Tax Tips
April 2021

➨ Parliament passes omnibus tax bill

The Taxation (Annual Rates for 2020-21, Feasibility Expenditure and Remedial Matters) Act (the Act) recently received the Royal assent and has since come into force.

The Act extends the bright-line test for residential property (refer to our March Tax Tips Alert here) and also contains a number of other changes including:

- a new business continuity test
- deductibility of feasibility expenditure
- purchase price allocation
- leases subject to IFRS 16 (leases)
- goods and services tax (GST), and
- donated trading stock.

We have previously published a Tax Tips here detailing the key changes. In this issue, we consider the amendments arising from the Finance and Expenditure Select Committee's recommendations following the submissions process, and we also discuss new measures that were introduced by way of a supplementary order paper (SOP).

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New business continuity test

In 2019, the Government proposed to change the shareholder continuity rules and undertook early, limited consultation with certain stakeholders. The proposal was intended to make it easier for businesses (particularly SMEs and early-stage businesses) to maintain tax losses through capital structure changes. The Government accelerated the proposal in response to the economic uncertainty and increased changes to capital structures caused by COVID-19.

The Act provides for a new business continuity test to supplement the 49% shareholder continuity threshold. The change was introduced by way of a SOP to the omnibus tax bill, which means the detail has not gone through the formal consultation process (although officials have engaged with industry experts on a limited basis).

Under the business continuity test, tax losses can be carried forward where there is no "major change" in the nature of the company's business activities. This will be assessed based on factors such as:

- business processes
- use of suppliers
- markets supplied to, and
- type of product or service supplied.

However, it is recognised that businesses will naturally evolve over time resulting in a change to business activities and assets. Therefore, the rules provide for a number of carve-outs from what might otherwise be considered a "major change". These include changes to:

- increase efficiency
- increase the scale of the business
- keep pace with technology,
- product or service types, which relate to those already being produced by the business in some way.

The new rules are intended to increase business growth and innovation while helping businesses avoid the risk of forfeiting losses. The Act contains other concessions, such as treating companies as a single company where they are part of the same group immediately before and after an ownership continuity breach.

The new test applies from the 2021 income year, and can apply to losses from the 2013/2014 income year onwards. The test requires there to be no "major change" in the business activities for five years after a change in ownership.

There are certain limitations for mineral mining companies, finance companies, and companies taking bad debt deductions. The SOP also introduces a specific anti-avoidance provision that may be applied to treat a company as not meeting the new business continuity test. The rules are intended to avoid loss trading, which is where a company acquires another company with little economic basis other than to access tax losses. The regulatory impact statement notes that existing stocks of losses are around $44 billion.

No changes are proposed to the shareholder commonality rules (66%) for loss offset between group companies and for carrying forward imputation credits.

