividend withholding tax paid by an Australian limited partnership (i.e., a partnership that is treated as a company for Australian tax law purposes, but in NZ retains its partnership status and flow-through tax treatment).

The deadline for comment on this item is 8 November 2017.

Tax and Corporate Australia

The Australian Taxation Office has published Tax and Corporate Australia, which analyses the income tax compliance of large corporate groups (i.e. the top 1,400 corporates with sales over AUD250million). The ATO estimates that the tax gap (the difference between the tax payable according to law and the tax actually collected) for this taxpayer group was approximately $2.5 billion / 5.8% for the 2014-15 income year. However, the ATO notes that there is a "strong compliance culture" in the large corporate taxpayer group and acknowledges that tax affairs and transactions for large businesses are complex, and there can be reasonable differences of opinion.

IR webpage updated for GST: Zero-rating of supplies

Inland Revenue has updated its webpage on zero-rated supplies. The webpage includes a comprehensive list and examples of taxable supplies which are taxed at the rate of 0%, including: duty free goods, exported goods, certain exported services, services performed outside New Zealand, exported vessels, certain financial services, goods not in New Zealand at the time of supply or delivery to the final recipient, internet sales, sales of going concerns, land transactions, and temporary imports. Inland Revenue also clarifies that goods that were to be exported but are destroyed owing to circumstances outside the control of both the supplier and the recipient are still zero-rated.

Special determination S56: Treatment of prepayments for services using IFRS

This determination applies to prepayments received by a limited partnership from customers under customer contracts and to prepayments made by the limited partnership to subsidiaries under supporting contracts on back-to-back loans. Specifically, this determination relates to the value of the consideration for one of the customer contracts and its supporting contracts and the spreading of any interest income or expenditure under the financial arrangement rules.

Depreciation Rates for potato cool stores finalised

The Commissioner of Inland Revenue has finalised the depreciation rates to apply for potato cool stores (General Determination DEP 102). Potato cool stores are specialist buildings that control humidity and temperature so that potatoes can be stored for long periods without spoilage occurring. Potato cool stores (excluding climate control plant) have an estimated useful life of 33.3 years, and are to be depreciated at the diminishing value rate of 4.5% and the straight-line rate of 3%.

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