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Tax Alert

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In this issue:

Purchase price allocation: Using a sledgehammer to crack a chestnut

R&D tax credits – an ever evolving regime, even before first returns are filed

Are you aware of changes to the taxation of telecommunication and travel allowances?

Happy New Year – a taxpayer (pyrrhic) victory, and a refresher on extrinsic aids

Recent developments

Deloitte Tax Calendar – order yours now

Purchase price allocation: Using a sledgehammer to crack a chestnut

By Hadleigh Brock & Matthew Scoltock

In mid-December 2019, Inland Revenue released an officials' issues paper proposing legislation in relation to allocating purchase price where multiple assets are bought and sold in a single deal. This proposal has significant commercial and tax consequences for vendors and purchasers, both now and in the future.

Citing concerns that vendors and purchasers: (1) do not always agree upon how to allocate the purchase price across the assets being bought and sold, (2) sometimes fail to follow the agreed-upon allocation (where one exists), or (3) may agree to a purchase price allocation that does not reflect "market values", officials propose that vendors and purchasers be required to base their purchase price allocations on "relative market values" and consistently adopt the same purchase price allocations in their income tax returns to eliminate the risk of 'tax asymmetries' and loss of fiscal revenue.

The Proposal

Officials propose enacting the following rules in relation to sales and purchases that are "mixed supplies" (i.e., transactions that involve a mix of capital account assets and revenue account assets, depreciable and non-depreciable assets, etc.):

(1) that in all cases the vendor and purchaser be required to use the same allocation of the purchase price in relation to the different assets;

(2) that this be achieved by a 'hierarchy' of rules. If a vendor and purchaser:

   a. agree a purchase price allocation, both must file their income tax returns using that allocation;
   b. do not agree a purchase price allocation, then:

i. the purchaser must use the vendor's purchase price allocation when filing its income tax returns. In this case, it is proposed that there will be a requirement for the vendor to disclose its allocation to both the purchaser and the Commissioner of Inland Revenue ("Commissioner") within a specified period of time (for example, within three months after the assets are treated for income tax purposes as being disposed of by the vendor);

ii. if the vendor fails to provide that allocation, the purchaser may determine its own purchase price allocation, which must be provided to the vendor and the Commissioner, and must be followed by the vendor;

(3) that, notwithstanding (1) and (2), purchase price allocations must be based on "relative market values" (except, possibly, with respect to a non-agreed allocation of the purchase price to depreciable assets, in which case it is proposed that either tax-depreciated cost or original cost may instead be available);

(4) it may be appropriate to have a *de minimis* exemption to protect purchasers in low-value transactions from an "unexpected consistency requirement" (the example provided in the issues paper is that the *de minimis* exemption could apply where the amount allocated to deductible or depreciable items is less than NZ$50,000).

The issues paper notes that the Commissioner will retain the power to adjust any agreed-upon purchase price allocation if she considers that it does not reflect the "relative market values" of the assets. In addition, it is proposed that if the rules are not followed, the Commissioner will disallow the purchaser's income tax deductions.

It is clear from consultation to date, and from the issues paper, that a major concern of officials is the lack of 'tax symmetry' in a transaction that gives rise to tax-free capital gains in the hands of the vendor and, at the same time, generates an increased tax-depreciable cost base for the purchaser.

Initial Observations

Overall, we believe the proposal is a 'sledgehammer' reaction to a very specific and targeted concern which, we understand, relates to a relatively small amount of potentially lost revenue (noting that the issues paper does not disclose the potential tax at stake from the proposal).

It is clear from consultation to date, and from the issues paper, that a major concern of officials is the lack of 'tax symmetry' in a transaction that gives rise to tax-free capital gains in the hands of the vendor and, at the same time, generates an increased tax-depreciable cost base for the purchaser. For example, say a depreciable asset with an original cost of NZ$100 and a tax-depreciated cost of NZ$80 is sold for NZ$120. The vendor will have NZ$20 of depreciation recovery income and NZ$20 of capital gain. The NZ$20 capital gain will be tax-free in the hands of the vendor (as New Zealand does not have a comprehensive capital gains tax), but will also give rise to NZ$20 of future income tax deductions (in the form of depreciation) in the hands of the purchaser (assuming it is not related to the vendor).

