Connecting you to the topical tax issues

Tax Alert

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In this issue:

Stop press: Inland Revenue releases Multinational Compliance Focus

OECD proposes a "unified approach" to addressing the digitalisation of the economy

New compulsory online BEPS disclosure forms now required!

Thin capitalisation calculations in a BEPS world

Attention Wholesalers & Distributors – Are you part of the chosen few?

Provisional tax changes: Two years on

Update on disclosing uncertain tax positions

Deducting holding costs for privately used land that is taxable on sale

Recent developments

Stop Press: Inland Revenue releases Multinational Compliance Focus

By Emma Marr

As we went to press, Inland Revenue released the Multinational Enterprises Compliance Focus 2019 document. Last released in 2016, this update aims to provide transparency and certainty to taxpayers. The document is available here.

As more and more businesses transact globally, and international organisations such as the OECD continue to proactively develop policies to prevent base erosion and profit shifting, New Zealand's tax rules will continue to adapt to tackle the challenge of taxing international commerce. The document includes checklists of actions MNEs should take in considering whether they comply with their New Zealand tax obligations. We will cover this in more detail in future editions of Tax Alert.

The key message is that Inland Revenue want to make it easy for taxpayers to comply with the law, to be open and transparent with Inland Revenue, and to be proactive in seeking guidance from, or agreement with Inland Revenue, as to their tax positions.

Future focus

Inland Revenue's future focus is to balance the need to ensure that multinationals pay their fair share of tax, while also creating a business environment that supports multinational businesses operating in and out of New Zealand, with few competitive distortions and the lowest possible compliance costs.

As part of this, Inland Revenue will focus on:

- **International monitoring framework**: New Zealand is party to a number of initiatives to share information between revenue authorities, such as Country by Country reporting, Exchange of Information on Tax Rulings, liaising with the New Zealand Customs Service, and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Combined with the annual International Questionnaire completed by substantial NZ-based MNEs, this provides a large data pool for Inland Revenue to mine.
- **BEPS disclosures**: The new disclosure requirements covered in this Tax Alert will allow Inland Revenue to monitor whether taxpayers are complying with New Zealand's anti-BEPS measures.
- **International compliance campaigns**: The first example of this is the new questionnaire for wholesalers and distributors Inland Revenue released recently. Future campaigns will focus on areas such as losses, royalties, and debt/thin capitalisation. Inland Revenue encourage taxpayers who are likely to be affected by an increased focus on these areas to consider their compliance with existing rules ahead of Inland Revenue knocking on their door. As an example, if you are subject to the thin capitalisation rules, you should read this month's article on how to tackle thin capitalisation calculations in a BEPS world
- **Monitoring hot spots**: this includes a focus by Inland Revenue on financing risks such as cash pooling, guarantees, and derivatives, to ensure they are used appropriately within transfer pricing rules.
- **Transfer pricing simplification**: Inland Revenue is committed to simplifying our transfer pricing rules, particularly for smaller MNEs, and is open to suggestions as to how the rules could be easier to comply with, while still achieving the aim of avoiding BEPS.
- **Continuing to develop plans to tax the digital economy**: Inland Revenue will consider implementing domestic options if OECD proposals do not progress quickly enough.

The overall message is that Inland Revenue has a wide range of tools at its disposal, both in the legislation that has been enacted in recent years, and in the technology and increased information it has at its disposal following the Business Transformation programme. Inland Revenue will make full use of these tools to ensure taxpayers comply with our anti-BEPS rules.

If you have any concerns about your compliance with New Zealand's comprehensive and robust international tax rules, please contact your usual Deloitte advisor.

Inland Revenue's future focus is to balance the need to ensure that multinationals pay their fair share of tax, while also creating a business environment that supports multinational businesses operating in and out of New Zealand, with few competitive distortions and the lowest possible compliance costs.

Emma Marr
Associate Director
Tel: +64 4 470 3786
Email: emarr@deloitte.co.nz

OECD proposes a "unified approach" to addressing the digitalisation of the economy

By Bruce Wallace and Bart de Gouw

Pillar 1 of the Inclusive Framework is moving!

Since 2015 the OECD has been working on BEPS Action 1, to find a consensus-based solution to the tax challenges arising from digitalisation. Recently this progress has crystallised in a programme which is imagining new approaches to the allocation of taxing rights among countries, including new approaches to nexus (permanent establishment) issues and the arm's length principle.

Following a public consultation document released in February 2019 which put forward two pillars (Pillar 1, allocation of taxing rights, Pillar 2, minimum taxation and other BEPS issues), the OECD Secretariat has now proposed a "unified approach" to Pillar 1 ("the Proposal"). The unified approach includes a wider scope for large digital and "consumer-facing" businesses, a new nexus rule, a three-tier profit allocation mechanism, concepts for eliminating double taxation, and sets a robust tax disputes process. The "unified approach" intends to be consensus-building to facilitate expanding the reach of the taxing authority in market jurisdictions in a way that is simple, avoids double taxation, and significantly improves tax certainty relative to the current practice. Whether the intended outcomes, most notably simplicity, are achieved is yet to be seen. At present it is unclear at what size a business would be subject to the new way of tax; there has been some talk of using a threshold of EUR750m which applies for other purposes, but there is also potential for this threshold to be increased.

Implications for NZ's large businesses

New Zealand's business community will be taking note of the Proposal's mechanisms (i.e. empowering taxing authorities to collect revenue based on a market base) as the document is, effectively, the OECD's multi-lateral 'response' to unilateral digital services taxes ("DST") that several countries have proposed / implemented over the course of the last year. The NZ Government has signalled that any decision to not progress its DST proposal

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(as outlined in its July 2019 DST discussion paper) would be contingent on significant OECD progress on the taxation of digital businesses. NZ businesses caught by either the proposed scope of the unified approach ("consumer-facing businesses") or the NZ DST will be waiting for the Government to confirm whether it will still pursue a DST in New Zealand. While the OECD timeline for developing the proposals is aggressive, it is still a slower timeline compared to the potential to implement a unilateral DST which can have relatively immediate (though potentially negative – think trade retaliations) impact.