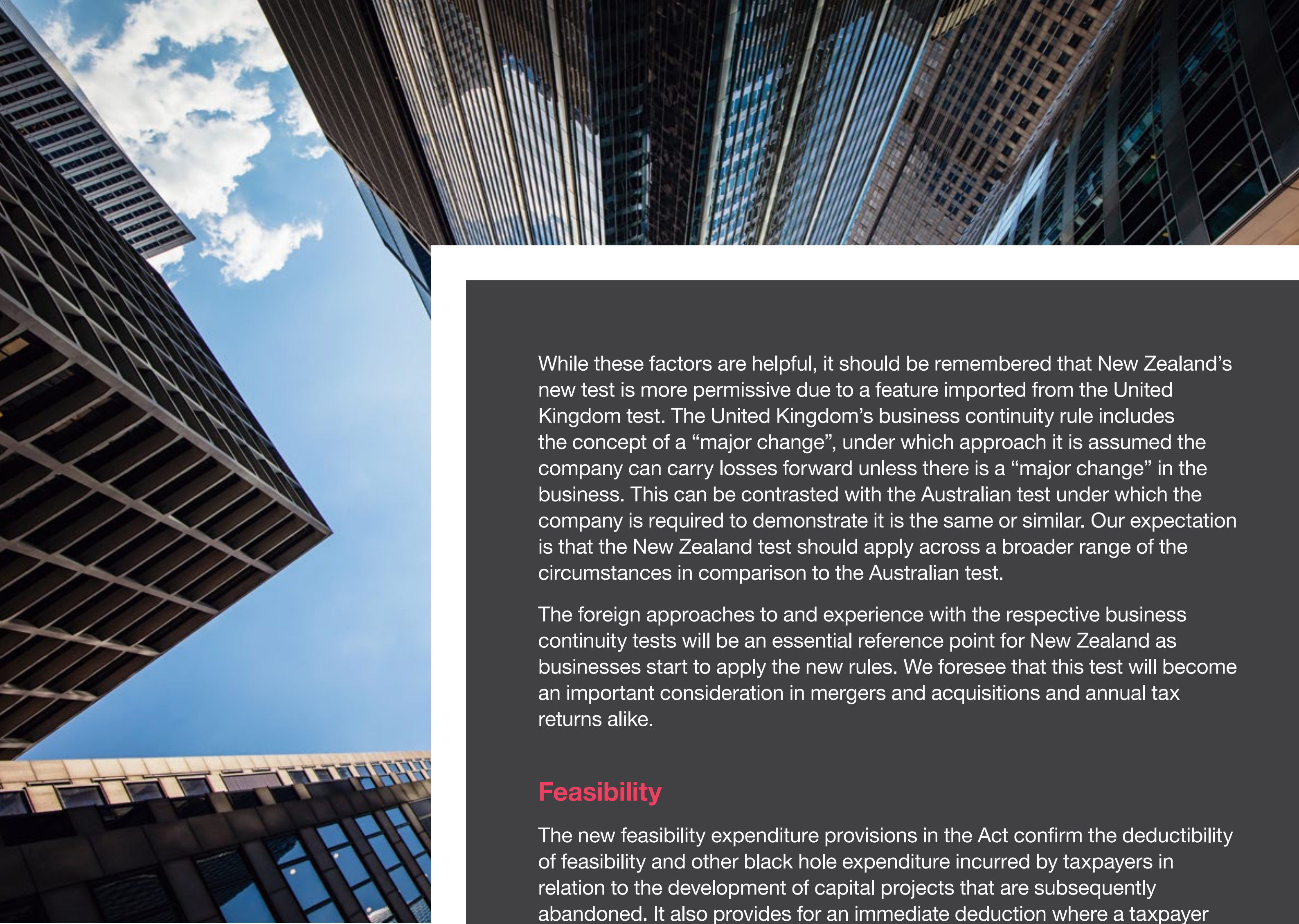
We welcome the changes to New Zealand's business continuity rules, which have been strict by international standards as noted by Treasury in the regulatory impact assessment. The changes will unlock some of the $60 million per year in tax losses that are usually forfeited following changes in ownership in New Zealand companies. Businesses who raised capital during the COVID-19 downturn will already be able to rely on this new test.

Insights from other jurisdictions

Inland Revenue has not yet published extensive guidance on the new test (but this is expected soon in a special report). In the meantime, it is helpful to consider guidance released in Australia and the United Kingdom, since New Zealand has based the new business continuity test on these jurisdictions.

The New Zealand test has primarily been described in government documents as being modelled on the Australian "similar business" test (a relatively new test introduced from 1 March 2019). The explanatory memorandum to the Australian legislation states the following as relevant factors when determining whether the business is "similar":

- the extent to which assets (including goodwill) that are used in the current business to generate assessable income were also used in the former business
- the extent to which the activities and operations from which the current business generates assessable income were also the activities and operations from which the former business generated assessable income
- the identity of the current and former business, which requires a broad-ranging inquiry into the characteristics and cumulative effects of the change
- the extent to which any changes to the former business resulted from the development or commercialisation of assets, products, processes, services, or marketing or organisational methods of the former business.



While these factors are helpful, it should be remembered that New Zealand's new test is more permissive due to a feature imported from the United Kingdom test. The United Kingdom's business continuity rule includes the concept of a "major change", under which approach it is assumed the company can carry losses forward unless there is a "major change" in the business. This can be contrasted with the Australian test under which the company is required to demonstrate it is the same or similar. Our expectation is that the New Zealand test should apply across a broader range of the circumstances in comparison to the Australian test.

The foreign approaches to and experience with the respective business continuity tests will be an essential reference point for New Zealand as businesses start to apply the new rules. We foresee that this test will become an important consideration in mergers and acquisitions and annual tax returns alike.