The issues paper specifically refers to software and "fixed-life intangible property" as examples of assets in relation to which market values might be greater than original cost. It also refers to the sale of commercial real estate as an area of concern (e.g., in relation the allocation of purchase price between fit-out (depreciable for income tax purposes), building (depreciable at 0%) and land (non-depreciable for income tax purposes).

This issue has been on Inland Revenue's 'radar' for some time, and has more recently become a high priority, particularly given the Government's rejection of the Tax Working Group's proposed capital gains tax in 2019. During this time, there has been a visibly strong commitment from officials to pursue a legislative course of action rather than issuing, for example, a Revenue Alert, operational statement, or other form of taxpayer guidance. In our view, a non-legislative route is likely to have gone a long way to 'correcting' the type

of behaviour that officials are concerned with, without also having the potential to significantly impact commercial outcomes and disadvantage purchasers (in particular, New Zealand purchasers), as discussed below.

Competitive Processes

Our experience suggests that, in many cases, vendors and purchasers are already negotiating and agreeing purchase price allocations with regard to market values within the natural dynamic of a competitive deal. Everyone would agree that this is best practice.

Legislating for the vendor to (by default) have the power to set the purchase price allocation will create an asymmetry of bargaining power that might otherwise not exist. The allocation of purchase price in the context of mixed supplies can result in materially different economic outcomes for vendors and purchasers (particularly if the purchase price is allocated to non-deductible and non-depreciable assets such as goodwill and certain other intangible assets, etc.). That asymmetry is likely to be exacerbated in the context of a competitive deal (i.e., involving multiple bidders) in which bidders have different income tax profiles. The most obvious example is a New Zealand bidder vs. a foreign bidder, where the tax laws of its home jurisdiction allow a foreign bidder to amortize/depreciate (or otherwise claim an income tax deduction for) certain assets that a New Zealand bidder cannot amortize/depreciate (e.g., goodwill).

The issues paper dismisses that fundamental issue by stating that "taxpayers can decline to enter into an agreement", and "any disagreement as to the allocation can easily be dealt with by an adjustment in price". This, of course, demonstrates little regard for the way in which competitive, multi-party deals work. In our view, it is unlikely for a prospective purchaser to remain competitive and, at the same time, negotiate a lower deal value.

It is also clear that New Zealand bidders are likely to be most disadvantaged by the proposal due to the fact that most intangible assets are unable to be amortized/depreciated for income tax purposes (by contrast, in the United States (for example), goodwill and "going concern value" are generally amortizable over 15 years on a straight-line basis). Thus, a foreign bidder for New Zealand assets will often be indifferent as to purchase price allocation (as it will be able to amortize or depreciate the purchase price for income tax purposes irrespective of how it is allocated, particularly if the intangible assets are acquired in the foreign bidder's jurisdiction), and is therefore likely to have a competitive advantage over a New Zealand bidder as a result of the officials' proposal.

The other obvious issue is that if a deal is competitive and the vendor and purchaser are unable to agree a purchase price allocation prior to signing (which is not uncommon in relation to cross-border deals or deals negotiated on short timeframes), enactment of the officials' proposal will allow the vendor to - in substance - dictate terms and create uncertainty. Agreeing a purchase price allocation (or even agreeing to accept a vendor's purchase price allocation) is not always a realistic possibility, particularly when a prospective deal is in its early stages (e.g., where a vendor is accepting initial bids from a number of possible purchasers).

Whilst in large part detached from the commercial reality, the officials' issues paper is clearly a high priority for Inland Revenue, and is likely to become the 'world' in which all vendors and purchasers will unfortunately have to live.

Whilst the issues paper briefly notes that concern, the officials' suggestion as to how it ought to be addressed is relatively weak. Officials note that it may be appropriate for the legislation to include an implied term requiring vendors to "act reasonably". However, the real impact of that suggestion is likely to be minimal given that, in practice, purchasers would likely need to prove loss and seek damages, which would involve considerable time and costs.

Alternative Approach

Officials have been clear that the proposal is a response to positions that they have seen taken in relation to mixed supplies, and that there is a genuine issue that 'needs to be fixed'.