For the group of large New Zealand businesses that operate above the EUR750m threshold, the main takeaway from the OECD's Proposal will be the wider definition – "consumer-facing businesses" (which goes beyond just highly digital businesses). This will be of interest, and potential concern, to some New Zealand businesses as it widens the scope of the Pillar 1 work to organisations that do not operate a digital business-to-customer model. There is also likely to be strong interest in the technical details of how the different mechanisms will operate. The Proposal makes it clear that more work is needed to define the application thresholds and set specific percentages / allocation keys for determining non-routine returns, allocation to market intangibles and allocating market intangibles to particular market jurisdictions. These details are intended to be developed in 2020 after high level principle decisions have been made.

The Proposal also notes a number of exclusions from the potential scope – exceptions that will have interesting applicability to some NZ businesses. For example, the application threshold could be set at a significantly higher level of group sales so as to target only very large multi-national groups. Far fewer NZ businesses could be in-scope if this change is agreed upon. The Proposal also indicates that the unified approach might not be applied to extractive industries, the financial services sector and the commodities sector. This raises some interesting questions around what counts as a financial services business (many businesses that provide financing services are not banks) and how the rules will apply to a business that has traditionally traded commodities but has evolved to also sell value-added products. The OECD has also not been clear as to what constitutes a commodity; nor where in the supply chain something becomes "consumer-facing".

Next steps

The programme of work on the Inclusive Framework is picking up pace. We expect a proposal on Pillar 2 will be released for consultation in November 2019, focusing on creating a global anti-base erosion mechanism to ensure multinational businesses pay some minimum level of tax. Looking into 2020, the OECD has expressed that it is hoping to build greater consensus towards the meeting of Inclusive Framework participants in June 2020. Once a general consensus is reached on the conceptual approaches proposed this should facilitate the (significant) technical work required to ready the proposals for agreement and implementation – a process expected to take 18 months.

Stakeholders are invited to provide comments to the OECD on the Pillar 1 proposal by 12 November 2019.

If you're interested in a more in-depth review of the OECD Secretariat's Pillar 1 proposal, please refer to this Deloitte article.

If you are interested in discussing the potential implications of the Pillar 1 proposal for your organisation further, please contact your usual Deloitte advisor or feel free to connect with Bart de Gouw or Bruce Wallace.

Bart de Gouw
Partner
Tel: +64 9 303 0889
Email: bdegouw@deloitte.co.nz

Bruce Wallace
Partner
Tel: +64 9 303 0724
Email: brwallace@deloitte.co.nz

New compulsory online BEPS disclosure forms now required!

By Bart de Gouw and Annamaria Maclean

Somewhat unexpectedly, Inland Revenue have recently released guidance on the requirements for taxpayers to file new online BEPS disclosures via myIR online services, as part of the tax return process.

The requirement to file income tax disclosures online is a new approach that we expect is driven by Inland Revenue's Business Transformation Programme and the increasing requirements for taxpayers to use myIR online services. We anticipate Inland Revenue will look to use this electronic data in new ways which may mean more data analysis that can be used for risk reviews and audits.

The disclosures ask taxpayers to confirm their compliance with three core changes that were introduced in The Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 (**BEPS Act**), being:

(i) Hybrid and branch mismatch rules.

(ii) Thin capitalisation: in particular, has your thin capitalisation group had a New Zealand group debt percentage for thin capitalisation purposes of 40% or higher at any measurement date during the income year?

(iii) Restricted transfer pricing rules: in particular, at any point during the year have you had $10 million or more of cross-border related party borrowing?

The first year for which BEPS disclosures are required, is for income years commencing on or after 1 July 2018. **So this means that June 2019, July 2019, August 2019 and September 2019 balance dates need to be working on these now** to ensure that the disclosures are in line with how they file their 2019 income tax returns (due on 31 March 2020).

The rules covered by the BEPS disclosures are technically complex and highly dependent on the facts and circumstances of the particular scenario. Even where significant work has already been undertaken by the taxpayer to assess the impact of the BEPS changes, further consideration may be required to complete the BEPS disclosures in an accurate and complete manner. Therefore, the BEPS disclosures should be considered as soon as possible and well before completion of your income tax returns. For many June to September 2019 balance dates, the tax return process is well underway, so taxpayers should be acting now to ensure that they are in a position to file these online disclosures appropriately.

Below is a summary of the key components of the BEPS disclosures to help taxpayers initially assess the potential impact of the rules and consider whether further work needs to be undertaken before the online questions can be completed.

Hybrid and Branch Mismatches

The BEPS Act included a comprehensive adoption of the OECD's hybrid recommendations with modification for the New Zealand context. The proposed rules are complex and are

designed to address mismatches in the tax outcomes between New Zealand and other countries. These mismatches result from differing treatment of financial instruments or entities that create either double deductions (in New Zealand and overseas), or a deduction in one country without a corresponding amount of income being recognised in the other country.

Along with the BEPS disclosure guidance, Inland Revenue have released a hybrids compliance and disclosure document (as replicated from the TIB Vol 31, No 3 and the special report on the hybrid and branch mismatch rules).

Some examples of common situations that can be impacted by the hybrid and branch mismatch rules include:

- Financial instruments (e.g. loans) that are treated as debt in one country but equity in the other;
- Financial instruments that have (or may have) a term of more than 3 years where the interest income is not recognised on a reasonable accrual basis or otherwise in an accounting period beginning within 24 months of the period in which a deduction is allowed for the interest expense;
- Branch operations in New Zealand or overseas;
- Limited partnerships and other entities that are treated differently for tax purposes in different jurisdictions;
- New Zealand unlimited liability companies (with a US "check the box" election);
- Dual resident entities; and
- Any payment on an ordinary cross border loan, which is funding a hybrid arrangement entered into between two non-resident members of a multinational group where the rules of those countries do not negate the hybrid outcome.

