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Tax Tips

Is your business on top of the latest tax insights?

August 2016

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New tax bill introduced

The Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill was introduced into Parliament earlier this month and contains three main policy proposals:

- changes to business taxation including a new method of collecting provisional tax
- implementing the G20/OECD standard for Automatic Exchange of Financial Account Information in Tax Matters, and
- changes to implement the disclosure requirements for foreign trusts recommended by the Government Inquiry into Foreign Trust Disclosure Rules.

We discuss and comment on the proposed changes in this edition of Tax Tips.

Business tax proposals

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The Taxation (Business Tax, Exchange of Information and Remedial Matters) Bill includes a raft of proposals aimed at making tax simpler for businesses.

As indicated in the Government's Budget earlier this year, the key proposed changes relate to provisional tax, withholding tax, and late payment penalties. Refer to our April 2016 edition of Tax Tips for more background about these changes.

We strongly support the proposals contained in the Bill. Continuing work by the Government and Inland Revenue to make tax compliance less painful for businesses is welcome. The Accounting Income Method proposals are a very significant step forward in the trend of business processes becoming more digital and requiring less human intervention. The challenge is to keep things simple and, at this early stage, the proposals seem to be on the right track. Other proposals including those in relation to withholding tax all make good progress towards simplifying tax for businesses.

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Accounting Income Method (AIM)

The Bill proposes a new method of paying provisional tax – the Accounting Income Method (AIM).

The AIM method allows smaller businesses (with turnover of less than $5 million) to use information in their accounting software to determine their provisional tax payments.

To facilitate the use of AIM, certain accounting software providers will extend the capability of their software to ensure the requisite tax adjustments are made throughout the year (i.e. they will provide an AIM-capable accounting system). Businesses that use the AIM-approved software will be able to calculate provisional tax based on their accounting results and pay it as it is earned rather than over three instalment dates (as is done under current methods).

Our observations

The rationale of embedding tax into the natural rhythms of running a business is a sound one and the AIM method has the potential to make calculating provisional tax much easier for many small businesses. However, the success of AIM will be highly dependent on the design and detail of this new approach. It is critical that the rules are kept as simple as possible (while still remaining fair). We provide further observations below on some of the additional detail included in the Bill.

Certification of AIM providers

The Bill proposes that accounting software providers must apply to the Commissioner of Inland Revenue for approval before offering AIM-capable products. However, this will be a self-certification process i.e. it is up to the providers themselves to determine whether or not they meet the requirements. The Commissioner maintains the ability to revoke an approval if the requirements are not met.

In addition, larger taxpayers with turnover higher than $5 million may use the AIM method as long as their tailored software package has been approved by the Commissioner first.

We expect that some of the more established accounting software providers will be early adopters of AIM. However, it will be interesting to see how the market develops. For instance, will accounting software providers be encouraged to become AIM-enabled to ensure their customers can use the AIM method?

It will also be interesting to see whether the benefits of using the AIM method for larger taxpayers outweigh the costs of working with software providers to develop an approved tailored AIM product.
In practice, the necessary tax adjustments may be more complex for larger businesses, requiring more investment than it is worth to develop a suitable product.

Use of Determinations

If the Bill is enacted as currently drafted, the Commissioner will issue a technical Determination detailing the core adjustments required to calculate a business's tax liability using AIM. An Inland Revenue working group will develop the Determination. This Working Group will consist of interested public and private sector parties, including representatives from the software and accounting professions.

We welcome the use of an open and transparent public consultation process as this will help to ensure that the adjustments included in the AIM method are fair and reasonable.

We stress that the tax adjustments required should be minimal to ensure the AIM method remains simple and easy to use, especially as it is targeting smaller businesses. A balance needs to be struck between practical applicability and the need to get provisional tax calculations absolutely right to reflect a business's tax liability for the year.

The Bill does not provide detail about all of the possible core tax adjustments. However, it does outline the following adjustments, which are based on public consultation to date:

- Tax depreciation
- Trading stock
- Temporary timing differences
- Provisions
- Financial arrangements / foreign exchange
- Shareholder salary accruals
- User defined entry

Tax depreciation – for tax depreciation to be calculated correctly, AIM software will be enabled to maintain depreciation schedules throughout the year. This will allow a taxpayer to then claim the correct tax depreciation to date at each provisional tax instalment.