However, we believe it is misguided to propose a legislative change that will impact every mixed supply - and potentially have a detrimental impact on New Zealand bidders - rather than seeking to identify a fair solution that will address truly mischievous behaviour giving rise to tax asymmetries. A more commercially-minded solution might involve requiring greater disclosure; for example, requiring New Zealand taxpayers to disclose with their annual income tax returns the key facts of a deal (e.g., vendor, purchaser, nature of the business/assets, deal value, purchase price allocation, etc.), with penalties for non-disclosure. This would give the Commissioner the information needed to identify mischief in the market, would not impact the commercial balance of every mixed supply, and would give Inland Revenue the ammunition needed to remedy such mischief - particularly given that officials believe "in all cases allocations should be based on relative market values, and the Commissioner must have the power to adjust an allocation (whether or not agreed) that is not so based. Officials believe that **this is already the law**…" (emphasis added).

Final Thoughts

Whilst in large part detached from the commercial reality, the officials' issues paper is clearly a high priority for Inland Revenue, and is likely to become the 'world' in which all vendors and purchasers will unfortunately have to live. It is also clear that purchase price allocations will become an even more significant focus for Inland Revenue (irrespective of if/when the proposal is enacted, given the officials' view that it simply clarifies existing tax laws). Our only hope is that through public submissions the proposal develops greater regard for commercial impact and practical application (e.g., through an increased (and more sensible) de minimis threshold).

We expect the proposal to result in more vendors and purchasers agreeing to purchase price allocations (or mechanisms/methods for allocating the purchase price post-signing), noting that, in our experience, this is already regular practice. Sale and purchase agreements might also more commonly include purchase price allocations that are determined by third-party valuations.

The most important takeaway from the proposal, however, is that a vendor and purchaser must make every effort to agree a purchase price allocation as early as possible in the course of a deal, and ensure that it is applied consistently for income tax purposes. Vendors and purchasers need to engage their New Zealand tax advisors as early as possible to determine the income tax consequences of purchase price allocations, and to ensure that they are not adversely impacted in unforeseen ways.

Public submissions on the officials' issues paper close on 14 February 2020. We expect that the proposal will be included in a taxation bill in mid-2020, with likely implementation in early-to-mid-2021.

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R&D tax credits – an ever evolving regime, even before first returns are filed

By Aaron Thorn, Simon Taylor and Emma Faulknor

More changes to the research & development ("R&D") tax credit regime were announced prior to Christmas, when the Taxation (Kiwisaver, Student Loans, and Remedial Matters) Bill ("the Bill") was reported back to Parliament. The changes predominantly affect entities that earn exempt income and those who will be seeking a refund of the tax credit.

Current situation

In overview, the R&D tax credit regime provides a 15% tax credit for eligible expenditure incurred on qualifying R&D activities undertaken in the 2019/20 and later tax years. The R&D regime was legislated for in May 2019 through the Taxation (Research and Development Tax Credits) Act 2019. In June 2019 amendments to the regime were first proposed in the Bill. We provided an explanation of the changes proposed when the Bill was first introduced in our July 2019 Tax Alert (available here).

The changes announced in the original Bill were mainly to extend the refundability of the tax credit to a broader range of recipients, in recognition that the regime was of little use to many businesses in a tax loss position.

The changes proposed in the original Bill included:

- Extension of the refundability provisions from year two of the regime (the 2020/21 tax year), so that the R&D tax credit is refundable to the extent of payroll taxes paid in that year;
- Exclude all entities that earn exempt income (except exempt income from wholly owned groups or foreign company dividends) from the regime.

Exempt income exclusion

The initial proposal in the Bill was to change the refundability rules from year two and to exclude entities who derive exempt income from being an R&D tax credit claimant altogether. This proposal would have resulted in significant overreach as many taxpayers may earn small amounts of tax exempt income.

The Finance and Expenditure Committee has recognised that organisations receiving small amounts of exempt income would be unfairly excluded from the regime. The Bill as reported back therefore contains

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changes so that only entities that derive the following types of exempt income will be excluded from being claimants:

- Business and non-business income derived by charities;
- Income related to public and local authorities;
- Local and regional promotion bodies;
- Income derived by a tertiary education institution or subsidiary.

A charity may have subsidiaries that are eligible for the R&D tax credit provided the subsidiary is not a registered charity.

Charities that claim in year one but have excess R&D tax credits will forfeit the excess R&D tax credits and will be unable to carry forward the tax credits to year two. Other entities can still carry forward R&D tax credits, provided the shareholder continuity requirements are met.

The rationale for excluding charities from the regime is due to the benefit they already receive under the tax system, such as the exemptions from income tax, the donor tax credit regime and other GST and FBT concessions.

Once enacted the above proposals would apply from the 2020/21 tax year.