In this section of the BEPS disclosures, taxpayers must firstly identify the relevant hybrid disclosure type, being: a hybrid entity/branch/dual resident disclosure; hybrid payment disclosure; hybrid receipt disclosure; double deduction disclosure; or imported mismatch disclosure.

The online form then requires specific details for each hybrid arrangement to be disclosed. This includes details of the counterparty to the arrangement (including tax ID, tax resident jurisdiction), the arrangement's terms, the amount of counteraction in New Zealand (denied deductions or inclusion of income), the counteraction in another jurisdiction, and a ledger of mismatch amounts and surplus assessable income.

Many taxpayers may read the last couple of paragraphs without much idea of what this means. We have assisted many taxpayers in navigating the complexity of the hybrid rules as well as working with officials to get legislative change where it is required. Completing the hybrid and branch mismatch disclosures is likely to take some time as the appropriate analysis will need to be undertaken on whether a hybrid arrangement exists, including obtaining the relevant information from group members in offshore jurisdictions, and then assessment of the related counteractions and mismatches.

If you have any of the above arrangements in your group then we would recommend getting in touch to work through the rules.

Thin Capitalisation Group Information

This section of the online form requires taxpayers to disclose details that, essentially, unpack information contributing to their thin capitalisation calculation where their **New Zealand group debt percentage is 40% or higher at any measurement date during the year**.

Broadly the thin capitalisation rules stop foreign-owned New Zealand companies overloading on debt. A number of changes have been made to the thin capitalisation rules to restrict the amount of debt the New Zealand company can have that gives rise to deductible interest. The new rules have imposed a "net asset" test, which means that the debt percentages will now be based on an entity's assets reduced by the value of "non-debt liabilities" on the company's balance sheet.

This change is likely to mean that many companies historically complying with the thin capitalisation rules will fall foul of them under the new test, and will have to either restructure their debt or accept that some interest deductions will effectively be denied for tax purposes.

This section is focused on taxpayers with a New Zealand group thin capitalisation percentage of 40% or more, which is below the usual safe harbour threshold of 60%. The 40% test is however connected to the "high BEPS risk" test in the restricted transfer pricing rules as discussed below.

We anticipate Inland Revenue will look to use this electronic data in new ways which may mean more data analysis that can be used for risk reviews and audits.

Bart de Gouw
Partner
Tel: +64 9 303 0889
Email: bdegouw@deloitte.co.nz

Annamaria Maclean
Partner
Tel: +64 9 303 0782
Email: anmaclean@deloitte.co.nz

Restricted transfer pricing rules

This section is required to be completed **where a taxpayer has NZ$10 million or more of cross-border related party borrowing** and therefore is subject to the restricted transfer pricing rules.

The disclosure asks three core questions on the nature of the borrowing for the restricted transfer pricing rules, including whether the interest rate on an existing loan has been reduced (a pricing change), the amount of non-deductible interest under the rules, and whether any concessions have been applied.

The restricted transfer pricing rules provide a prescriptive approach for determining the borrower's credit rating and determining whether certain features of the loan should be modified or disregarded.

Generally this means that debt that is subject to the regime may have to be priced based on the assumption that the borrower's credit rating is one notch below the credit rating of the member of the worldwide group with the highest unsecured third party debt (or two notches where the resulting credit rating for the New Zealand-resident borrower will be BBB- or higher), regardless of that borrower's actual credit rating. This has resulted in a significant change in credit rating for some New Zealand subsidiaries for the purposes of pricing cross-border related debt for tax purposes.

Whether or not this "deemed" credit rating must be used depends on whether the borrower is considered to be at a high risk of BEPS behaviour, having failed one or more of the following tests:

- The borrower has a greater than 40% thin capitalisation ratio, and they exceed the 110% worldwide debt test; or
- Borrowing comes from a jurisdiction, that is not the ultimate parent jurisdiction, where the lender is subject to a lower than 15% tax rate.

Once a credit rating is established, some features of the debt may have to be disregarded or modified when pricing the debt. These features include (among other things) the term of the loan, whether the payment of interest can be deferred for more than 12 months, changes to interest rates that are controlled by the borrower or lender, and whether the debt is subordinated.

In our experience, it has taken considerable time and effort to work through these rules for our clients. In addition, the BEPS disclosures appear to require taxpayers to quantify and disclose the level of non-deductible interest that can be attributed to the adjustment to the borrower's credit rating and the modified or disregarded features of the loan. In order to undertake this analysis, taxpayers would effectively need to show a reconciliation between the new restricted interest and the arm's length interest that was applied previously.

Given the level of analysis required, we would recommend that affected taxpayers undertake a comprehensive review of their cross-border related borrowing to ensure there is sufficient documentation to support any interest deductions and the level of analysis required to complete the BEPS disclosures.

Final word

As outlined above, the BEPS disclosures require immediate attention for taxpayers with June to September 2019 balance dates.

The BEPS changes are also now in effect for all taxpayers and therefore October 2019 to May 2020 balance dates should already be considering how the rules may impact their tax positions and whether arrangements or financing need to be adjusted.

The rules are complex and affected taxpayers should consider testing application of these rules as soon as possible to ensure there is sufficient analysis and documentation to support the tax positions taken.

If you have any questions or concerns regarding the BEPS disclosures or have not yet considered how the BEPS rules would apply to you, we recommend you contact one of the authors or your usual Deloitte tax advisor before the BEPS disclosures are completed online.

Thin capitalisation calculations in a BEPS world

By Susan Wynne and Annamaria Maclean

As discussed in our related November Tax Alert article new BEPS disclosure requirements have been introduced by Inland Revenue. These follow the enactment last year of the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018. The changes from this legislation apply to taxpayers for income years starting on or after 1 July 2018, so are now applicable.

Included in the BEPS changes were updates to the thin capitalisation rules. It is now timely to consider the practical application of the thin capitalisation calculation changes, particularly given the BEPS disclosure requirements for affected taxpayers.

