Connecting you to the topical tax issues

Tax Alert

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Taxing your Airbnb and family bach

Andrea Scatchard and Emma Faulknor

Many people will have enjoyed a sausage around the BBQ this summer at an Airbnb or family bach and recent tax announcements may have been a hot topic of discussion.

For people with a spare bedroom or empty bach, providing short term accommodation has never been simpler. Hosts can utilise peer-to-peer platforms, such as Airbnb and Bookabach, to provide advertising, collect payment and help manage bookings. This ease means taxpayers overlook the tax measures that affect the provision of short term accommodation.

To ensure taxpayers aren't hit with an unexpected tax bill, Inland Revenue asked taxpayers what issues or questions they wanted addressed. As a result, Inland Revenue has published several documents for consultation on the income tax and GST implications of providing short term accommodation.

Although the documents do not propose significant changes to the current practice, they should help to simplify what can be a confusing area for taxpayers. Accommodation provided by a trust will be addressed by Inland Revenue at a later date.

Income tax issues

The income tax treatment when providing short term accommodation will vary depending on the situation. The income tax documents address the different methods available to calculate taxable income in each situation, such as providing a room in your home, your whole home or holiday home for rent.

Accommodation provided in your home

Generally short term accommodation providers will have the choice of returning income under a new standard cost method or an actual cost method. The standard cost method is intended to reduce the compliance costs of taxpayers.

Standard cost method

Under the proposed standard cost method, the rental income is not taxable provided the income earned is less than the standard cost. To the extent the income earned exceeds the standard cost the amount will be taxable.

The standard cost method will generally only be available to individual hosts, who rent rooms for less than 100 room nights per year and who are not GST registered. The proposed standard costs are $50 per room per night if the host owns the home, or $45 per room per night if the host rents the home. These amounts have been set based on the average cost of owning or renting a home plus the cost of short term accommodation items such as breakfast, linen, cleaning etc.

Although the documents do not propose significant changes to the current practice, they should help to simplify what can be a confusing area for taxpayers. Accommodation provided by a trust will be addressed by Inland Revenue at a later date.

The standard cost method for boarders will continue to apply to the provision of boarding services. The draft determination will apply from the start of the 2020 year and reduces the set weekly cost to $183 per week for each boarder, although there will no longer be a different rate for the third and subsequent boarders. The standard cost determination for boarders cannot be used for short stay guests, flatmates or tenants.

The standard cost method will be simpler to apply than the actual cost method. Taxpayers who earn income less than the standard cost amount do not have to return the income. However, by using the standard cost method taxpayers will not be able to deduct for any actual expenditure and will be unable to claim any losses from providing the accommodation.

Actual cost method

If taxpayers cannot or do not want to use the standard cost method, for example if their actual costs are higher than $50 per night, the deductions can be based on actual expenditure.

Unlike the standard cost method, the rental income will be treated as taxable.

Expenditure that relates only to the rental activity should be 100% deductible. However, expenses that are for both rental and private purposes should be apportioned. Depreciation losses on assets that are also used by tenants should also be apportioned.

The apportionment calculation should take into account the floor area of your house and the number of nights the room or rooms were rented out.

Holiday homes

Specific rules apply to holiday homes, as they are frequently left unoccupied. In our experience the rules can be quite complex to apply, so this draft guidance on the different rules is welcomed.

Mixed use assets

The mixed use asset rules apply to taxpayers who provide accommodation on a property that they and short term guests use but that is vacant for more than 62 days in a year, such as the family bach.

The mixed use asset rules factor in the vacancy to the deductions available and taxable income should not include rental receipts from certain family members or when renting to people for less than 80% of the market value rental.

Standard tax rules

If you cannot use the mixed asset rules, the standard tax rules will apply to your property. It is possible for a taxpayer to switch between the rules in different income years where the number of vacant days varies each year.

Under the standard tax rules, all amounts received for accommodation services provided will be taxable. Expenditure will need to be apportioned between private and rental use although expenditure wholly related to renting the property should be fully deductible. Such expenditure could include advertising, cleaning and additional rates and insurance costs incurred because the property is rented out.

Goods and services tax

Unlike the income tax draft items, which are generally quite comprehensive, the GST draft item is remarkably light on detail, to the point where a little knowledge could be dangerous for homeowners. We hope that the more detailed document promised is issued promptly, as without this the current draft item may serve as a useful high level summary, but it provides no real guidance for taxpayers who face some very complex GST issues.