Refundability

In the reported back Bill, the Finance and Expenditure Committee has changed the name of the refund cap calculation from "payroll-tax based cap" to "refundability cap". The refund of the tax credit will continue to be based on Fringe Benefit Tax (FBT), Employer Superannuation Contribution Tax (ESCT) and Pay As You Earn (PAYE) paid but in response to submissions the reported back Bill also proposes a one-time concession to allow year one payroll taxes to also be included when determining what can be refunded in year two (i.e. to allow any 2019/20 R&D tax credit carried forward to be refunded if there has been sufficient payroll taxes paid).

We note that the calculation still largely remains the same, which means that the regime remains unfavourable for organisations, such as start-ups, that use contractors instead of hiring employees and do not pay payroll taxes. Unfortunately it seems unlikely that this will be reviewed before the five-yearly evaluation of the regime.

Considerations for year two

There are already claimants (including a number with December balance dates) who have now entered year two of the regime. Although the regime has always required contemporaneous documentation to be maintained, from year two the

process for applying for the R&D tax credit includes a pre-approval process.

The two approval regimes are a general approval regime, and, for claimants with more than $2 million of eligible R&D expenditure, the significant performer regime. These regimes are explained further in our July 2019 Tax Alert referenced above.

Pre-approval deadlines under both regimes are the seventh day of the second month after the end of the income year, but claims can be submitted throughout the year. The changes in respect of these regimes proposed in the Bill as reported back are:

- General approval is binding on the Commissioner, and
- Significant performers must obtain criteria and methodologies approval (this was previously optional).

It is important that businesses implement systems to gather information to obtain approvals throughout the year, so they are ready by the approval deadlines.

What to do next?

As a reminder, we recommend talking to those responsible for R&D in your business to gauge the level of eligible activity occurring. Deloitte is happy to assist with this stage and our R&D experts have experience with a wide range of technical activities and industries.

If you do have an eligible R&D activity, then you will also need to check your documentation processes to see whether adequate records are in place to track eligible projects and expenditure.

If the above sounds like it might apply to you, please contact one of us, or your usual Deloitte advisor.

It is important that businesses implement systems to gather information to obtain approvals throughout the year, so they are ready by the approval deadlines.

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Are you aware of changes to the taxation of telecommunication and travel allowances?

By Sarah Kennedy

Late last year Inland Revenue finalised its views on the taxation of telecommunication allowances/reimbursements and employer provided travel.

This guidance is relevant to any employers who provide phone allowances or reimbursements to employees using their own devices / usage plans, and for all employers who pay for or reimburse for travel costs. Employers should review their compliance with this guidance and make any updates to existing policies as a matter of priority. If you are interested in reviewing your existing policies and practices in light of Inland Revenue's recent publications, please contact your usual Deloitte advisor.

We outline the key aspects of "Determination EE001: Employee use of telecommunications tools and usage plans in their employment" and "OS 19/05: Employer-provided travel from home to a distant workplace – income tax (PAYE) and fringe benefit tax" below.

Use of employee provided telecommunication tools and usage plans in employment

Inland Revenue has set out three standardised options for identifying the exempt portion of telecommunications reimbursement or allowance for employee provided devices (sometimes referred to as a "bring your own device" or "BYOD" arrangement). Employer provided devices and usage plans will still be subject to FBT and the business tools exemption (as applicable), rather than falling into this new classification.

The key take away is that the old "50% rule of thumb" where employers treated 50% of an allowance/reimbursement as exempt can no longer be used. Instead, there are three new rules proposed – 25%, 75% and a 100% de minimis rule. Employers can also choose a different method to these three options if they have sufficient supporting data to justify it.

Given this, employers should be reviewing allowance policies now to ensure they are compliant with the new Determination as soon as possible. It applies from 20 December 2019.

The starting point is that if the allowance/reimbursement only covers the business use of the device, then the payment will be fully exempt. However, if the payment covers some private use then the three classes available should be considered. The three classes are as follows:

Class A

- Applies if the principal use of the device / usage plan is for employment.
- 75% of the allowance or reimbursement will be exempt.
- Employers need to demonstrate reasonable judgement in determining whether the principal use is employment. This can be based on time spent, a staff survey or signed declarations from employees confirming principal use.
- Class A can also apply to under 50% business usage in some limited situations where on call requirements mean it is very important for employees to be available at all times for calls.

