Tax Tips

Is your business on top of the latest tax insights?

February 2017

In this issue:

- ***Proposals to simplify and modernise the Tax Administration Act***
- ***Our thoughts on tax reform proposed by The Opportunities Party***
- ***Inland Revenue finalises statement on feasibility expenditure***
- ***Tax bills update***

pwc

1

Proposals to simplify and modernise the Tax Administration Act

In December 2016, the Government released the discussion document Making tax simpler – Proposals for the modernising the Tax Administration Act (the December Document). This document follows the November 2015 discussion document, Towards a new Tax Administration Act.

Sandy Lau
Director

Harry Cundy
Manager

The December Document provides more detailed proposals for the Tax Administration Act 1994 (the TAA). The proposals are intended to modernise and simplify the TAA. The two key themes arising from the package of reforms are to provide the Commissioner greater flexibility when administering the tax system and to enable greater information sharing by Inland Revenue.

Summary of the proposals

The proposals relate to five main areas:

- the confidentiality of information relating to the tax system
- the collection of information by Inland Revenue
- the provision of advice by Inland Revenue to taxpayers
- the role of tax intermediaries, and
- the Commissioner's obligation for the care and maintenance of the tax system and design of a new TAA.

Submissions on the proposals closed on 24 February 2017. We comment on each of these areas in more detail on the next page.

Tax information and confidentiality

The secrecy obligations currently imposed on Inland Revenue are wide and cover "all matters relating to" New Zealand's tax legislation and relevant ACC and superannuation legislation. There are, however, a number of exceptions permitting Inland Revenue to disclose information to various government agencies.

These wide obligations imposed on Inland Revenue contrast with the treatment of information held by other government agencies, which are generally governed by the Official Information Act 1982 (the OIA). Unlike the TAA, the OIA presumes that information held by government agencies should be made available on request unless there are good reasons not to.

With this in mind, the Government is proposing to narrow the coverage of Inland Revenue's secrecy obligations to information that identifies, or could identify, specific taxpayers. This means non-taxpayer-specific information would be significantly relaxed allowing this information to be made public, including on request under the OIA. The example provided in the December Document refers to Inland Revenue being able to release social sector data to a New Zealand NGO provided that data is aggregated or depersonalised to the extent that individuals cannot be identified.

The December Document notes that Inland Revenue does hold non-taxpayer-specific information that is still very sensitive. It is proposed that such information should be kept secret. For example, Inland Revenue notes that information relating to audit and investigative techniques and strategies should not be made public even though there may be no taxpayer-specific information involved. Inland Revenue's view is that releasing such information could give taxpayers the opportunity to "game" the system. Therefore, it is proposed that the secrecy of non-taxpayer-specific information should be maintained if disclosure would be likely to affect the integrity of the tax system.

The December Document also proposes modernising the legislation that allows sharing of information (including taxpayer information) between government agencies and for the details of any information sharing arrangements to be made public. Specifically, the proposal is to shift to a regulatory model, with inter-agency sharing to be authorised by Order in Council on recommendation by the Minister of Revenue. In this way, inter-agency sharing would be subject to oversight by the Cabinet and Regulations Review Committee. The proposals will not change the current restriction that Inland Revenue can only share information where the receiving agency is lawfully able to collect the information itself.

Finally, the proposals provide for sharing of taxpayer-specific information where the taxpayer explicitly consents to this sharing.

Our comment

We generally support the proposal to relax secrecy obligations in relation to non-taxpayer-specific information. Transparency of government processes is important in a democratic society. However, we also recognise that paramount to transparency is the need to protect taxpayer confidentiality and the integrity of the tax system. Taxpayers need to have confidence that information provided to Inland Revenue, in particular information that is highly commercially sensitive, will remain confidential. As such, we are pleased to see the proposals look to retain secrecy over information that may identify a specific taxpayer.

We are also pleased to see a clear framework being proposed to ensure there is transparency around the information that will be shared with other government agencies on a non-consent basis. In particular, we appreciate the consideration officials have given to the submissions received on this point from the previous consultation process including preserving the rule that information may only be shared where the receiving government agency is able to lawfully collect that same information. Finally, the recognition of the need for the information to be adequately protected by the receiving agency is also critical as this provides a level of comfort that the receiving agencies will have sufficiently robust information security systems in place to ensure taxpayer information is protected.

In terms of the proposal regarding sensitive information that does not identify a taxpayer, we consider it would be helpful if further examples are provided of information that, if disclosed, would risk the integrity of the tax system. For example, it is not clear whether the disclosure of Inland Revenue's views as to the interpretation and application of tax laws expressed in private rulings or adjudication reports would be permitted. The 2015 Document at least appears to contemplate the possibility of sharing anonymised adjudication reports. Disclosure of such information could provide some helpful guidance to taxpayers. It might also be relevant for determining whether the unacceptable tax position penalties should apply in a particular case.

Collection of information

The December Document proposes amendments to Inland Revenue's authority to collect large sets of information.

Currently, Inland Revenue is empowered to engage in the collection of large datasets where such collection is "necessary or relevant" for the administration of the tax system. These datasets can include:

- government agency data about businesses, and
- electronic payments information.