That said, it is useful for the moment to touch on some (but definitely not all) of the common GST issues that are faced in relation to short term accommodation to illustrate the things that homeowners should be considering:

- Is the accommodation exempt from GST as residential accommodation (such as a standard residential rental tenancy) or potentially subject to GST (such as short term accommodation, whether in a room or a whole house or bach)?
- Is the nature of the accommodation provision business like and therefore a taxable activity, or is it in fact more like a hobby?
- If subject to GST, is there a need to charge GST? If the property owner is registered for GST already, even if in relation to some other taxable activity, then GST must be charged. If the property owner is not already registered for GST, they must register if the level of taxable supplies exceeds (or is expected to exceed) $60,000 per annum. Voluntary registration is possible even if the level of supplies is under this threshold.
- While it can be attractive to register for GST voluntarily, in order to recover 3/23 of some or all of the purchase price of a property, in the long term this may not be the best decision financially. Upon sale of the property, or deregistration from GST, the homeowner could effectively lose 3/23 of any capital gain on the property.
- If the property is owned in a trust, company or other entity, then "private" use by individuals associated with the owner (such as shareholders, trustees or beneficiaries) is a deemed supply for GST and the market value must be taken into account when assessing the $60,000 threshold. If GST registered, GST must be returned on the market value of these "private" supplies.
- Complicated change of use adjustments can be required if the home is used for both personal and GST taxable purposes.

We note the deadline for consultation on these documents is 22 March 2019. If you wish to provide comment on the consultation documents please contact your usual Deloitte tax advisor before then.

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Changes for residential rental owners from 1 April 2019

By Robyn Walker and Blake Hawes

As the media and commentators continue to have a field day analysing the recommendations in the Tax Working Group Final Report and its majority position advocating a capital gains tax, a different set of new rules which will affect many residential landlords are close to implementation and requires some serious thought.

The Taxation (Annual Rates for 2019-20, GST Offshore Supplier Registration, and Remedial Matters) Bill which was introduced to Parliament on 5 December 2018 includes fundamental changes to the treatment of residential rental property losses as one of its "remedial matters".

These new rules have an intended application date of the start of the 2019-20 income year. And if you're wondering whether that application date seems alarmingly close, you'd be correct. As most residential rental property owners are likely to have a standard 31 March balance date, these rules will apply from 1 April 2019.

To put it simply

The proposed legislation intends to end landlords offsetting losses incurred on residential rental properties against other sources of income (for example salary or wages and investment income), which generally results in a reduced tax liability and in many cases an income tax refund.

Any losses should not be permanently lost, instead they are 'quarantined' and can be carried forward and offset against any future income derived from residential rental property, and in some cases this could include any taxable income arising from the sale of the property itself.

What you need to know

While these rules are still to be enacted and therefore are subject to change, the key features of these rules and what may need considering if you own a residential rental property are:

1. Property affected by the changes will only be "residential rental properties" which are on "residential land" and the rules will not apply to any land that is your main home, a mixed use asset or property that will be taxed on sale under the ordinary land sales rules, such as land purchased with the intention of resale which is rented out

in the interim. This doesn't provide an out for property which simply *may* be taxed, for example if it is sold within the 5 year bright-line period.

2. "Residential land" is not restricted to land in New Zealand. Land anywhere in the world will potentially be subject to these rules.

3. Taxpayers with more than one rental property who wish to treat their rental properties on a property-by-property basis will be required to make an election to Inland Revenue or the default position of a portfolio basis will be deemed to have been chosen. This choice can have an impact on the use of ring fenced losses and should be considered carefully. For existing landlords, an election must be made with the tax return for the 2019/20 income year.

4. Particular provisions will apply to prevent taxpayers using interposed entities to avoid the application of the proposed rules. The use of a company between the taxpayer and the residential rental property would be caught if the company was considered to be "land rich".

It is worth noting that these rules will not apply to widely-held companies (those with 25 or more un-associated shareholders).

Thought should be given to

The choice to treat rental properties on a portfolio basis or property-by-property basis isn't necessarily a straightforward one. It may depend on the expectation of what will happen in the event of property being sold.

- The portfolio basis (the default option) will allow a taxpayer to treat all of their properties as if they were one. This will allow an offset of expenses against income across all rental properties in a portfolio. In the event that property is taxable on sale (for example if it is sold within a 5 year or 10 year period, as applicable), carried forward losses can be used to offset any taxable gain on the sale to nil. In the event that an entire portfolio of property is sold, any remaining carried forwarded losses would be left stranded unless the entire portfolio was taxable on sale.
- The property-by-property basis will not allow expenses from one property to be offset to income from another. However, if any of the properties in the portfolio becomes taxable on sale, the ring fenced losses for that property will be accessible to the taxpayer to offset against other income.