Feasibility

The new feasibility expenditure provisions in the Act confirm the deductibility of feasibility and other black hole expenditure incurred by taxpayers in relation to the development of capital projects that are subsequently abandoned. It also provides for an immediate deduction where a taxpayer incurs less than $10,000 of this kind of expenditure in an income year.

The new rules form part of the Government's agenda to increase innovation and provide support to businesses by reducing black-hole expenditure (non-deductible and non-capitalisable costs).

Prior to the decision in Trustpower Ltd v Commissioner of Inland Revenue [2016] NZSC 91, Inland Revenue considered that feasibility costs are deductible up until the point where the capital project was committed to (often referred to as the "commitment test"). However, the Trustpower decision significantly moved the boundary of the type of expenditure that is deductible. Specifically, a deduction is only available where feasibility expenditure is incurred as an ordinary and recurring incident of a taxpayer's business when:

- it is not directed towards a specific capital project, or
- if directed towards a specific project, it is so preliminary that it does not materially advance that project.

The Act introduces legislative amendments to reverse this and increase the availability of deductions for taxpayers incurring feasibility expenditure recognising that the blackhole expenditure distorts investment decision-making. For example, a business may be incentivised to complete a project to ensure the feasibility expenditure incurred is deductible as part of the resulting depreciable property. This creates an incentive for businesses to complete projects that, but for the lack of a deduction for costs incurred, would otherwise be abandoned.

The claw-back

As noted by officials, the clawback mechanism is an integrity measure designed to stop taxpayers from unnecessarily abandoning work on property, then subsequently reinstating it to obtain greater deductions. In these circumstances, taxpayers could effectively get two deductions for the same expenditure. The mechanism will operate to ensure no deductions are claimed relating to abandoned property if the property is reinstated.

While we supported the intent of the clawback, we had concerns that there would be significant difficulty in applying this rule, in particular in determining whether a particular project represents a restart of a project previously abandoned (in which case the clawback would apply) or is sufficiently different to the earlier project such that it can be considered a new project (in which case it will not). We are pleased to see that calls for a time limit of seven years on the application of the clawback is accepted.

We are also pleased to see officials' commitment to provide guidance on what factors will be considered when determining whether a project represents the restart of an earlier abandoned project. The Officials' Report indicates that this will be provided in the Tax Information Bulletin.

Declined submissions

However, we are disappointed that some substantive items have been declined, or at least deferred until Budget 2021 decisions are made. The declined submissions include proposals that:

- feasibility expenditure proposal should be backdated for projects abandoned because of the level 4 lockdown, such that taxpayers with a 30 June balance date would be able to claim deductions for projects abandoned due to COVID-19 between 1 April 2020 and 30 June 2020
- the immediate deduction threshold of $10,000 is too low and will not ease compliance or provide sufficient benefit to small businesses. This is further exacerbated in a COVID environment.

Other submissions also suggested extending the scope of the proposals to include "pre-commencement expenditure" that would otherwise be non-deductible as it would not satisfy the general permission. Officials agreed there were good reasons to allow a deduction for this sort of expenditure in the context of existing business, but were concerned about the fiscal and integrity risks.

Purchase price allocation

Following on from our June 2020 Tax Tips, the proposed tax rules in relation to the allocation of purchase price in a transaction involving a mix of assets for income tax purposes have since undergone significant consultation and, although the same general principles still apply, a revised set of rules has now become law. The rules apply to agreements entered into from 1 July 2021.

Overview of the revised tax rules

The new rules govern the way parties to a transaction must allocate a global transaction price across different classes of assets. The rules cover the situation where the transaction parties agree allocation, and also provide a default mechanism if no agreement is reached. In both instances, the allocation must ascribe relative market values to the assets, and the Commissioner of Inland Revenue may require the parties to adopt a different allocation if she considers that the allocation does not reflect market value.

Where the vendor and purchaser have agreed and documented a purchase price allocation before filing their respective income tax returns incorporating their tax position in relation to the transaction, section GC 20 of the Income Tax Act 2007 states that the parties must file in accordance with the agreed allocation. Agreement between the parties made within this timeframe will override any allocation made by the parties under the mechanisms outlined below.