The December Document proposes maintaining the current "necessary and relevant" standard in relation to when Inland Revenue can use its information-gathering power but to make it explicit that Inland Revenue can obtain large datasets on a one-off or recurring basis. The repeated collection of large datasets will be authorised by regulation, these regulations being subject to oversight by the Cabinet and Regulations Review Committee. Inland Revenue will also publish details of the datasets to which it has regular, repeated access (except to the extent that publishing these details might disclose sensitive information about compliance strategies).

Our comment

As noted, Inland Revenue already has the power to obtain large datasets. However, given the rapid increase in data capture, storage, and analytic technologies, we consider it is necessary to establish a regulatory framework for repeated collection.

We therefore support the proposed reforms in principle, along with the oversight and transparency that this framework affords. We also support the proposal to retain the "necessary or relevant" standard for the collection of large datasets.

However, while we generally support the proposals, we consider further clarity is required around the ambit of Inland Revenue's power to obtain repeated large datasets from third parties. For example, while Inland Revenue may consider the collection of a specific set of data from a taxpayer to be "necessary or relevant", the practical reality may be that the taxpayer's internal system does not produce the data as requested easily or without significant costs. In those circumstances, the taxpayer should not have to incur the additional costs required to produce that requested data. Parameters are therefore needed to ensure Inland Revenue may only request data that is easily accessible to the taxpayer or look to reimburse the taxpayer for the costs to produce that data.

Getting it right from the start

A large part of Inland Revenue's transformation project is to implement changes that will help taxpayers to get it right from the start. This includes establishing processes to make it easy for taxpayers to get it right and difficult not to. In line with this, Inland Revenue is looking at ways that it can help taxpayers to get it right from the start by providing more certainty, when they take a tax position.

The Government recognises that the binding ruling regime is a key method in providing certainty to taxpayers. Therefore, the December Document proposes to widen the scope of the rulings regime to make it more flexible and more affordable for small and medium-sized enterprises (SMEs). The proposed changes include:

- significantly reducing the cost for SMEs to obtain a ruling by replacing the current hourly rate to another fee structure either in the form of a low flat application fee or a graduated schedule of application fees depending on the size or type of entity applying for the ruling
- allowing post-assessment binding rulings, and
- extending the scope of the rulings regime by:
  - removing the prohibition on ruling on the purpose of a taxpayer under certain provisions
  - relaxing the requirement that a ruling can only be issued on an "arrangement" to allow for some specific quasi-factual matters, and
  - clarifying the role of assumptions and conditions in rulings.

The December Document also looks to refresh Inland Revenue's approach to minor errors for both GST and income tax amendments by proposing to supplement the current monetary threshold (recently increased to $1,000 from 1 April 2017) with a materiality approach. For example, a taxpayer may include any error in a subsequent return if the amount of the error is equal or less than a monetary amount and a certain percentage of the taxpayer's taxable income or output tax.

Our comment

We agree that the rulings regime plays a critical role in providing certainty to taxpayers. Therefore, we strongly support any changes that would make the regime more accessible. Our only question is whether Inland Revenue's Rulings unit will be adequately resourced to process an increased number of applications. Currently, the Rulings Unit undertakes to provide a ruling within three months of an application being made and it has sufficient resources to respond to taxpayers' commercial imperatives if a ruling is required in a shorter timeframe. We encourage the Government to consider providing additional resourcing to the Rulings Unit to ensure that this same responsiveness can be maintained if demand increases as a result of the proposed changes.

We agree with the December Document that cost may be a key factor in preventing some SMEs from obtaining a ruling. We consider a graduated fee schedule would be the appropriate tool to help address this. This would deliver a significant reduction in fees for SMEs while ensuring that the fee reduction is commensurate with the size of SME.

We also support the proposal to extend the scope of the rulings regime and to allow for post-assessment binding rulings, both of which will deliver more certainty to taxpayers. We note the December Document does raise a concern about the interaction of the rulings regime with the disputes process as a result of allowing post-assessment rulings. We do not have concerns with this as disputes can often be drawn out and the ability to obtain a ruling could reduce the stress that a taxpayer may face by providing an alternative to engaging in a full dispute.

Finally, we also support the proposal to extend the current approach to minor errors. We support the proposal to supplement the current monetary threshold with a materiality approach. This would make the rule more meaningful and relevant to a taxpayer by reflecting their own circumstances.

The role of tax intermediaries

The proposals look to expand the definition of tax agent to include a wider group of "tax intermediaries" who are in the business of acting on behalf of taxpayers in relation to their tax affairs. However, the application of the extension of filing time will remain the same (i.e. apply only to persons who prepare income tax returns for 10 or more taxpayers). The proposals also include the introduction of a new discretion for the Commissioner to choose not to recognise a person as a taxpayer's nominated person if doing so would adversely affect the integrity of the tax system.

Our comment

We consider the proposals to be sensible as the role of intermediaries have evolved over time and a reconsideration of the term "tax agent" is required. We therefore support the proposals.