The provisional tax rules may apply to certain taxpayers who previously used rental property losses to reduce their income tax liability. If without rental property losses your residual income tax liability may be higher than $2,500 consideration will be required to determine provisional tax obligations and effort will be required to manage these payments of tax going forward.

Given the spotlight rental properties have been given in the last year and the changing legislative landscape we recommend consulting your tax advisor to make sure you have your head around all the changes before they take effect next month.

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Tax is changing – for everyone

By Susan Wynne and Emma Faulknor

The transformation programme of Inland Revenue to modernise the tax system continues and changes taking effect in April this year will include a new year-end process that will impact all individual taxpayers. To clarify, an individual taxpayer is a natural person, that is, you or me but not a company, trust or other type of entity.

The Government intends to simplify individual taxpayers' filing obligations and ensure that the appropriate rates of tax are deducted throughout the year. For individuals that only earn salary and wages or investment income it is intended that Inland Revenue will work out whether they have a refund or tax to pay after the end of the year. The Personal Tax Summary (PTS) that many individuals will have requested in the past will no longer be provided. This will apply from the tax year ending 31 March 2019.

These changes are dependent on the passing of legislation in the Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill, which is currently before the Committee of the whole House. It is also dependent on the processes in Inland Revenue's new computer system START (which stands for Simplified Tax And Revenue Technology). The go-live date for income tax data and processes to be available in the new system is 26 April 2019.

Information collection

In our article earlier this year, we discussed the changes to Inland Revenue's collection of employment income information from payday reporting. Inland Revenue will be using the information they collect to pre-populate individuals' income tax information.

The frequency of reporting investment income, such as interest and dividends, is also set to increase and this will assist Inland Revenue in pre-populating individuals' income tax information. The changes to the reporting of investment income are optional from April 2019 and become mandatory from April 2020. The due date for interest income reporting for the 2019 and 2020 years has been moved forward from the traditional 31 May due date to 15 May until investment income information is received monthly from 1 April 2020.

The new online services provided by Inland Revenue via myIR are intended to make it easier for businesses to meet the new reporting requirements. These changes will allow IR to have a more real-time view of taxpayer's obligations. These types of income on which information will be collected regularly are referred to as 'reportable income'.

Automatic tax square up

Under the proposals, individuals will fall into one of three groups for operational proposes that will determine the level of information they are required to provide to Inland Revenue. It will be possible for a person to move between the groups in different income years. Inland Revenue will use current year income information along with previous returns and personal tax summaries to determine what additional

information is needed and whether to automatically calculate the taxpayer's assessment.

The first group will generally include people who only earn income that is reported to Inland Revenue throughout the year, such as PAYE deducted income or investment income. If Inland Revenue judges the information to be correct it will automatically generate a tax refund or tax obligation. The taxpayer will not have to interact with Inland Revenue as was required in the past. Refunds are intended to be paid by direct credit and individuals will just need to make sure their contact details and bank account are up-to-date with Inland Revenue.

A key issue here is if there is other income to report for a particular year when an automatic tax refund is generated. Officials recommended changes to the legislation for the year-end process so that taxpayers treated as solely earning reportable income have until terminal tax due date to make an amendment to their automatic assessment without interest or penalties being imposed, unless they are subject to the provisional tax regime. Individuals will also be able to notify Inland Revenue via myIR if they expect to begin earning other income so their tax position isn't automatically calculated.

Based on figures released by Inland Revenue, it is expected that approximately 1.67 million people will automatically receive a tax refund for the 2019 tax year. This will include 950,000 people who had previously applied for and received a refund and also 720,000 people who had not previously received a refund. It may be less agreeable if you are part of the approximately 115,000 that are expected to have additional tax to pay for the first time. This number is expected to decline as Inland Revenue targets taxpayers to make changes during the year to ensure the correct of amount of tax is paid during the year so year-end tax debt is minimised.

There will be some concessions to year-end tax debt. For example, if the tax to pay is $50 or less and relates to income of $200 or less which should have had tax deducted under a withholding regime then the tax may not have to be paid. This will include employment income, dividend and interest income which should have had PAYE or resident withholding tax (RWT) withheld.

Do I have to provide additional information?

The other two groups of taxpayers will be required to provide additional information to Inland Revenue. Those taxpayers categorised in the second group will have to provide or confirm some additional information whereas those in the third group will have to provide income information similar to the current IR 3 process. The categorisation is based on the level of additional information required but will include people who earn only some or no reportable income.

Taxpayers will have access to this information online via myIR. The website will show income details which have been pre-populated by Inland Revenue based on payroll information. MyIR will also show the income categories Inland Revenue associates with you, for example rental income, based on previous returns filed. Investment income will also be visible once those provisions come into force but until then individuals will need to provide this information to Inland Revenue.