Where the vendor and purchaser have not agreed an allocation before filing their tax position in relevant returns, section GC 21 contains three mechanisms to give an allocation for the parties to use. These mechanisms are:

1) Vendor allocation

In the first instance, the vendor may determine the allocation. If the vendor notifies both the purchaser and the Commissioner of this allocation within three months of the change of ownership in the assets occurring, the parties will be bound by the allocation. Both parties must then file tax returns based on this allocation. The allocation chosen by the vendor for a particular asset must not be less than the vendor's tax book value of the asset.

2) Purchase allocation

If the vendor fails to notify an allocation within the three-month timeframe, the opportunity to determine the purchase price allocation is transferred to the purchaser, who has a further three months to make their allocation. For the allocation to bind the vendor, the purchaser must notify the vendor and the Commissioner within the allocated time frame, with both the vendor and purchaser then bound to file their tax returns based on that allocation. Other than the requirement for the allocation to reflect relative market values, there are no constraints on the purchaser's allocation.

3) If no allocation is made by the parties

If neither party makes an allocation within six months of the change of ownership in the assets occurring, the Commissioner may allocate the purchase price across the assets at what she considers to be "market value", and the vendor and the purchaser are treated as disposing and acquiring the property for this deemed market value.

Until an allocation is made by one of the parties (and notified to the Commissioner), or by the Commissioner, the purchaser will be treated as having no cost base in the assets acquired. Deductions disallowed as a result of this rule are intended to be deferred rather than denied.

Exceptions for small transactions and some residential land transactions

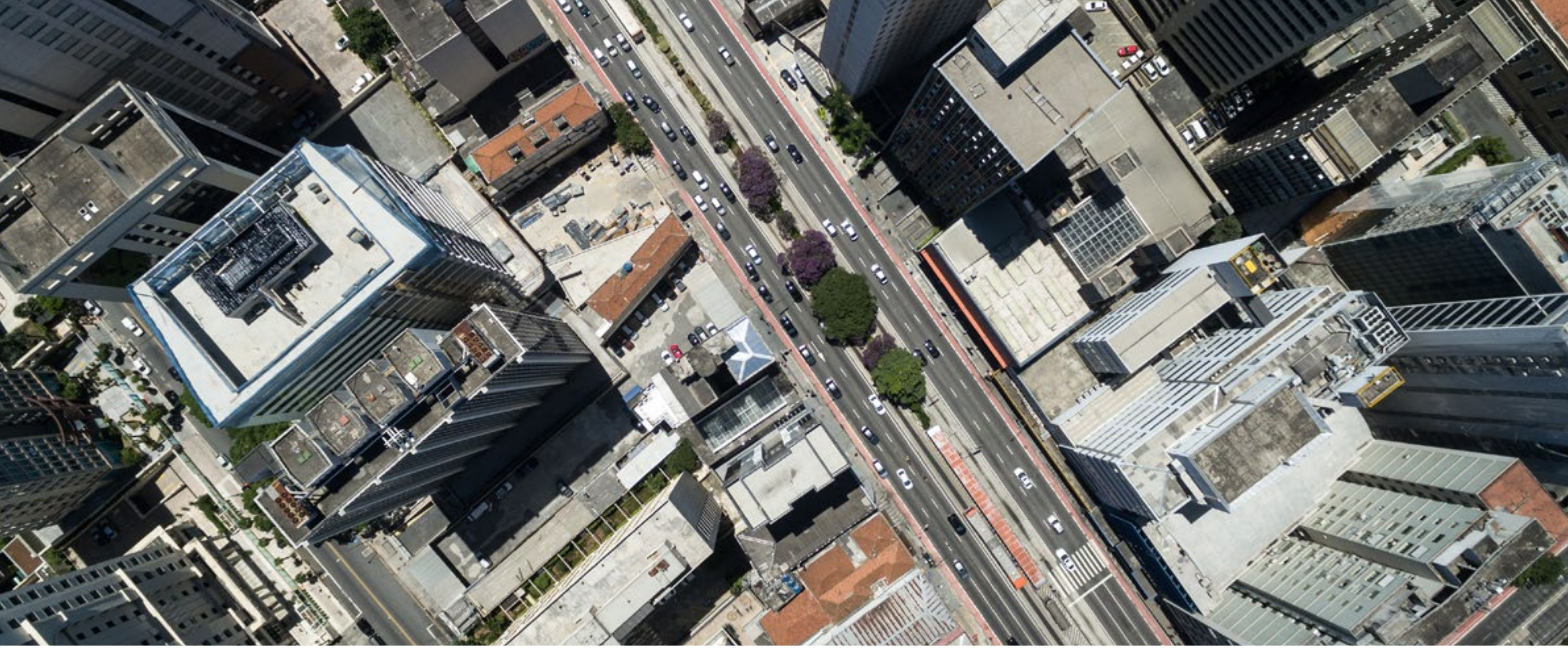
The new rules will always apply where parties have agreed an allocation. However, parties will remain free to choose their own allocations if either (a) the total purchase price is less than $1 million, or (b) the only property being disposed of is residential land together with its chattels, and the total consideration for them is less than $7.5 million.