While this approach sounds reasonable, the creation and maintenance of tax depreciation schedules should be as automated as possible to prevent any hidden compliance costs. In our experience, depreciation schedules can require a significant amount of manual input so software providers should ensure the process of maintaining a depreciation schedule for AIM is as simple as possible.

Provisions – the Bill proposes that all provisions accounted for are reversed for AIM purposes. As such, all provisions in the accounts will be automatically reversed (i.e. "added back") under the current proposals. While this is a straightforward approach, we think this could be overly simplistic and conservative, particularly in relation to provisions that meet the deductibility test (i.e. the amounts are definitively committed to and capable of estimation). As such, further consideration needs to be given to determine the types of provisions that should be reversed.

User Defined Entry – the Bill proposes that businesses should be able to manually override the AIM system if the core adjustments do not result in an accurate taxable income figure. As every taxpayer's circumstances are different, we agree in principle that taxpayers should have the ability to override the AIM software system when required. However, from a practical point of view, we question how Inland Revenue will build in the appropriate checks and balances to ensure any manual overriding is fair and reasonable.

Use-of-money interest (UOMI)

The Bill proposes that businesses using AIM and making the required payments will not be exposed to UOMI should their residual income tax liability change at the end of the year. UOMI will only apply if the businesses fail to pay the full amount that the AIM-capable software calculates. In our view, the removal of UOMI in this circumstance will help create certainty for businesses.

Withholding tax

The Bill also includes proposed changes aimed at modernising and simplifying the withholding tax rules. Proposals include:

- allowing contractors subject to the schedular payment rules to elect their own withholding tax rate (subject to a minimum rate)
- extending the schedular payment rules to contractors that work for labour hire firms, and
- allowing contractors not already covered by the schedular payment rules to enter into a voluntary withholding agreement with their payers.

Our observations

The proposals will make it much easier for contractors to comply with their tax obligations. However, we question whether the proposed new rules will introduce more complexity and compliance costs for businesses that deal with a number of contractors.

For example, under the proposed new 'elect in' rules, a contractor can decide their withholding rate without requiring the consent of the payer unless the contractor has previously changed their rate twice in the same income year. While this is a favourable outcome for contractors themselves, it can create an additional compliance headache for the payer. Payers may find it difficult to manage all of their contractors, particularly where contractors elect rates that are different to the 'default' or standard rate in the payer's system. Businesses that deal with a number of contractors will need to ensure systems are in place to track and amend rates where contractors choose to elect a different withholding tax rate.

While we generally support changes that help taxpayers ensure the right amount of tax is paid and appreciate that withholding tax is a good way to achieve this, we consider it is worthwhile to recognise the potential increase of compliance costs for the payers.

Other changes

The Bill also contains a number of small amendments including:

- the removal of 1% monthly incremental late payment penalties for income tax, GST and Working for Families tax credit overpayments
- changes to the 63 day adjustment rules giving businesses a choice to claim a deduction for employee entitlements paid out within 63 days of balance day
- allowing close companies to elect to use the motor vehicle expenditure rules instead of returning FBT on benefits provided to shareholder employees
- a new simplified method for calculating deductions for mixed use premises and vehicles
- the removal of the requirement to renew RWT certificates annually
- an increased threshold for returning FBT on an annual basis to $1 million of PAYE/ESCT.

These taxpayer-friendly amendments are a positive step towards making tax compliance just that little bit easier for businesses.

Automatic exchange of information

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The Bill proposes legislative amendments that will give effect in New Zealand to the OECD's Standard for the Automatic Exchange of Financial Account Information in Tax Matters (the AEOI).

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What is the AEOI standard?

We have previously discussed the implementation of the AEOI standard in New Zealand in our *Tax Tips published in February 2016.*

In summary, the AEOI standard was developed by the OECD at the request of the G20 countries as part of a global initiative to address tax evasion by persons holding wealth in offshore accounts. The AEOI standard enables the exchange between jurisdictions of certain information relating to financial accounts maintained by offshore persons.