An individual and their tax agent (if they have one) will be able to update the information held by Inland Revenue via myIR. For example, provide details of rental income, overseas income or tax deductions.

Essentially, if you currently file an IR 3 you will still be required to disclose similar information to Inland Revenue. The process may be simplified though where information such as salary and wages can be pre-populated by Inland Revenue.

Taxpayers will have access to this information online via myIR. The website will show income details which have been pre-populated by Inland Revenue based on payroll information. MyIR will also show the income categories Inland Revenue associates with you, for example rental income, based on previous returns filed.

How does Inland Revenue know what my correct tax rate is?

Currently an employer deducts PAYE based on the information provided by the employee. Inland Revenue only advises the employer to change the tax rate where they have information that the rate applied is incorrect. Inland Revenue does not suggest a more suitable tax code where one is available. We note a person who earns PAYE income can be on an unsuitable tax code without it being incorrect. This means in some situations, an over or under payment of tax will arise which previously was settled under the PTS/IR 3 process.

Under the proposed changes, Inland Revenue will notify taxpayers who earn PAYE income if there is a more suitable tax code. Recognising that the ultimate decision rests with the taxpayer, the individual does not have to accept the suggested tax rate but Inland Revenue will notify the employer if they do.

This same monitoring will also apply to investment income. However Inland Revenue will instruct the payer to update the withholding tax rate applied to investment income where the individual accepts or does not respond to Inland Revenue's suggestion.

Tailored tax code

Where a person has two sources of PAYE income, they are currently required to use a secondary tax code or apply for a special tax code. Because of the nature of New Zealand's progressive personal income tax rates the use of a secondary tax code frequently results in overpayments of PAYE and, to be fair, most people either are not aware they can apply for a special tax rate or are unable to estimate their income for the year to apply for one. To overcome these issues, the Government has proposed a tailored tax code process effective from 1 April 2019. Inland Revenue will introduce an online application process and proactively recommend tailored tax rates to individuals.

How do I claim my donations rebate?

The administration of donation tax rebates is also changing. From April 2019 Inland Revenue will accept donation receipts uploaded electronically via myIR. A taxpayer may no longer have to file a tax credit claim if they upload donation receipts during the year, as Inland Revenue will automatically issue a refund where they consider the person is entitled to the refund. Inland Revenue will consider things such as whether a valid donation has been made to a charitable organisation and whether the taxpayer's taxable income exceeds the donations made in the claim.

This new approach is not compulsory for taxpayers. A person may complete the donation section when providing other income information in myIR or still complete a separate tax claim form either online or in paper form. If you have a tax agent, they can complete this for you on your behalf.

What if I don't have a myIR account?

Once income tax is live in the START system taxpayers will be encouraged to use myIR to check whether they will receive a refund or have tax to pay and update their details, rather than contact Inland Revenue. Inland Revenue acknowledges that not all customers are able to, or want to, use its online services and has confirmed that it will keep other channels of communication, including mail and telephone, open so taxpayers can meet their tax obligations.

Conclusion

We note Inland Revenue have announced they will temporarily shutdown from the afternoon of 18 April 2019 until the morning of 26 April 2019 to update their systems for these changes. This covers the Easter and Anzac day public holidays so will only impact three working days to minimise disruption to taxpayers.

The changes to individuals' filing obligations apply to the year ending 31 March 2019 and will replace the existing personal tax summary and income tax return filing processes. Given some of the fundamental changes involved we can only hope Inland Revenue systems can cope and that Inland Revenue will have sufficient resources to manage the increased activity.

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How will a CGT affect your lifestyle block or home office?

By Emma Marr

Since the Tax Working Group (TWG) released their final Report on 21 February 2019, there has been a flood of commentary on the pros and cons of a capital gains tax (CGT). Understandably the commentary has been at a policy level, rather than detailed debate about how the CGT would work.

Although it is well understood that the family home would not generally be subject to a CGT, there is some detail around this that is probably not as well understood. We won't know until April 2019 which recommendations from the final report the Government will be adopting, but understanding more about the proposals would help create a more fully informed debate about the effect of a CGT in New Zealand.

We'll cover a couple of the issues affecting family homes below. As always, if you want to discuss this or any other aspect of the TWG Report in more detail, contact your usual Deloitte advisor. You can also read our initial analysis of the Report, and refer to our useful infographic.

What is an 'excluded home'?

To go back to basics, the majority of the TWG recommended that there be a comprehensive CGT that applies to most assets. The main exemption to this would be the family home – the place that a person owns, where they "choose to make their home by reason of family or personal relations or for other domestic or personal reasons". Every taxpayer could have an excluded home, but a couple would generally only have one excluded home between them, unless special circumstances meant two excluded homes had to be maintained. Otherwise, if a person owns more than one property that they consider is an 'excluded home', they would have to choose which one is the excluded home.