A de minimis will also apply to the Commissioner's ability to challenge an allocation, with the Commissioner unable to challenge an allocation to an item of depreciable property if:

- the original cost of the property is less than $10,000; and
- the total allocated amount for the item and for any identical property is less than $1 million; and
- the allocated amount for the item is no greater than its original cost for and no less than its tax book value.

When the rules do not apply

The rules only apply where there are multiple asset classes in a transaction, and where the asset classes are treated differently from each other for tax purposes. Sales of shares or trading stock are not caught, but sales of businesses (via asset transfer rather than share transfer) or commercial properties will, in most cases, be in the rules.



Key changes to the rules since those proposed in the June 2020 Bill

Inland Revenue continued to refine its thinking and carried on consulting on what the new rules should look like following the introduction of the draft legislation in the June 2020 Bill. Policy officials took on board a number of submissions made on the detail of the rules to attempt to make them more practical, which was good to see, and this fed into their recommendations to the Finance and Expenditure Select Committee. Important changes include clarifying the timing of deductions where an allocation has been made late, and the interaction of these rules with other tax rules requiring market values to be used.

Degree of specificity

Under the new rules, the categories of allocation required are much clearer. Allocation is to be made across six defined property categories, namely:

- trading stock (other than timber or a right to take timber)
- timber or a right to take timber
- depreciable property (other than buildings)
- buildings that are depreciable property
- financial arrangements, and
- purchased property for which the disposal does not give rise to assessable income for the vendor or deductions for the purchaser.

Effective date deferred

The effective date of 1 April 2021, as proposed originally, has been pushed out to 1 July 2021 to give transaction parties a small amount of extra time to adjust to the new rules. This also gives relevant industry bodies such as the Auckland District Law Society and the Real Estate Institute of New Zealand time to update commonly-used contract templates.

Comments

It was encouraging to see some useful changes to the rules as enacted when compared to the proposals in the original bill, especially an exemption for sales of residential land and chattels under $7.5m, and clarity as to how the rules will interact with the Act's existing timing rules for the disposal of certain types of assets (financial arrangements, revenue account property, etc).

Despite these changes, we still consider that the default rules create a negotiating power imbalance in favour of the vendor over the purchaser (as the vendor is allowed the first go at making an allocation where no allocation has been agreed), although this is diminished compared to the original proposals. There also continues to be a lack of clarity as to how the rules will apply to purchase price adjustments occurring post-completion, such as earn-outs and warranty claims. Officials have indicated that they intend to undergo further consultation in relation to drafting rules to accommodate these. However, we do not know when this might occur.

The new purchase price allocation rules remain complex and represent a significant change to current market practice in some types of transactions. There are definitely challenges ahead in ensuring transaction parties and their advisers are up to speed on the new rules. Inland Revenue will have an important role to play in this. In most circumstances, our advice to clients has been to seek to reach express written agreement on price allocation with their counterparty to manage tax risk. This is now even more important to ensure the new default tax allocation rules do not apply. An alternative way of reaching agreement, or a way of supporting a particular allocation, is to obtain a third party valuation. These approaches will be the best way for the parties to achieve as much certainty as possible over their tax position following a change in ownership of assets.