Class B

- Applies if the device / usage plan is required for business (i.e. it is necessary, not a "nice-to-have") and the device / usage plan is not principally used for employment.
- 25% of the allowance or reimbursement will be exempt.
- An employment policy (noting the business reasons for needing a device) will sufficiently support using Class B provided that some actual business use by employees occurs over time.

De minimis Class C

- Applies if the amount reimbursed is $5 a week or less (maximum of $265 a year).
- 100% of the allowance or reimbursement will be exempt.
- No records are required to support this de minimis level of reimbursement.

While pragmatic in parts, there are some complexities involved in applying the apportionment classes. Employers will need to invest some time in gathering further evidence, developing signed declarations or refreshing employment policy documents in order to align with Inland Revenue's new approach.

Employer-provided travel from home to a distant workplace

As working and living arrangements grow in flexibility and complexity, Inland Revenue is aware that many employers are uncertain as to the proper tax treatment of employer provided travel. On 18 December 2019, Inland Revenue released its final operational statement to "clarify and simplify the tax rules around employer-provided travel to distant workplaces".

Applying this statement is compulsory from 1 April 2020 and optional from the date of issue. Employers do not have to correct historic positions if they are different to the positions in the operational statement and the Commissioner will not be looking backwards except in cases of identified tax avoidance.

As a starting point, the cost of commuting between home and work is private expenditure of an employee, and employer payments for travel from home to a workplace are usually taxable.

However, Inland Revenue recognises four exceptions to this:

1. The travel is one-off or very occasional (de minimis);
2. The travel relates to a temporary posting or secondment (up to two years);
3. The employee also genuinely works at a hometown workplace (meaning they have two workplaces);
4. The employee works from home on specified days and the travel relates to one of those days.

This guidance is relevant to any employers who provide phone allowances or reimbursements to employees using their own devices / usage plans, and for all employers who pay for or reimburse for travel costs.

In our view, the requirement for fixed "work from home" days is unlikely to reflect commercial reality for a number of employers. This is because many flexible working arrangements have some variability based on business need (for example allowing "work from home" and "work from office" days to be switched if there is an important meeting on a day that an employee ordinarily works from home)

The travel is one-off or very occasional (de minimis)

Any incidental travel, for example attending a conference, will not be subject to tax. This rule applies regardless of whether the employee ordinarily works from home or at an office.

The travel relates to a temporary posting or secondment

If travel to a distant workplace is reasonably expected to last for less than two years, it is not taxable (this aligns with the treatment of accommodation for secondments). However, if at any point the expectations for the period of travel change, then the tax treatment changes from the date of that change in expectation.

The employee also genuinely works at a hometown workplace (meaning they have two workplaces)

Travel to a distant workplace for a period of greater than two years is generally taxable unless an employee has multiple workplaces (e.g. Auckland office and Wellington office) which means that travel between these workplaces can be non-taxable on an ongoing basis.

It is possible to meet the multiple workplace test where one of these workplaces is an employee's personal home. This requires both a clearly documented multiple workplace arrangement and a business need for the employee to work from home (this need must arise from the nature of the work rather than from the personal choice or personal circumstances of employee).

The employee works from home on specified days and the travel relates to one of those days.

Where an employee contractually and actually uses their home to work, travel to a distant workplace on these "work from home" days is non-taxable. One key point to note here is that this non-taxable treatment only applies when the travel occurs on the fixed "work from home" day.

In our view, the requirement for fixed "work from home" days is unlikely to reflect commercial reality for a number of employers. This is because many flexible working arrangements have some variability based on business need (for example allowing "work from home" and "work from office" days to be switched if there is an important meeting on a day that an employee ordinarily works from home). Having these variable arrangements in place means that travel from home to a distant workplace will be taxable.

Next steps

As the telecommunications tools determination is an interpretation of the law as it stands, employers with BYOD policies should make reviewing compliance with the statement and making updates to their telecommunications policies a matter of priority. In addition, employers should be reviewing all travel-related payments provided to employees, particularly recurrent payments, prior to 1 April 2020 when these rules become compulsory to apply.

If you are interested in reviewing your existing policies and practices in light of Inland Revenue's recent publications, please contact your usual Deloitte advisor.