If property is owned by a family trust, that property can be an excluded home if a settlor of the trust is living in the property or the property is occupied by a beneficiary of the trust and the beneficiary is irrevocably entitled to the property or the proceeds from the sale of the property as beneficiary income.

Will my lifestyle block be subject to CGT?

The short answer to this is: it depends how big it is. The proposed exemption for the family home only extends to the home, the land under the home, and the land around the house up to the lesser of 4,500m² or "the amount required for the reasonable occupation and enjoyment of the house".

The Report includes an example to illustrate how this works. A farmer owns a 100 acre sheep farm, and approximately 4,000m² of this comprises their house and gardens. The rest is used for the farm. Only the house and the surrounding 4,000m² would be the excluded home. If the farmer sold their house and farm, the excluded home would be exempt from CGT but the rest of the land would not. A valuation would be used to determine the value of the excluded home.

Conversely, if the gardens surrounding the home exceeded 4,500m2, the additional land above the 4,500m2 allowance would be subject to CGT on sale. Obviously the same principles would apply to smaller lifestyle blocks.

What if the excluded home is used for earning income?

If you are using your excluded home partially as your home and partially for a business (such as a home office, holiday accommodation, flatmates or borders), this will influence whether your excluded home escapes the CGT net. The TWG suggests that the owners of such a property should either:

- Choose to treat the house as an excluded home (if they use at least 50% of it as their home), but have no deductions for any business-related property costs; or
- Take deductions for business related costs, but also pay CGT if they sell the house, on that part of the house that was used for running a business.

The Report includes some examples to illustrate how this would work, we replicate these below.

"**Home office**. Dinesh owns a five-bedroom house that he uses as a residence for himself and his family. He also runs a consulting business out of one room in his house. As the area of the house used for income-earning purposes is minor and the house is more than 50% used as a residence, Dinesh can choose that the entire property will be an excluded home. However, if Dinesh chooses this option, he will not be entitled to claim any deductions for expenses relating to the property against the income from his consulting business"

If you are using your excluded home partially as your home and partially for a business (such as a home office, holiday accommodation, flatmates or borders), this will influence whether your excluded home escapes the CGT net.

"**Airbnb**. Mary purchases a house, which she occupies as her main home. The house has two living areas, one of which has a small kitchenette. Mary decides to advertise the use of one of the bedrooms and the second living area with the small kitchenette (approximately 33% of the total floor area of her house) on Airbnb. Mary has paying guests staying in her house for an average of 50 days each year. Mary uses those areas for her own private use at other times of the year.

"Both the area used (33% of the floor area) and time the area was used for income-earning purposes (an average of 50 days a year) amount to less than 50% income-earning use of the property. Therefore, Mary can choose that the entire property will be an excluded home. However, if Mary chooses this option, she will not be entitled to claim any deductions for the expenses relating to the property against her Airbnb income."

"**Part of a larger building used for private purposes.** Ruby owns a five-bedroom property that she uses to run a bed and breakfast business. Ruby uses four of the bedrooms and most of the living areas for the bed and breakfast business. However, Ruby occupies one of the bedrooms and a small living area and bathroom attached to that bedroom, as her residence – approximately 20% of the floor area of the property.

"The 20% of the property used as Ruby's residence can be treated as an excluded home and Ruby would only have to pay tax on 80% of the gain on sale."

The same would apply to home owners who have flatmates or borders.

Deloitte comment

We're resisting the temptation to read the tea leaves and predict whether either of these proposals will be adopted by the Government. Commenting on the proposals at this stage might be premature, as the Government might reject both ideas. The difficult part, as always, will be in getting the proposals into sensible legislation that can be easily understood and implemented.

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The Commissioner can't have her cake and eat it too…

By Campbell Rose, Virag Singh and Krishant Sen

On 5 November 2018, the High Court delivered its judgment in Frucor Suntory New Zealand Limited v Commissioner of Inland Revenue, deciding that a financing transaction involving the use of optional convertible notes was not a tax avoidance arrangement.

The case is noteworthy for its findings on the manner in which to assess the commercial and economic reality of an arrangement - including the extent to which a lens of commercial/unrelated party orthodoxy must be applied in doing so. The Court also made important findings regarding whether foreign tax savings are relevant to a New Zealand anti-avoidance analysis, and whether an issue of shares gave rise to economic cost in the sense contemplated by Parliament so as to result in deductibility for income tax purposes.