The AEOI standard includes the Common Standard on Reporting, Due Diligence and Exchange of Information on Financial Account Information (CRS). Under CRS, financial institutions in participating jurisdictions are required to conduct specified due diligence procedures in relation to their financial accounts in order to identify those accounts held (or controlled by) non-residents, and to report certain information on those accounts to their local tax authority. The local tax authorities then exchange the information automatically with approved participating jurisdictions under the Multilateral Competent Authority Agreement.

As at 26 July 2016 101 jurisdictions had committed to implementation of the AEOI standard, including New Zealand.

Implementation of the AEOI standard in New Zealand

From 1 July 2017 New Zealand financial institutions including banks, fund managers, custodians, and brokers (NZFIs) must conduct due diligence to identify and report accounts maintained by non-NZ residents.

Where an account is maintained by a non-financial entity that derives predominantly passive income, the NZFI will need to look through the entity to determine whether the non-financial entity is controlled by non-NZ resident persons. These due diligence and reporting obligations are broadly similar to those imposed on NZFIs under the United States Foreign Account Tax Compliance Act (FATCA) rules, although there are a number of differences.

Similar to FATCA, the definition of an NZFI for the purposes of AEOI is broad and includes certain entities that would not normally be considered financial institutions e.g. NZ family trusts that are professionally managed and predominantly investing in financial assets will be NZFIs.

The specific due diligence and reporting obligations imposed on NZFIs will be phased in over time depending on whether accounts are new or pre-existing, maintained by individuals or entities, and in the case of pre-existing individual accounts, whether the accounts are of high value (generally, a balance exceeding US$1 million).

Key dates

- Due diligence requirements for NZFIs in respect of new accounts commence: ***1 July 2017***
- Deadline for NZFIs to complete due diligence procedures in respect of new accounts and pre-existing high value individual accounts: ***30 June 2018***
- Deadline for NZFIs to provide information to Inland Revenue in respect of new accounts and pre-existing high value individual accounts: ***30 June 2018***
- Information exchange between Inland Revenue and overseas tax authorities to commence: ***30 September 2018***
- Deadline for NZFIs to complete due diligence procedures in respect of pre-existing entity accounts and low value individual accounts: ***30 June 2019***

Although implementation of the CRS is intended to be consistent across the globe, the standard provides implementing jurisdictions with certain options in areas that are intended to reduce compliance costs for financial institutions while maintaining the effectiveness of the standard.

The key New Zealand specific implementation areas proposed in the Bill are:

- New Zealand is to adopt a 31 March reporting period for the purposes of CRS. This aligns with the New Zealand standard balance date and the reporting period applicable in New Zealand for FATCA. This reporting date has proven to be problematic at a practical level for global financial institutions as it is out of line with the 31 December reporting period end date used by the rest of the world.
- NZFIs are required to adopt the "wider approach to due diligence". This means NZFIs are required to collect and report information relating to accounts maintained or controlled by all non-NZ resident persons, as opposed to just offshore persons who are tax resident in other CRS reporting countries. This option addresses the practical issue that additional jurisdictions will implement CRS over time and become reportable jurisdictions. Without specific rules, each new jurisdiction joining would trigger new due diligence procedures. To ensure consistency, and prevent any financial institution from being put at a competitive disadvantage, the "wider approach to due diligence" will be mandatory for all NZFIs.
- However, NZFIs will have the option as to whether to adopt a "wider approach to reporting". That is, (1) whether to report information to Inland Revenue relating to accounts maintained or controlled by all non-NZ resident persons (with Inland Revenue then having the responsibility for sorting and filtering the data such that only information relating reportable jurisdictions is exchanged with the various overseas tax authorities); or (2) whether to report information to Inland Revenue relating to accounts maintained or controlled by residents of other CRS reporting jurisdictions only.
- New Zealand financial institutions can treat the dollar amounts referred to in CRS (which, by default are in United States currency) as being in New Zealand dollars.
- New Zealand will publish its list of New Zealand "non-reporting financial institutions" and "excluded accounts" that pose a low risk of being used for tax evasion purposes and are therefore carved out of CRS. For example, we would expect KiwiSaver funds to be "non-reporting financial institutions" as is currently the case for FATCA. We encourage organisations that believe they should be subject to such an exemption to contact us as we will be able to assist you in applying for an exemption from CRS.
- The Bill proposes a comprehensive suite of enforcement rules and civil penalties. For consistency, the Bill also proposes amendments to the FATCA implementation legislation to align the CRS and FATCA anti-avoidance rules, enforcement procedures, and penalty regime.
- NZFIs that fail to comply with their CRS obligations will be subject to an absolute liability fine of $300 per failure. This includes things such as failing to obtain the necessary information or self-certification of tax status before opening an account. There are also civil penalties for lack of reasonable care ($20,000 for a first offence and $40,000 for any subsequent offence), although a transitional period will apply until 31 March 2019 during which penalties will not be imposed provided the financial institution can demonstrate it has made reasonable efforts to comply.
- A civil penalty of $1,000 will also be imposed directly on a customer of an NZFI (e.g. an account holder, controlling person or intermediary) that (i) provides false information or a false self-certification, (ii) fails to comply with a request for information or a self-certification, or (iii) fails to inform of any material change in circumstances. This will be subject to the application of "no fault" and "reasonable efforts" defences.