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Happy New Year – a taxpayer (pyrrhic) victory, and a refresher on Parliamentary sovereignty

By Campbell Rose and Michael McInerney-Heather

A Court of Appeal judgment released in late 2019 – a taxpayer win – serves as a useful reminder of some fundamental statutory interpretation principles. That same day, the Government moved quickly to overturn its outcome, by announcing a legislative amendment to be included in the current Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill when that Bill has its second reading. Despite this, the Court has sent a clear signal that tax law is to be construed by reference to its text and Parliament's purpose, not through the lens of tax policy officials' comments.

Background and first stage of statutory interpretation

In *Roberts v CIR* [2019] NZCA 654, the Court had to decide whether the forgiveness of debt owed by a charity was a "gift [of money]" or a "monetary gift" of $5 or more that was paid by the creditor (Mrs Roberts). If so, Mrs Roberts was entitled to the tax credits that she claimed in respect of the debt forgiveness.

Inland Revenue's Disputes Review Unit had sided with the Commissioner at the conclusion of the pre-litigation disputes process, but Mrs Roberts successfully challenged this in the High Court.

The Court of Appeal started its analysis by referring to the dual requirements of section 5 of the Interpretation Act 1999, namely, that the text of a statutory provision and its purpose will determine the correct interpretation. Justice Stevens observed that even when a meaning of a provision appears clear, it is necessary to cross-check that meaning against its purpose (and where the meaning is not clear, context and purpose become essential guides to meaning).

In relation to the ordinary meaning of the statutory text, the Court agreed with Mrs Roberts, that "monetary" and "money" mean more than just cash, and have a wider definition for the purposes of the tax credit rule.

Use of legislative history/extrinsic aids

In seeking to cross-check that conclusion against Parliament's purpose, the judge noted that Inland Revenue had placed "considerable emphasis" on what it described as "compelling" extrinsic interpretative aids and legislative history, to identify that purpose. Inland Revenue referred to comments by its tax policy officials in two discussion documents (published in 2001 and 2006), in commentary to a tax bill introduced in 2007, and in an officials' report to the Finance and Expenditure Committee in November 2018 regarding a proposed legislative amendment to overturn the High Court's decision in Roberts. These officials' comments were said to support Inland Revenue's argument that Parliament's purpose was to exclude debt forgiveness and only include "cash" gifts within the ambit of the tax credit rules (i.e. a transfer of money from donor to donee).

The Court of Appeal observed that these extrinsic aids did not analyse the boundary between "cash" and "non-cash" donations, nor were they precise in terms of what those terms mean. Justice Stevens noted that the reference to "cash donations" in those documents differed from the statutory language. His Honour then set the scene for a refresher on statutory interpretation by stating that "imprecise paraphrases of this kind [do not] provide any real assistance in interpreting the statutory language".

Although there had been somewhat of a "disconnect" for a number of years between the actual wording of the legislation and the commentary/discussion generated by officials, there was "no support" for the Commissioner's interpretation that required a donation to be "in cash". The clearest guidance from the Court in this respect is worth setting out in full (from paragraph [62] of the judgment):

> Comments in reports by officials about 'cash' do not assist the Commissioner when that is not the wording of the statute (...) The task of the Court is to interpret the words used in the statute, not paraphrases, and in particular imprecise paraphrases, used in discussion papers and officials' reports. We should add that comments by officials, unless they form part of the parliamentary record, are not an especially reliable, or orthodox, form of legislative history.

In relation to the November 2018 amendment (which sought to overturn the High Court judgment), his Honour rejected Inland Revenue's submission that that subsequent amendment confirmed it was not Parliament's purpose for gifts of forgiveness of debt to qualify for donation tax credits as having 'no merit'. In this regard, the Court described the officials' report in respect of that amendment as expressing the "so-called" policy intent for the first time (to address the issue of forgiveness of debt).

Policy grounds

Finally, the Court of Appeal did not find any of the policy grounds advanced by the Commissioner to be persuasive.

An argument by Inland Revenue that finding against it would result in significant compliance and administrative costs was said to be "exaggerated" (and Parliament could address any such concerns through more detailed and specific drafting of the relevant rules). Inland Revenue's concerns about tax avoidance opportunities if Mrs Roberts' argument was accepted were "overstated".

The Court closed by observing in relation to policy grounds that such arguments:

> (...) cannot succeed in carrying the day in circumstances where the words used in the statute do not support the Commissioner's case and the legislative history is at best unhelpful.