Background facts

The key facts can be summarised as follows:

- Frucor had issued optional convertible Notes (the **Notes**) to a third party bank (the **Bank**) with a face value of $204m. Interest was payable on the Notes at a rate of 6.5% per annum. The maturity date for the Notes was 5 years from the issue date.
- The repayment of the principal sum owing on the Notes could be satisfied through the Bank exercising its option to acquire shares (the **Shares**) in Frucor on maturity of the Notes. The Shares would not carry any voting rights.
- On the day the Notes were issued to the Bank, Frucor's Singapore-based parent (the **Parent**) entered into a forward purchase agreement to acquire the Shares on maturity of the Notes for $149m (this amount was paid by the Parent to the Bank upon entry into the forward purchase agreement). The Bank and Parent had agreed in the transaction documentation that the lowest price in respect of the Shares for financial arrangements rules purposes was $204m. This resulted in interest deductions for the Bank equal to the difference between $204m and $149m i.e. $55m. The remaining $55m of the amount lent by the Bank under the Notes was borrowed by the Bank from its group's offshore treasury vehicle.
- Frucor paid interest of $66m over the term of the Notes and claimed deductions for this amount under the financial arrangements rules.

- Frucor had used the funds borrowed under the Notes to buy back its shares for $60m and to repay existing loans from the group treasury vehicle of $144m.

The Commissioner of Inland Revenue (the **Commissioner**) denied Frucor's interest deductions for the full $66m, arguing that the transactions constituted a tax avoidance arrangement. This was on the basis that "in reality" Frucor had borrowed only $55m, being the $204m issue price for the Notes, less the $149m paid by its Parent to the Bank in respect of the forward purchase. The Commissioner sought to limit Frucor's interest deductions to $11m, which represented the interest paid by the Bank on its borrowing from its treasury department.

In the High Court, Muir J disagreed with the Commissioner, deciding that the tax outcomes arising under the arrangement did not constitute tax avoidance.

Individual entity v economic group approach

The Commissioner's argument relied heavily on expert evidence, and was predicated on what was referred to as the 'group approach'. On this approach – which Muir J referred to as a "seductive invitation to look at what was occurring 'in reality'" - Frucor and its Parent are treated as a single economic group, not individual entities in their own right; and the transactions are assessed at a group/consolidated level, looking at the net external position of entities under common control. At a group level, in the Commissioner's view, Frucor had borrowed only $55m.

Muir J was not receptive to this analysis. His Honour noted that Parliament's intention on how particular rules are to be applied must be considered within the overall scheme of the income tax legislation. He illustrated this by noting that an economic group approach was inconsistent with at least three specific aspects of New Zealand's international tax regime - namely the non-resident withholding tax (**NRWT**), thin capitalisation and transfer pricing regimes - and was more broadly inconsistent with the individual entity framework that underpinned them.

Muir J noted that, because New Zealand is a net importer of capital, NRWT provides an effective tool to protect New Zealand's tax base – and NRWT can only be effectively applied to interest payments between a New Zealand subsidiary and an offshore group member if they are separately recognised for tax purposes. His Honour went on to observe that the transfer pricing regime, and its underpinning arm's length principles, are premised on a separate entity approach. Finally, the thin capitalisation regime assumes individual entity recognition in a multi-national group context.

Against this backdrop, Muir J found that it could not be Parliament's intention to require that cross-border arrangements such as those at hand should be examined in terms of the overall impact at a group level.

Put another way, his Honour confirmed that taxation in a cross-border financing context where multiple tax regimes are in play requires separate entity recognition. The Commissioner could not cherry pick when to treat entities on an individual vs overall economic group basis.

Foreign tax savings

Muir J also confirmed that foreign tax savings do not constitute tax avoidance for the purposes of New Zealand's general anti-avoidance rule. He noted that the arrangement had "real and legitimate economic drivers, primary among them offshore tax minimisation".

His Honour found that the Commissioner had ignored (or at least understated) foreign tax motivators in undertaking her anti-avoidance analysis.

Manner in which the arrangement was carried out

Muir J noted that the transaction involved real money flows. Actual amounts were lent to Frucor. Frucor actually paid out funds of $60m for a share buy-back and $144m to repay loans. Even the Commissioner's expert accepted that real money was involved.

Muir J noted that some aspects of the arrangements, such as the pricing of the Notes, were unorthodox. However, he did not see this as an indicator of tax avoidance in this case. His Honour noted that it is the relationship between the arrangement and the tax outcomes that should be examined - not whether a particular aspect of a transaction may seem different from an arrangement wholly between unrelated parties. He advised against placing the Notes within a "straightjacket of orthodoxy". Muir J observed that when assessing whether Frucor had 'gained the benefit' of a specific tax rule in an artificial and contrived way, it was not simply a matter of focussing on whether – compared to arm's length norms – aspects of the transaction might be described as unorthodox or even artificial.