Next steps

- ***Submission on the Bill:*** While a number of the key implementation areas are likely to be set in stone, there is still time to make submissions. In addition, as noted above, requests can be made to have certain types of financial institution or financial account included on the list of New Zealand "non-reporting financial institutions" and "excluded accounts". We invite NZFIs and other affected taxpayers to discuss potential submission points and any areas of concern with us.
- ***Considerations for NZFIs:*** NZFIs should revisit their FATCA and CRS compliance programmes to ensure their CRS obligations will be met within the timeframe set out above.
- ***Considerations for customers of NZFIs:*** Customers of NZFIs should expect to be asked questions relating to their tax residency status either as part of the NZFIs on-boarding procedures or through receiving separate requests for information or a "self-certification" from the NZFI. Customers of NZFIs will need to be proactive in responding to such requests given the proposal that civil penalties be extended to customers of NZFIs in the circumstances described above. Please get in touch if you have any difficulty responding to a request received from an NZFI.

Foreign trust disclosure rules

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The Bill proposes changes to the foreign trust disclosure rules as recommended by the Government Inquiry into Foreign Trust Disclosure Rules. The Government had previously indicated its commitment to act on all recommendations from the inquiry conducted by John Shewan. The changes contained in the Bill demonstrate that commitment. While some modifications from the recommendations have been made to the proposed changes contained in the Bill, no recommendations have been rejected.

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The proposed amendments signal that the Government has taken public concern about the New Zealand foreign trust regime seriously. The changes are intended to deter offshore parties from misusing New Zealand foreign trusts and signal the importance of complying with the disclosure rules.

We welcome the additional disclosure requirements and changes to these rules.

A summary of the key disclosure changes

- ***Registration***
  Proposed amendments will require foreign trusts to formally register with Inland Revenue. A foreign trust will need to declare that the person establishing the trust, the settlor, and the trustees have agreed to comply with the applicable requirements in the Tax Administration Act 1994, anti-money laundering regulations, and AEOI requirements.
- ***Disclosure***
  Upon registration of a foreign trust, a number of increased disclosure requirements have been introduced. The name, email address, foreign residential address, country of tax residence, and taxpayer identification number will need to be provided by all parties to the trust (settlor; protector; non-resident trustees; any natural person with effective control of the trust; and beneficiaries of fixed trusts).
- ***Annual filing***
  Foreign trusts will be required to file annual returns, which disclose any changes to the information provided at registration, the trust's annual financial statement, the amount of any settlements and distributions paid/credited and details of the settlor or beneficiaries (names; foreign address; taxpayer identification number; country of tax residence).

The proposed registration requirements will apply to all trusts formed after enactment and existing foreign trusts will need to fulfil the new requirements by 30 June 2017.

The Bill proposes sanctions for non-compliance with the rules. A foreign trust will lose the exemption from New Zealand tax, which is currently available in the legislation, if it has not registered and fulfilled its disclosure obligations (i.e. it will become taxable in New Zealand on its worldwide income).

Finally, amendments in the Bill require Inland Revenue to share information in the foreign trusts register as required for law enforcement purposes. This will apply from the date of enactment.

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Court of Appeal upholds High Court decision that payments received by Vector are not income

On 12 August 2016 the Court of Appeal issued its judgment in Commissioner of Inland Revenue v Vector Ltd [2016] NZCA 396 upholding an earlier High Court decision in favour of the taxpayer (Vector Ltd v Commissioner of Inland Revenue [2014] NZHC 2069 – refer Tax Tips October 2014).