The significant change to thin capitalisation calculations is that debt percentages are now calculated based on debt over assets net of "non-debt liabilities", rather than debt relative to gross assets as was previously allowed. This change can have a significant impact on the thin capitalisation position of taxpayers.

Taxpayers that are subject to the thin capitalisation rules must calculate the debt percentage of their New Zealand thin capitalisation group. In the case of a taxpayer with inbound debt, if the debt percentage exceeds 60% further calculations are required to test if the debt percentage of the New Zealand group is not more than 110% of the debt percentage of the worldwide group. This subsequent test is designed to ensure that the amount of debt allocated to the New Zealand group is proportionate to the amount of genuine external debt of the worldwide group (i.e. New Zealand is not disproportionately geared compared with the global group).

If both the 60% and 110% debt percentage thresholds are breached a taxpayer will need to calculate an amount of interest expense that will be non-deductible.

The change to the debt percentage formula will require taxpayers to think more carefully about their thin capitalisation positions. This may include undertaking more detailed calculations to determine if the debt percentage thresholds have been breached, including looking more closely at the different options available in the thin capitalisation calculations and also calculating the worldwide group threshold to check whether this is also breached. Taxpayers should also consider whether it is the right time to restructure debt.

When preparing thin capitalisation calculations some of the issues that are useful to consider include:

- What is the New Zealand thin capitalisation group?
- What thin capitalisation measurement date will be used?
- What amounts will be "non-debt liabilities"?
- Can on-lending concessions be applied?
- What about the worldwide group debt percentage calculation?
- BEPS consequences - restricted transfer pricing rules.

We discuss these points below.

New Zealand thin capitalisation group

In general, when determining the members of a New Zealand group it is necessary to identify the top tier company resident in New Zealand (with an immediate non-resident shareholder). Once the New Zealand parent is identified, all companies that are within the control threshold of the New Zealand parent must be included in the New Zealand group. Broadly, the default control threshold is ownership of 66% or more, otherwise an election is required for a 50% interest.

There is also an ability to elect to form a wider New Zealand thin capitalisation group in certain instances, for example, where a non-resident controls two separate chains of New Zealand groups. These elections are made when filing the income tax return.

The rules to determine the membership of a thin capitalisation group can be complex and are spread over several sections in the Income Tax Act 2007. However, given the new debt percentage formula and the consequences of a higher thin capitalisation debt percentage, it may be worthwhile reconsidering which entities are eligible to elect to form a thin capitalisation group and making elections where these are of benefit.

Thin capitalisation measurement date

Measurement for thin capitalisation purposes may be on a daily, quarterly or annual basis. Most taxpayers simply choose to measure the thin capitalisation debt percentage on an annual measurement date at the end of the income year.

If measuring the thin capitalisation debt percentage at the standard annual measurement date results in a breach of the thin capitalisation threshold, then testing the average amount at the end of each day or quarter could produce a different outcome. There are also options to revalue foreign denominated balances at different exchange rates, which can make a difference to the calculations.

Looking at the differences in the calculation using different measurement dates could be particularly relevant if debt or asset balances or exchange rates fluctuate during the year.

However please note that a new avoidance rule was introduced as part of the BEPS legislation that essentially provides that taxpayers cannot substantially repay a loan or enter into a transaction near a measurement date with the purpose or effect of manipulating the thin capitalisation rules. Therefore care will need to be taken if there was a repayment of debt or increase in assets near a measurement date.

Non-debt liabilities

As noted above, the thin capitalisation rules were strengthened as part of the BEPS initiatives. The key change was the amendment to the debt percentage formula so that assets are now measured less non-debt liabilities. The new formula provides that the debt percentage is calculated as:

Group debt / (Group assets – Non-debt liabilities)

Broadly, non-debt liabilities are all liabilities in the financial statements less:

- Interest bearing debt included as group debt in the debt percentage formula;
- Certain interest free loans from shareholders;
- Certain shares from shareholders that are liabilities in the financial statements, e.g. preference shares;
- Provisions for dividends;
- Certain deferred tax liabilities.

The intent is that all liabilities will reduce the value of group assets in the debt percentage formula except for interest bearing debt, shareholder funding that is effectively equity, or certain deferred tax liabilities. However the exclusions from non-debt liabilities are somewhat limited.

For example, non-debt liabilities can be reduced for certain interest free loans from shareholders. However, this exclusion does not apply to wider interest free related party loans (e.g. by entity's in the same group as the shareholder) nor does it apply to trade liabilities with shareholders or related parties. The new legislation only refers to arrangements "with a shareholder" and the Inland Revenue commentary specifically makes the point that "as drafted, the exclusion only applies to a loan from a shareholder".

On-lending concession

The on-lending concession has sometimes been overlooked in the past if the debt percentage has been low. But with the changes to the debt percentage formula it is worthwhile considering if the on-lending concession will reduce the debt percentage.

The concession for on-lending represents assets which are financial arrangements that provide funds to an unrelated person or related party outside the thin capitalisation group. These are most commonly cash deposits and other loans on-lent outside the group.

Worldwide group

The worldwide group debt percentage calculation is relevant if the New Zealand debt percentage is over the 60% threshold, or if the "high BEPS risk" taxpayer 40% threshold is breached (see discussion on BEPS consequences further below).

However, there are some differences between the calculation of a New Zealand group debt percentage and a worldwide group debt percentage.

The worldwide group generally comprises all entities that are required to consolidate with the New Zealand companies' ultimate non-resident parent under generally accepted accounting practice (GAAP), or an equivalent standard in the country where the ultimate parent resides.

The debt, assets and non-debt liabilities of the worldwide group must be calculated under GAAP, or the financial standard of the country in which the ultimate non-resident parent company resides, as this applies for the consolidation of companies for the purposes of eliminating intra-group balances.

The measurement date under the thin capitalisation rules for the worldwide group can be on a daily, quarterly or annual basis. However if an annual measurement date is used this is based on the last day of the accounting year of the worldwide group ending immediately before the income year of the taxpayer's New Zealand group.