Muir J also noted that absence of certain characteristics in a related party refinancing context, which would otherwise exist when "new debt" was being raised, cannot be regarded as a significant indicator of avoidance.

Artificiality, circularity and contrivance

Muir J accepted that that the presence of artificiality and contrivance can indicate that an arrangement has been structured in a manner that is not reflective of its commercial and economic reality. However, here the transactions had a legitimate commercial purpose, which resulted in a real change to Frucor's funding structure. Genuine contractual obligations had been discharged, and so the Arrangement here was not circular in any sense relevant for anti-avoidance purposes.

"No cost" Argument

One of the Commissioner's further points was that the Shares to be issued by Frucor on maturity of the Notes (which the Commissioner contended would inevitably be held by the Parent, not by the Bank) would involve no cost for Frucor and so was incapable of discharging a liability so as to give rise to a deduction as intended by Parliament.

Dismissing this argument, and endorsing Frucor's, Muir J noted that the financial arrangements rules and the Commissioner's determinations issued in respect of those rules (particularly in relation to convertible notes) contemplated that shares could be issued in discharge of legal obligations. His Honour could not find any distinction in this respect between share issues to a parent and to a third party.

In summary, Muir J found that Parliament must have intended for Frucor to:

- take a deduction for interest economically incurred;
- deduct financial arrangements expenditure deemed to be incurred over the life of a financial arrangement;
- account for tax on a separate entity basis, even if it was a member of a multi-national group; and
- issue shares to satisfy a liability owed to a third party, including its Parent.

Shortfall penalties

Having decided in favour of Frucor, Muir J considered, in the alternative, whether shortfall penalties for an abusive tax position (100% of the tax shortfall) would be imposed if he had found for the Commissioner.

The starting point was whether Frucor had taken an unacceptable tax position (i.e. fails to meet the standard of being about as likely as not to be correct). The inquiry was whether Frucor's arguments had substantial merit and whether they would be seriously considered by a court. Looking at the "commercial and juristic nature of the transaction", Muir J considered that there were strong arguments in Frucor's favour and that Frucor was always in a position to credibly challenge the Commissioner's economic analysis of the arrangement. For these reasons, his Honour found that Frucor did not take an unacceptable tax position.

Conclusion

Muir J's judgment is a refreshingly objective assessment of a cross-border financing transaction in an anti-avoidance context.

His Honour has made valuable comments in terms of what should really be involved in ascertaining the commercial and economic reality of an arrangement, and in particular what significance/relevance non-arm's length features should have on the anti-avoidance analysis. He has reconfirmed that assertions of artificiality, contrivance and circularity can be easily made by the Commissioner in an anti-avoidance context, but these require the application of an objective and consistent lens in determining whether Parliament cannot have contemplated the tax outcomes in question.

Given the inevitable appeal of this decision, it will be interesting to see whether the Court of Appeal feels equally disinclined to accept the Commissioner's "seductive invitation", and will resist placing the transactions within a "straightjacket of orthodoxy".

At the very least, the *Frucor* judgment(s) will need to be reflected in the Commissioner's update of her interpretation statement on general anti-avoidance, which is currently a work-in-progress.

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Interim digital services tax to be implemented ahead of OECD work

On 18 February 2019, the New Zealand government announced that it will issue a discussion document for consultation in May on the introduction of a digital services tax (DST). The DST is targeted at multinational companies offering social media networks, trading platforms and online advertising in New Zealand. Although the New Zealand government is committed to working with the OECD on a global solution (known as BEPS 2.0), there is concern that agreement could be several years away.

Until now, tax policy officials have been keeping a watching brief on other countries that are implementing unilateral measures. The New Zealand government feels that there is enough critical mass and that the country should move ahead with its own work and be ready to implement the DST. It is intended that a New Zealand DST be introduced as an interim measure until the OECD reaches a consensus. Estimates are that if a DST is set at a range of between 2% to 3% of digital revenues, it could raise between NZD 30 million to NZD 80 million, but this will depend on how the tax is designed. Any proposals will go through a full consultation and legislative process, although the Minister of Revenue has suggested that the DST could be implemented and ready to apply from sometime in 2020.

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Snapshot of Recent Developments: March Tax Alert

Policy Developments:

Taxation (Annual Rates for 2018-19, Modernising Administration, and Remedial Matters) Bill passes second reading with supplementary order papers introduced.

The Taxation (Annual Rates for 2018-19, Modernising Administration, and Remedial Matters) Bill ("TARMTARM Bill") passed its second reading but not before two supplementary order papers ("SOP") were added to it.