Observations

In practice we often see Inland Revenue referring to discussion documents and officials' reports in seeking to establish application of the general anti-avoidance rule. The courts have confirmed that – in that context – those materials can provide some assistance.

However, the Court of Appeal's statements in Roberts serve as a clear reminder that, when construing tax legislation on a black letter basis (before any potential application of the general anti-avoidance rule), the words of Parliament (including the Parliamentary record such as Hansard) are critical. Inland Revenue cannot simply rely upon its own officials' statements regarding Parliament's purpose. The Court has made clear that officials' comments must be treated with caution given they are not a "reliable" or "orthodox" extrinsic aid to interpreting legislation.

All of which serves to underscore the crucial importance of getting the legislation as clear as possible in the first place. In a world where the volumes and complexity of tax legislation passing through Parliament each year are increasing exponentially, getting it 'right first time' through drafting unambiguous tax rules is critical to the smooth functioning of New Zealand's tax system. Or – where the first attempt has not quite hit the mark, then equally critical is an effective process by which post-enactment reviews and remedial amendments are considered and implemented.

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Snapshot of Recent Developments:

Tax legislation and policy announcements

KiwiSaver Bill reported back

On 18 December 2019, the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill, introduced on 27 June 2019, was reported back to Parliament. Broadly the key measures of this bill include:

- Allowing KiwiSaver members to change their contribution rates through their scheme provider or Inland Revenue, in addition to through their employer.
- Allow the Commissioner of Inland Revenue to change the tax rate applied for portfolio investment entity (PIE) investors in a greater variety of circumstances, rather than leaving the onus solely on the investor.
- Broaden eligibility for refundable research and development tax credits.
- Exempt overseas-based borrowers with serious illnesses or disabilities from being required to pay interest on student loan repayments.
- Making numerous remedial and technical amendments to a wide variety of income tax issues, some of which we will pick up in future issues of Tax Alert, once enacted.

The bill will undergo its second reading in the house once Parliament has resumed in February and is expected to be enacted before the end of March 2020.

New DTA with China is now in force

On 27 December 2019, the New Double Tax Agreement between New Zealand and China (DTA) came into force. It replaces an earlier agreement dating back to 1986 and therefore provides a modern set of tax rules to deal with double tax issues. The new DTA with China does not extend to Hong Kong, which is managed by a separate DTA.

The new DTA intends to provide cross-border investors with more certainty about tax treatment, particularly for dividends, interest and royalties. The DTA introduces a lower withholding tax rate for dividends where the beneficial owner is a company that has held a direct interest of at least 25% of the capital of the company throughout a 365-day period that includes the payment date.

The new agreement also reflects recent work by the Organisation for Economic Co-operation and Development (OECD) on base erosion and profit shifting (BEPS). The new agreement includes a number of anti-BEPS measures to improve the ability of both countries to detect and prevent tax evasion. That is, it now incorporates many of the MLI articles.

The DTA will apply from 1 January 2020 in respect of withholding taxes and to taxable income years beginning on or after 1 January 2020 for income and other taxes.

For more information about this new DTA see our earlier article.

Government to clarify donation tax credit rules

On 17 December 2019, Revenue Minister Stuart Nash announced that the Government would move to restrict the issuance of donation tax credits and gift deductions to cash donations (including payments made by credit card or bank transfer). The announcement follows a Court of Appeal decision that ruled that, under current law, donors are entitled to claim a tax credit or gift deduction on debt forgiveness. The proposed change would be included as a late item in the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Bill due for its second reading in Parliament in early 2020. Refer to our other article in this edition of Tax Alert: Happy New Year – a taxpayer (pyrrhic) victory, and a refresher on Parliamentary sovereignty.

Tax treatment of operating leases

Late last year, the Government released details of proposed changes that would allow taxpayers who apply IFRS 16 to more closely follow their accounting treatment of leases for tax purposes if they choose to. This has come about because IFRS 16 removes the accounting distinction between operating and finance leases. The proposed changes would only apply for the person using the asset (the lessee), not the person supplying the asset (the lessor), and would also only apply to taxpayers with IFRS reporting obligations for income years starting on or after 1 January 2019. The proposed changes will be included in a tax bill planned for introduction early in 2020.

A fact sheet has been released to explain the proposed changes.

These new rules would apply to taxpayers with IFRS reporting obligations for income years starting on or after 1 January 2019, to align with the commencement of IFRS 16. Early adopters may be able to agree a filing position using this basis with Inland Revenue even though the tax rules are not enacted.