The new debt percentage formula must also be used for the worldwide group debt percentage. For a worldwide group, total group non-debt liabilities for an income year are more widely defined.

BEPS consequences – restricted transfer pricing rules

The broader implications of the thin capitalisation percentage should also be considered given the BEPS measures that now apply.

In particular, under the restricted transfer pricing rules, New Zealand taxpayers may be classified as "high BEPS risk" taxpayers if they exceed a 40% thin capitalisation debt percentage threshold and the 110% worldwide debt test. Therefore, even if the 60% debt percentage threshold is not breached, if the 40% threshold is breached, it will be useful to test the 110% worldwide group debt threshold, as this could exclude taxpayers from being classified as "high BEPS risk".

Based on the BEPS disclosure guidance that was recently released by Inland Revenue, it appears that taxpayers subject to the thin capitalisation rules will be specifically asked if the New Zealand group debt percentage is 40% or higher at any measurement date during the year. This disclosure requirement will apply for tax returns for income years commencing on or after 1 July 2018. In addition, the components of the thin capitalisation calculations will need to be provided to Inland Revenue so taxpayers need to be prepared to provide this information.

Conclusion

The thin capitalisation debt percentage calculation has become a more complex calculation with potentially significant implications for taxpayers. Our recommendation is that the impact of the new debt percentage formula is considered before year end, if possible, and given careful consideration. Taxpayers should also be aware of the requirement to provide thin capitalisation information to Inland Revenue as part of the new BEPS disclosures. Please contact your usual Deloitte advisor if you would like further information.

Susan Wynne
Associate Director
Tel: +64 7 838 7923
Email: swynne@deloitte.co.nz

Annamaria Maclean
Partner
Tel: +64 9 303 0782
Email: anmaclean@deloitte.co.nz

Attention Wholesalers & Distributors – Are you part of the chosen few?

By Lucy Scanlon and Eleanor Yew

Did you receive an International Wholesaler / Distributor Questionnaire? Inland Revenue has initiated a campaign recently whereby selected wholesalers/distributors operating in New Zealand are requested to complete an International Wholesaler / Distributor Questionnaire (**the questionnaire**) as part of a wider compliance approach for multinational enterprises.

The results of Inland Revenue's 2018 International Questionnaire survey of 623 foreign-owned groups (excluding banks and insurers) identified that wholesalers and distributors were the largest industry in this group of respondents, accounting for 24%, or approximately 150 wholesalers/distributors with annual turnovers in excess of NZ$30m.

By way of background, Inland Revenue introduced a range of simplified measures which were aimed at serving the dual purposes of protecting the tax base whilst reducing compliance costs in instances where a low transfer pricing risk is present. One of these simplified measures is for foreign-owned wholesale distributors with an annual turnover of less than NZ$30m. Inland Revenue currently considers a weighted average earnings-before-interest-tax-and-exceptional-items (**EBITE**) ratio of 3% or greater to be broadly indicative of an arm's length rate. Our recent Tax Alert article explains the measures in more detail.

Inland Revenue's questionnaire aims to ascertain if there is a need for simplification measures or adjustment of the threshold levels set for the existing measures. The data collected may also be used to inform Inland Revenue's input into further anti-Base Erosion Profit Shifting (**BEPS**) measures being discussed in the Organisation for Economic Co-operation and Development (**OECD**) OECD Consultation Paper on its risk assessment processes. With the responses collected from this taxpayer group,

Our advice is that it is imperative to provide accurate responses that are representative of your entity's transfer pricing position, as the information you provide to Inland Revenue will also be used to assess whether the entity is compliant in its transfer pricing practices.

Inland Revenue will also have information to review whether more in-depth review work is required of a particular taxpayer's transfer pricing practices.

In substance, the questionnaire asks relatively specific questions of taxpayers, requesting information pertaining to the following:

a. basic worldwide group details;

b. principal business activities;

c. the New Zealand entity's financial accounting information;

d. cross-border associated party sale and purchase of goods; and

e. disclosure of transactions with group entities with jurisdictions with perceived favourable tax regimes.

Our advice is that it is imperative to provide accurate responses that are representative of your entity's transfer pricing position, as the information you provide to Inland Revenue will also be used to assess whether the entity is compliant in its transfer pricing practices. Contextual information, clarifying comments and/or explanation should be supplied to elaborate on any of the answers provided if necessary. Our Transfer Pricing team is well placed to assist in the completion and/or review of the questionnaire and identify the responses that could potentially raise 'red flags' in the eyes of Inland Revenue and also any broader queries surrounding your transfer pricing needs.

Inland Revenue's International Wholesaler/Distributor questionnaire is due by **22 November 2019**.

Lucy Scanlon
Associate Director
Tel: +64 4 470 3502
Email: lscanlon@deloitte.co.nz

Eleanor Yew
Associate Director
Tel: +64 9 306 4413
Email: eyew@deloitte.co.nz

Provisional tax changes: Two years on

By Liz Nelson & Vicky Yen

We are now two years into the provisional tax and concessionary Use of Money Interest (UOMI) rules which were updated from the 2018 income year onwards. In summary, these rules meant UOMI would generally only apply from the last instalment date, provided tax was paid under standard uplift correctly and on time.

How has Inland Revenue in fact been applying the rules operationally? How have taxpayers' payment behaviours and tax pooling been impacted? What other legislative amendments are in the pipeline?

We have partnered with Tax Management NZ (TMNZ) to share some of our observations below.

Please note that safe harbour taxpayers are subject to other additional rules which are not covered by this article. If you have any questions please contact your usual Deloitte tax advisor.

Calculating uplift liabilities - the lesser of 105% and 110%?

It has come as a surprise to many that the standard uplift and UOMI calculations are not as clear as originally thought.

The general understanding was that taxpayers' standard uplift obligations should be calculated based on the most recently filed return (so either 105% of prior year RIT, or 110% of RIT from two years prior if the prior year return has not yet been filed), and that uplift for purposes of the UOMI rules would be determined on the same basis. As a result, we have seen many taxpayers make conscious decisions to delay or accelerate filing their prior year tax returns in order to benefit from lower provisional tax uplift liabilities.