SOP No 188. In addition to minor remedial amendments, this SOP also proposes income derived for the purposes of the purchase of disability support services is exempt income and group companies are included in the ASX-listed companies demerger dividend exemption.

SOP No 189 proposes the New Zealand Memorial Museum Trust — Le Quesnoy is treated as a donee organisation under schedule 32 for a period of approximately 4 years. Gifts of money to the New Zealand Memorial Museum Trust — Le Quesnoy may be eligible for donee organisation tax breaks.

The Bill has now moved to the Committee of the Whole House stage.

Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill Supplementary Order Paper introduced

Supplementary Order Paper No. 193 has been added to the Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill. This reintroduces the proposal to extend the Commissioner of Inland Revenue's care and management role, which was removed from the Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill earlier this year.

The proposed amendments provide options to resolve legislative anomalies where there are issues with tax laws that produce outcomes which are inconsistent with clear and understood policy intent. The options allow for an Order in Council to be made on the recommendation of the Minister of Revenue, and provide the Commissioner of Inland Revenue with an exemption-making power. These can be used to modify the application of tax laws, at the optional application of taxpayers, for a limited period of time, and following a period of public consultation.

Research and Development tax incentive draft guidance now available

On 25 February 2019 Inland Revenue released draft guidance on how the R&D tax incentive regime will apply. They have made this available on a new forum where you can comment and view the draft guidance.

ATO releases synthesized text of the MLI and the convention between Australia and New Zealand

On 22 February 2019, the Australian Taxation Office published the synthesized text which shows the modifications made to the treaty by the MLI. The text was jointly prepared by the competent authorities of Australia and New Zealand and represents their shared understanding of the modifications made to the treaty by the MLI. The sole purpose of the document is to facilitate the understanding of the application of the MLI to the Convention and therefore does not constitute a source of law.

Unless stated otherwise in the synthesized text, the provisions of the MLI will have effect with respect to the Australia - New Zealand Income Tax Treaty (2009) as follows:

- with respect to taxes withheld at source on amounts paid or credited to non-residents, where the event giving rise to such taxes occurs on or after 1 January 2019; and
- with respect to all other taxes levied by Australia, for taxes levied with respect to taxable periods beginning on or after 1 July 2019; and
- with respect to all other taxes levied by New Zealand, for taxes levied with respect to taxable periods beginning on or after 1 July 2019.

Finalised Inland Revenue Items:

Exemption from electronic filing – operational statement 19/01

On 8 February 2019, Inland Revenue released operational statement OS 19/01 Exemption from electronic filing. The statement applies from 7 February 2019 to persons applying for an exemption from electronic filing pursuant to section 23G, 25P and 36BD(3) of the Tax Administration Act 1994. An exemption from the requirement to file returns or supply information digitally is available for those who are unable to comply due to lack, or inadequacy, of digital services.

Tax payments – when received in time – SPS 19/01

On 20 February 2019 Inland Revenue released SPS 19/01 – Tax payments – when received in time.

The statement will apply from 1 March 2019 and will replace SPS 14/01 – Tax payments when received in time. The statement sets out Inland Revenue's practice of accepting a payment has been received on time. The statement covers electronic payments, debit/credit cards, cash and eftpos, payments by cheque, tax pooling, tax transfers, overseas electronic payments, and weekends and public holidays.

Income tax – application of schedular payment rules to non-resident directors' fees – IS 19/01

On 28 February 2019 Inland Revenue released the finalised interpretation statement IS 19/01: Income tax – application of schedular payment rules to non-resident directors' fees.

The Interpretation Statement considers the situations in which tax must be withheld from directors' fees paid to non-residents. This includes a discussion of when directors' fees paid to non-residents are considered to have a New Zealand source. The Interpretation Statement then goes on to consider when and how much tax must be withheld and paid to the Commissioner, if withholding is required from directors' fees paid to a non-resident.

Tax Cases:

Payments held to not be donations

Church of Jesus Christ of Latter-Day Saints Trust Board v CIR [2019] NZHC 52

The Court of Appeal ruled in favour of the Commissioner in a case concerning whether payments made to a church in order to support a missionary serving overseas are donations per section LD 1.

The case concerned payments made by missionaries and family members of missionaries, who are required to contribute funds towards the work of other missionaries in New Zealand. The Commissioner successfully argued that the payments were made to meet the costs of the mission and not gifts, as they were not made gratuitously to the trust.

The case considered considerable discussion over the meaning of gift. The court concluded that payments made by the missionary, parents and grandparents are not gifts, however payments made by siblings, other distant relatives and other unrelated members of the Church are gifts for this purpose.

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