IFRS 16 - leases

The introduction of International Financial Reporting Standard (IFRS) 16 has resulted in a difference in treatment between accounting and tax for leases that are considered operating leases for many tax purposes. The Act aims to reduce compliance costs for many taxpayers by allowing taxpayers to elect to adopt the IFRS 16 treatment, which removes the distinction between operating and finance leases for accounting purposes and, instead, requires all leases to be recognised on the balance sheet by recognising both a right-of-use lease asset and a lease liability.

Submissions generally supported closer alignment between the accounting and tax standards. The Finance and Expenditure Select Committee also considered the following issues:

Other adjustments

- We submitted that adjustments should not be required for impairments, revaluations and makegood expenditure because they would result in increased compliance costs for taxpayers. A number of adjustments require daily spreading over the remaining lease term that will need to be separately and manually tracked on an asset-by-asset basis. We said the maintenance of separate tax schedules would reduce the intended efficiency objective of the change.

  This submission was declined, noting certain concessions exist already - such as allowing straight line basis adjustments (i.e. no recalculation is required if the lease term is extended). However, officials acknowledged any timing benefit would be small on low value, short-term leases. A change is therefore made so that no adjustments are required to be made for those types of leases. A short-term lease is defined as four years or less and a low-value lease is less than $100,000.

Irrevocable election

- Some submitters said the requirement that taxpayers make an irrevocable election is too restrictive. While this was declined, an amendment to allow taxpayers to follow IFRS 16 for just one lease (for its duration) was made, so taxpayers can now apply the rules on a lease by lease basis.

GST

A number of changes to the Goods and Services Tax Act 1985 (GST Act) were made by the Act including:

- changes to the GST treatment of mobile roaming, so that inbound mobile roaming services are zero-rated or not subject to GST, and outbound roaming services are subject to GST at 15%
- changes to the credit note rules to clarify that a credit note may be issued to correct a supply which was incorrectly charged GST at 15% when it should have been zero-rated, exempt, or not subject to GST
- changes to limit the use of credit notes to errors that occurred four years before the error being corrected (or eight years to adjust an overpayment of tax that occurred due to a clear mistake or simple oversight), and
- remedial changes to the application of the compulsory zero-rating (CZR) rules for land leases.

The substantive proposals were covered in detail in our June 2020 Tax Tips. The Officials' Report recommended a limited number of minor technical changes to the Act to address submissions received. However, the amendments remain largely unchanged in substance.

Donated trading stock

Businesses that donated trading stock to help with the Covid-19 relief effort in 2020 found themselves faced with adverse tax consequences. An anti-avoidance rule applies when trading stock is disposed of for less than market value. The rules not only prevent the “donor” from receiving a donation tax concession, but it further deems the “donor” as deriving an amount of taxable income equal to the market value of the trading stock. These rules can act as a disincentive against businesses seeking to donate their trading stock in order to advance some sort of public good or address a pressing need (e.g. in response to COVID-19).

Last year, tax policy officials consulted on a proposal to switch off the anti-avoidance rule in certain circumstances to ensure that businesses donating trading stock could do so without facing a tax liability. The amendments made by the Act apply in relation to trading stock donated between 17 March 2020 and 16 March 2022. Trading stock donated to public authorities (e.g. district health boards), donee organisations, or other persons not associated with the donor during this period will not be subject to the anti-avoidance rule.

In our view, the amendment is a welcome and necessary one that ensures tax rules do not act as a disincentive to providing support in times of urgent and pressing need. Further, we note that the amendments include the ability to also turn off the anti-avoidance rule during a period outside of 17 March 2020 to 16 March 2022 by way of an Order in Council. Although we would have preferred that the amendments are not tied to a time period at all to provide greater certainty to taxpayers, we appreciate that the Order in Council approach does allow the Government to respond more quickly to the next adverse event.

General comment

This Act has enacted a number of significant changes that will impact a broad range of taxpayers. While some of the changes are intended to be business-friendly, the reality is that even those changes will result in more complexity for taxpayers to navigate.

Combined with other recently implemented tax changes (e.g. the increase of the personal tax rate to 39% and international tax changes) and those that have been announced (e.g. proposed changes to the deductibility of interest costs for residential investment properties), New Zealand’s tax landscape is quickly becoming murkier and, consequently, harder to navigate.

Please contact your usual PwC adviser to discuss how these new measures will impact your business.

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