Operationally however, Inland Revenue's system has applied a more flexible approach to taxpayers' advantage:

- If 105% is lower than 110%, 105% will be applied retrospectively to any previous instalment(s), irrespective of when the tax return is filed.
- If 105% is greater than 110%, uplift can be calculated based on the lower 110% amount for instalments prior to when the tax return is filed.

An amendment has been included in the Taxation (Kiwisaver, Student Loans and Remedial Matters) Bill, to retrospectively align legislation on UOMI calculations to what Inland Revenue's system is doing operationally. However, this amendment does not change the calculation of amounts payable under standard uplift, which remains based on the most recently filed return notwithstanding UOMI may not be charged on that basis. We are seeking further clarification from Inland Revenue on the inconsistency between uplift vs UOMI calculations and its expected implications.

Should I be filing an estimate?

Taxpayers still have the option of filing an estimate, if they believe their tax liability will be less than that calculated under the standard uplift method. However, the downfall of filing an estimate before the final instalment is that you automatically fall out of the concessional UOMI rules and will be charged interest if payments are not exactly aligned to what your final tax liability is for the year.

This can also have a flow-on affect to any provisional tax associates, as they will fall out of the concessional UOMI rules as well.

Therefore, our general advice would be to be very wary of filing estimates. If you do expect your tax liability to be less than that calculated under the standard uplift method, tax pooling is a good option for managing this (without filing an estimate and falling out of the concessionary rules).

However, there has been some confusion as to whether taxpayers need to file an estimate if they pay less than uplift at the final instalment.

Under current legislation, the technical position is that an estimate should be filed in such instances.

The Taxation (Kiwisaver, Student Loans and Remedial Matters) Bill includes proposed amendments such that from the 2019-2020 year, if taxpayers wish to remain under the UOMI concessionary rules, they can

At the end of the year taxpayers who use tax pooling could potentially align their tax payments to the UOMI calculation without being exposed to interest or penalties. This may result in an additional cash advantage from deferring tax payments

still pay an amount based on expected RIT for the year instead of uplift at the final instalment without filing an estimate.

Tax pooling

Tax pooling remains a useful tool to manage provisional tax obligations under the concessionary UOMI rules. The key benefits were discussed in our previous article. In summary, tax pooling provides taxpayers with the flexibility and hindsight to obtain optimal interest / penalty outcomes and cash flow benefits.

In recent discussions with Inland Revenue, inconsistencies have been highlighted between the rules used to calculate tax due at each instalment, compared to the (sometimes lower) amount that would be subject to UOMI at the end of the year.

Inland Revenue has clarified that the UOMI calculation is not a method for calculating the amount of provisional tax due at each instalment. At each instalment the methods as set out in the Income Tax Act 2007 (uplift, estimation, AIM etc.) should be used.

At the end of the year taxpayers who use tax pooling could potentially align their tax payments to the UOMI calculation without being exposed to interest or penalties. This may result in an additional cash advantage from deferring tax payments due at earlier instalments to the final instalment. However, taxpayers should be aware that this approach would not meet the "uplift" payment requirements to qualify for the UOMI concessionary rules. This would become especially relevant if, for example, the tax period is later subject to a reassessment (noting that the impact of reassessment could be mitigated if tax pools have a sufficient supply of tax which can be used for the appropriate tax pool arrangements).

Payment behaviour

Inland Revenue's rationale behind the UOMI rule change was to ensure taxpayers no longer carried a deadweight cost in the form of overpaid tax at earlier instalments. This appears to have been achieved.

TMNZ comments that the overall trend has been larger payments at the final instalment date, although this has not been as large as expected, as payment behaviour is still influenced by other factors such as a need to top up imputation credits at earlier instalment dates for dividend payments.

The rules have provided additional certainty and potential to defer a significant part of tax payable to the final instalment. This has in particular benefited taxpayers who have previously been in losses or had low levels of income, and also taxpayers with highly volatile income.

Taxpayers are now mostly familiar with how the 2018 rule changes apply in standard cases, however the rules can still be tricky to apply in unusual circumstances (e.g. non-standard number of instalments, transitional years etc.). In all cases it can be worth checking that Inland Revenue's systems have calculated the correct outcome (which does not always happen!), and working with your usual Deloitte tax advisor and tax pool support staff to identify potential savings or opportunities.

Other legislative amendments to be aware of

The following provisional tax amendments are part of the Taxation (Kiwisaver, Student Loans, and Remedial Matters) Bill.

- **Removing the ability for taxpayers to choose the provisional tax instalment to which a payment is applied**. The Commissioner will instead allocate the payment to the oldest debt first. Taxpayers could face further interest and late payment penalties at future instalment dates if they miss or underpay one of their earlier provisional tax payments.
- **Clarifying late payment penalties charged at the final instalment**. This is to correct an inadvertent legislative change and align to Inland Revenue's current approach, which calculates late payment penalties at the final instalment on the lower of the uplift instalment amount, or actual RIT divided by the number the instalments for the year.
- **Clarifying provisional tax truncation**. When Inland Revenue's system truncates provisional tax amounts to whole dollars, payment of those whole dollar amounts (rather than the amount including cents) will be deemed as satisfying the required liability for UOMI concessions.

Liz Nelson
Associate Director
Tel: +64 9 303 0841
Email: lnelson@deloitte.co.nz

Vicky Yen
Manager
Tel: +64 9 975 8610
Email: vicyen@deloitte.co.nz

Uncertain tax positions – it's now time to report these in your financial statements

By Iain Bradley and Belinda Spreeuwenberg

New accounting standards applying in 2018 and 2019 to for-profit entities that report under Tier 1 and Tier 2 (namely revenue from contracts with customers, financial instruments, and leases) have kept many accountants preoccupied, however there is a new interpretation that has not received the same level of attention.