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The issue in dispute was the correct income tax treatment of amounts derived by Vector on the granting of land rights to Transpower New Zealand Limited (Transpower). While the significance of the decision has been partially superseded by subsequent legislative amendment, the judgment is useful in confirming the need for Parliament to use clear language if it wishes to tax capital amounts.

Background

Among the assets that comprise Vector's Auckland electricity distribution network are a tunnel to the south and a series of land rights making up the North Shore Transmission Corridor. In 2010 Vector entered into an agreement with Transpower in relation to these assets. Transpower was granted a right to use part of the tunnel via a licence to occupy and easements to enable it to use the North Shore Corridor. In consideration Vector received payments of $50 million for the tunnel use and $3 million for the northern access rights.

The dispute

Vector initially returned the payments as income (to be spread over six years under section EI 7 of the Income Tax Act 2007 (the Act)). Subsequently, Vector issued a notice of proposed adjustment on the basis that the payments were non-taxable capital receipts.

The Commissioner rejected Vector's adjustment but the High Court found in favour of Vector.

Issues on appeal

The key issues on appeal were:

(a) whether the payments were "other revenues" in terms of section CC 1(2)(g) of the Act; and

(b) if not, whether the payments were in any case income in the hands of Vector on the basis that it had not permanently given up an incoming producing asset (or part thereof).

Other revenues

Section CC 1 provides that amounts described in the section are income if they are derived from a lease, licence, or easement affecting the land or the granting of a right to take profits from the land. The section then lists specific amounts including rents, fines, premiums, and payments for business goodwill. The final amount on the list is "other revenues".

The payments received by Vector were not within the specific amounts listed. The question, therefore, was whether they were within the term "other revenues". The issue before the Court of Appeal was whether the term "other revenues" included capital receipts or was limited to amounts considered revenue under ordinary principles.

The Court of Appeal upheld the High Court's interpretation of section CC 1 finding that "other revenues" does not include capital amounts. The Court considered the Commissioner's approach assumed a coherent, overriding scheme for taxing receipts from land use. However, in the Court's view, there is no such scheme but rather a history of inconsistency in the tax treatment of such receipts.

Having rejected the Commissioner's overriding scheme approach, the Court of Appeal then found that the term "other revenues" must be read in its most natural sense, which in the context of tax means in line with the capital / revenue distinction.

Permanently giving up an asset

In the alternative, the Commissioner argued that the payments were disguised rent (and therefore revenue in nature) rather than consideration for Vector permanently giving up in part an income earning asset (as found by the High Court).

The Court of Appeal rejected the Commissioner's argument. The Court found that Vector had granted Transpower permanent interests and had suffered a permanent impairment to its ability to use the assets. Further Vector had no ability to regain its interests.

Our comment

Since the facts that gave rise to this case occurred, the law in relation to amounts received for the use of land has been significantly modified, in particular by the introduction of section CC 1B of the Act (Consideration relating to grant, renewal, extension, or transfer of leasehold estate or licence).

However, the Court of Appeal accepted that, even now, section CC 1B does not achieve a comprehensive scheme for the taxation of payments made in relation to the use of land. For example, the Court noted that the new rules in section CC 1B only apply to leases and licences, payments for the surrender or transfer of easements would still generally be governed by ordinary principles of capital and revenue. Consequently, under the new legislation, the two payments in dispute would likely be treated differently if derived today with the consideration for the licence subject to tax and payment for the easements non-taxable.

As noted in our October 2014 Tax Tips, the High Court drew a similar distinction between easements and leases/licences. The position calls into question the correctness of the view expressed in Inland Revenue's 2002 Interpretation Statement on the deductibility of expenditure incurred for the preparation and registration of easements that "an easement as an interest in land is therefore a 'lease' as defined in the Act."

Looking at the decision more broadly, the Court of Appeal has helpfully reiterated the paramount importance of the words when interpreting any taxing provision. The Court confirmed that the best indication of the purpose of a taxing provision remains the detailed wording read in context and in its most natural sense.

As at the date of publication it is unknown whether the Commissioner will appeal this decision.

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