Draft Inland Revenue items released

Distributions from foreign trusts

On 19 December 2019, Inland Revenue released IS 19/04: Income tax – distributions from foreign trusts. This interpretation statement discusses the tax treatment of New Zealand residents from overseas who receive amounts of money and property that are potentially distributions from trusts. It covers how to determine if the amounts come from a trust, whether they are beneficiary income or a taxable distribution from a foreign trust, and the ordering rule (s HC 16) in the Income Tax Act 2007. It also considers the law of administration of deceased estates. The interpretation statement will be useful for the significant number of migrants to NZ and the many New Zealanders with relatives overseas. This was covered in our October 2019 Tax Alert article.

Trust property as it relates to short-term rentals

Inland Revenue have published and finalised two further Questions We've Been Asked, relating to the income tax and GST consequences of providing short-stay accommodation through peer-to-peer websites such as Airbnb, Bookabach and Holiday Houses.

- QB 19/15 explains how the income tax rules apply if property held in a trust is rented out by a beneficiary of the trust.
- QB 19/16 explains how the income tax rules apply if property held in a trust is rented out by the trustees.

Treatment of alteration to rights attached to shares

Inland Revenue has released finalised public rulings BR Pub 19/05 and BR Pub 19/06 on the treatment of alteration to rights attached to shares under s CB 4 of the Income Tax Act 2007. The updated rulings discuss arrangements where a shareholder holds shares in a company and where those shares were acquired for the purpose of disposal. The rulings conclude that an alteration of rights attached to shares does not result in a disposal of personal property for the purposes of s CB 4 and that the time of acquisition of a share with altered rights held on revenue account is the time the share was acquired before the alteration.

Draft statement on charities and donee organisations

On 16 December 2019, Inland Revenue released ED0207/a and ED0207/b, which are draft standard practice statements on the treatment of charities and donee organisations respectively. The statements set out how Inland Revenue and Charities Services will monitor and advise charitable entities of the requirements for income tax exemption and donee status. The purpose of the statements is to assist organisations in the charitable and not-for-profit sectors to understand their tax obligations and the tax exemptions available to them. Comments close on 14 February 2020.

New bloodstock rules - standout yearlings at Karaka 2020

As a result of legislation passed last year, new rules allow new bloodstock investors to claim tax deductions, as though they had a bloodstock breeding business, if they purchase a standout yearling with an intention to breed from the horse in the future. The aim is to incentivise new investors into bloodstock breeding while targeting the best yearling prospects.

Inland Revenue has published minimum purchase costs and criteria to meet. To be eligible for the policy, the investors will have to provide Inland Revenue with evidence within four months of acquiring the yearling that they intend to derive a profit from breeding the high-priced yearling. Inland Revenue has set out a list of information to be submitted when making applications.

NSC 2020: National Standard Costs for Specified Livestock

Released on 28 January 2020, this determination is made under section EC 23 of the Income Tax Act 2007 and applies to any specified livestock on hand at the end of the 2019-2020 income year where the taxpayer has elected to value that livestock under the national standard cost scheme for that income year.

Other items of interest

Update on Australian corporate residency rules

The Australian Board of Taxation has been reviewing the Australian corporate tax residency rules in the wake of concerns raised following its finalised practical guidance on the central management and control tests of corporate residency. The Board has now released two consultation papers on this topic, the last one in December 2019. Submissions closed on 31 January 2020.

Late last year the Australian Tax Office also published an update to PCG 2018/9. The Guideline contains practical guidance to assist foreign incorporated companies and their advisors to apply the principles set out in TR 2018/05: *Income tax: central management and control test of residency.* The specific updates to PCG 2018/9:

- extend the transitional compliance approach period for companies that are taking active and timely steps to change their governance arrangements in line with the approach;
- confirm the transitional and ongoing compliance approaches on penalties for failing to lodge taxation documents;
- clarify that Australian directors flying overseas to attend board meetings where the company has a substantive commercial presence is not considered an 'artificial or contrived arrangement';
- clarify in the ongoing compliance approach that decisions undertaken by circular resolution are captured when it is considered whether a substantial majority of central management and control is exercised in a foreign jurisdiction;
- provide that tax residency for companies operating wholly offshore will often be regarded as 'low risk' due to permanent establishment or branch exemption rules.

Deloitte Tax Calendar – Order yours now

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