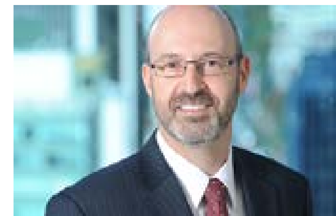
NZ IFRIC 23 *Uncertainty over Income Tax Treatments* clarifies how to reflect uncertainties relating to income taxes in financial statements, and applies for annual reporting periods beginning on or after 1 January 2019, with early adoption permitted.

We wrote about IFRIC 23 in our Tax Alert of November 2017, over two years before entities were required to comply with the interpretation. To summarise, the points to be aware of are:

- Uncertainty exists when it is uncertain whether the relevant tax authority will accept a tax treatment under tax law.
- Judgement is required to determine whether an entity should consider each uncertain tax treatment independently, or together with one or more other uncertain tax treatments.
- 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.
- Where the entity concludes that it is not probable that a tax authority would 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.
- Changes in facts and circumstances on which an earlier judgement or estimate of an uncertain tax treatment are based should be reflected as a change in accounting estimate. Examples include changes that arise upon the release of an Inland Revenue interpretation, court judgements, or the expiry of a tax authority's right to examine or re-examine a tax treatment.
- On initial application of NZ IFRIC 23, an entity can either restate comparatives if possible to do so without the use of hindsight, or adjust the cumulative effect of initially applying the interpretation in the opening balance of retained earnings.
- NZ IFRIC 23 does not introduce new disclosure requirements and instead the interpretation highlights disclosures that should be considered under other existing accounting standards.

If you haven't already done so, it is now time to consider uncertain tax positions and the extent these should be reported in your financial statements.

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



Iain Bradley
Partner
Tel: +64 9 303 0905
Email: ibradley@deloitte.co.nz

Belinda Spreeuwenberg
Manager
Tel: +64 9 303 0876
Email: bspreeuwenberg@deloitte.co.nz

Holding costs for privately used land that is taxable on sale – Should these be deductible?

By Emma Marr and Nicole Tan

Highlights from the IRD consultation document

In October 2019 Inland Revenue released a tax policy consultation document on Holding costs for privately used land that is taxable on sale. This outlines Inland Revenue's view on the way in which the current rules work for deducting land holding costs, and proposes two legislative changes to make them work as intended.

There is currently a lack of clarity around the deductibility of holding costs (for example, rates, interest, insurance, and repairs and maintenance expenditure) for land that is subject to tax on sale, and is used privately before sale. Inland Revenue's current view is that denying deductions for all holding costs for periods of private use would be the best option.

Further, if land is vacant for a period of time while it is held, but it is used for other periods of time, whether it is treated as being held privately or for income earning purposes will depend on what it is used for while it is not vacant (e.g. for a bach, whether it has been used privately or rented out for the periods it is not vacant).

Finally, the rules allowing deductions will need some tweaks to make them work properly.

Options for allowing costs to be deducted

The document considers three options for deciding what costs should be deductible. The first is to apportion the costs between the private use benefit, and the taxable gain on sale. The obvious problem is that it would be difficult to work out the value of the private use benefit, and, in Inland Revenue's view, apportionment would be inconsistent with other areas of New Zealand tax law.

The second option is to allow all deductions. This would be a generous solution, and unsurprisingly Inland Revenue didn't favour it, on the basis that this would allow deductions for private expenditure, which is inconsistent with an important principle of New Zealand's tax framework.

The third (and Inland Revenue's preferred) option is to deny all deductions for costs for periods when the land is used privately. Inland Revenue acknowledge this may seem unfair because it denies a deduction

for costs that relate to earning a taxable profit. Nevertheless, Inland Revenue viewed this unfairness as more palatable than the problems with the other two options.

Consistency across different types of entities

The IRD consultation document focuses mainly on individual ownership, but acknowledges that different entities can hold land. The question arises as to whether the approach should be the same across different types of entities and what the impact would be on taxpayer incentives if the approach was inconsistent. On the basis that people should not decide which entity to use in owning land based on the tax rules, the Inland Revenue concludes that the rules should be the same for every entity.

Periods of private use vs vacancy

The document considers how to treat costs incurred on vacant land. Inland Revenue concludes that whether or not it is held for private or income earning purposes will depend on how it is used for the majority of the time. For example, if it is usually a rental but vacant for a couple of months, it can be treated as held for income earning purposes. If it is a bach but vacant half the year, it will be treated as held for private purposes. If it is vacant all the time, to be able to deduct holding costs it will need to have been acquired with the purpose of earning income, otherwise it will be considered to be held for private purposes.

Legislative changes

Currently, the law is drafted so that the rule allowing costs for holding land to be deducted, is subject to two other rules:

- the general permission: this requires that for costs to be deductible they need to have a connection to earning income or carrying on business to derive income;
- the private limitation: this prevents deductions for costs that are of a private nature.

For land holding costs to be deductible where the land is held for private use, both of these provisions would have to be made subject to the rule that allows the deduction in the first place. The discussion document proposes a legislative change to make this happen.

If you would like to discuss the implications of these proposed changes please contact your usual Deloitte advisor.

For land holding costs to be deductible where the land is held for private use, both of these provisions would have to be made subject to the rule that allows the deduction in the first place. The discussion document proposes a legislative change to make this happen.

Emma Marr
Associate Director
Tel: +64 4 470 3786
Email: emarr@deloitte.co.nz

Nicole Tan
Consultant
Tel: +64 9 953 6091
Email: nicoltan@deloitte.co.nz

Snapshot of Recent Developments:

Policy and legislative developments

FIF deemed rate of return reduces

On 26 September 2019, an order in council came into force which reduces the deemed rate of return for taxing foreign investment fund interests to 5.86% for the 2018-19 income year (reduced from 6.44%). The rate is based on taking an average of the five-year Government bond rate at the end of each quarter, plus a margin of four percentage points. The cabinet paper which provides information to Ministers on how it is determined and the reasons for the change has been made available here.

Partnership Act re-enacted

The Partnership Law Act 2019 received the Royal Assent on 21 October 2019. The purpose of the Act is to re-enact, in an up-to-date and accessible form, the Partnership Act 1908. The Act does not make any substantive policy changes. It applies to every partnership regardless of when it was formed. Schedule 4 of the Act contains consequential amendments to a number of enactments including the Goods and Services Tax Act 1985 and the Income Tax Act 2007. This Act comes into force immediately after the expiry of the 6-month period that starts on the date of Royal assent, i.e. 22 April 2020.

Finalised determination for depreciation rate

The tax depreciation rate for pushrod/ cable propelled pipeline camera inspection systems (not including pipeline crawlers) has been finalised and will apply for the 2019 and subsequent income years. DEP105 provides for an estimated useful life of 4 years, a 50% DV rate or a 40% SL rate.

These rates have been added into the “Dairy Plant”, “Fishing", Medical and Medical Laboratory", “Oil and Gas” industry categories, and the “Compressed Air Plant (where not industry specified)”, “Factory and Other Sundries”, “Reticulation Systems including Power Generation (excluding electrical, communications and gas reticulation)” and “Water and Effluent Treatment (where not industry specified)" asset categories.

Draft Inland Revenue items released

What to do when GST incorrectly accounted for

A draft QWBA PUB 00352 has been released asking the question: “if a supplier determines they have incorrectly accounted for GST on a supply, can they make an adjustment under section 25 or are they limited to amending their return?” This situation could arise when a supplier subsequently offers a discount for poor quality, or when the supplier wishes to reduce consideration because GST was incorrectly charged.

Submissions close on 12 November 2019. Deloitte does not agree with the outcomes in this draft item and will be submitting. If ultimately Inland Revenue’s position is not changed, we will be advocating for a legislative change.

Alteration of rights attached to shares acquired for disposal

On 21 October 2019, Inland Revenue issued two draft rulings for consultation. The draft PUB 00369 is a re-issue of rulings BR Pub 17/04 and BR Pub 17/05 which are set to expire in March 2020. They concern an arrangement where a shareholder holds shares in a company and the shares were acquired for the purpose of disposal. Subsequently, the rights attached to the shares are altered and the following apply:

- The shares are in a company registered under the Companies Act 1993.
- The alteration is not structured as a cancellation and issue of shares.

Consistent with the rulings originally issued, the rulings conclude that:

- An alteration of share rights does not result in a disposal of personal property for the purposes of s CB 4.
- The time of acquisition of the shares where the rights attached to them are altered after acquisition is the time the shares were acquired before the alteration.

Once finalised, it is proposed that the rulings will apply for an indefinite period from 1 April 2020.

Short-stay accommodation

Inland Revenue has released a draft interpretation statement and two Questions We've Been Asked (QWBA) covering aspects of short-stay accommodation for consultation:

- PUB00347 (interpretation statement): GST treatment of short-stay accommodation. The draft confirms the supply of short-stay accommodation will not be an exempt supply and then discusses the requirements for registration, the main consequences of registration and what happens when the property is sold or the short-stay accommodation activity ceases.
- UB00346 (QWBAs): If property held in a trust is rented out by a beneficiary of the trust for short accommodation, who should declare the income, and what deductions can be claimed? The draft states that the income belongs to the beneficiary as they're the one granting the licence to the guests to stay. Non-capital costs related to the earning of income can be claimed although they may need to be apportioned if they also relate to private use of the property.

  If property held in a trust is rented out by the trustees for short-stay accommodation, who should declare the income? The draft states that income belongs to the trustees and will have to be declared in the trust's tax return unless and to the extent it is allocated as beneficiary income. Non-capital costs related to the earning of income can be claimed although they may need to be apportioned if they also relate to private use of the property.

The deadline for comment is 3 December 2019.

Tax payments – when received in time

On 21 October 2019, Inland Revenue released draft ED0221 which will update SPS 19/01 from 1 March 2020 (once finalised). The key changes to note are that:

- From 1 March 2020, Inland Revenue will no longer accept cheques as a method of payment for tax. Customers will be expected to explore other bank services. The Commissioner may agree in exceptional circumstances to receive a payment by cheque where a customer is unable to pay by any other means.
- From 1 July 2020, customers making over-the-counter payments at a Westpac branch must either include a barcode obtained from the letters, returns and statements issued by Inland Revenue, or create a barcode (through IR's website payment page) to provide clear payment instructions.

The deadline for comment is 13 December 2019.

Other items of interest

Unclaimed Money

Inland Revenue provides a service for the true owners of unclaimed money which has been left untouched for six or more years in companies such as financial institutions and insurance companies. Unclaimed money is not income tax refunds or any other unpaid tax refunds. This list and next steps to claim can be found here.

New Zealand Directory

Auckland Private Bag 115033, Shortland Street, Ph +64 (0) 9 303 0700, Fax +64 (0) 9 303 0701
Hamilton PO Box 17, Ph +64 (0) 7 838 4800, Fax +64 (0) 7 838 4810
Rotorua PO Box 12003, Rotorua, 3045, Ph +64 (0) 7 343 1050, Fax +64 (0) 7 343 1051
Wellington PO Box 1990, Ph +64 (0) 4 472 1677, Fax +64 (0) 4 472 8023
Christchurch PO Box 248, Ph +64 (0) 3 379 7010, Fax +64 (0) 3 366 6539
Dunedin PO Box 1245, Ph +64 (0) 3 474 8630, Fax +64 (0) 3 474 8650
Queenstown PO Box 794 Ph +64 (0) 3 901 0570, Fax +64 (0) 3 901 0571
Internet address http://www.deloitte.co.nz

Follow us on Twitter
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Queries or comments regarding Alert can be directed to the editor, Emma Marr, ph +64 (4) 470 3786, email address: emarr@deloitte.co.nz.

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The Editor, Private Bag 115033, Shortland Street, Auckland, 1140.
Ph +64 (0) 9 303 0700.
Fax +64 (0) 9 303 0701.

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