Role of the Commissioner and design of a new Tax Administration Act

The proposals contained in the December Document provide further details on what changes will be made to ensure the TAA can deliver on the Government's objectives for better public services as well as building a New Zealand economy that is more competitive and productive. The concern is that the current TAA is too rigid and inflexible to achieve those goals.

Extending the care and management provision

It is proposed that the care and management provision in the TAA be extended to allow the Commissioner greater administrative flexibility in limited circumstances. Those limited circumstances includes:

- minor and transitory legislative anomalies
- cases when the relevant legislation does not adequately deal with a particular situation because a statutory rule is difficult to formulate
- a long-standing established practice of both the Commissioner and taxpayers, and
- cases of unfairness at the margins.

It is proposed that the application of the care and management decision be optional, giving taxpayers the discretion to only apply the decision if they think it is favourable to them to do so.

Parameters are proposed to be set around the exercise of the care and management provision by the Commissioner. Specific safeguards being considered include:

- exercising the discretion consistently with policy intent
- continuing to be guided by the current principles by having regard to the resources available to the Commissioner, and the importance of promoting compliance, and the compliance costs incurred by taxpayers
- requiring consultation before discretion is exercised
- being transparent about the use of the discretion by requiring public disclosure, and
- requiring the discretion to be exercised by an appropriate person.

Making greater use of regulations

The December Document proposes allowing the use of more regulations for tax administration, which will allow a more tailored approach to different types of taxpayers as well as allowing trials of tax administration processes to be carried out.

It is recognised that the use of regulations in the tax administration system has the potential to be seen as undermining the role of Parliament. Therefore, at this stage, the use of regulations is proposed to be only for administrative processes and would not, for example, extend to remedying legislative anomalies.

Structure of the TAA

Finally, it is proposed that the structure of the TAA needs to be reconsidered to ensure it remains coherent and reflective of the tax administrative process. Specific consideration includes how the TAA will reflect the changes occurring under Inland Revenue's Business Transformation project.

Our comment

We generally support the changes proposed in relation to the role of the Commissioner and for the design of a new TAA.

Extending the care and management provision to give the Commissioner greater administrative flexibility is a positive step for taxpayers. The changes should hopefully reduce some of the frustrations that taxpayers experience from time to time and ensure the Commissioner has the ability to direct her resources to where they are most needed instead of committing them to deal with minor legislative anomalies. We consider it prudent to have safeguards in place to provide comfort that the discretion will be applied in a consistent manner. We also support the optional approach put forward so that taxpayers can decide what is best for their own circumstances.

To support these proposals, we consider clear guidance will be required to ensure taxpayers have a clear understanding of how the care and management provision will be applied in practice. Clear guidance will also ensure consistency within Inland Revenue.

We also recognise the need for the TAA to be agile and flexible so that it may continue to be fit-for-purpose as business and tax administration processes continue to change. As such, we see merit in allowing for the greater use of regulations in tax administration processes provided there are adequate safeguards in place to ensure the rule of law is maintained and there is continued adherence to the generic tax policy process.

2

Our thoughts on tax reform proposed by The Opportunities Party

Geof Nightingale
Partner

Sandy Lau
Director

Harry Cundy
Manager

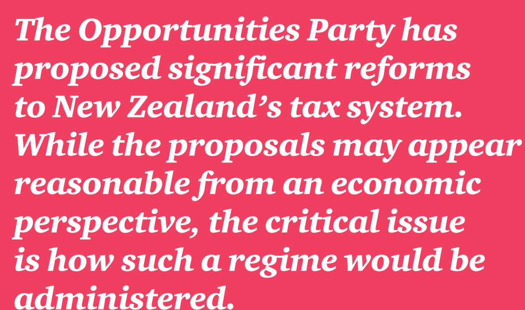
New Zealand's next General Election is due to be held on 23 September 2017. In-line with previous elections, we expect that tax will, once again, be a topic of discussion for the various political parties.

On 7 December 2016, the Opportunities Party (TOP), led by Gareth Morgan, launched the party's tax policy. It proposes significant reforms to New Zealand's tax system. In particular, it sets out a proposal to deem a minimum rate of return on all productive assets including housing and land. While the proposals may appear reasonable from an economic perspective, we believe the critical issue is how such a regime would be administered. Particular issues that raise concern include cash flow (as the tax is imposed on an unrealised basis) and the ability to obtain a market valuation for the range of assets that could be subject to such a regime

The proposal

Currently, TOP's proposals are expressed in broad terms only. TOP proposes to deem a minimum rate of return - at least - on all owner-occupied housing and all productive assets, and tax this accordingly. In TOP's view, the proposal will create a fairer tax system in New Zealand by closing the existing "loopholes" thereby leading to increased investments, growth, and employment.

Revenue raised under this new tax would be applied to reduce existing tax rates making the proposal fiscally neutral overall.



The loopholes

The main "loophole" identified by TOP appears to be the current mismatch between the concept of income for tax purposes and the concept of income in economics which results in the inadequate taxation of certain income.

In New Zealand, property and trust law concepts of income have influenced the concept of income for New Zealand tax purposes. Income is generally understood as being something that comes "in", and as something that is distinct from capital gains[1].

In contrast, the definition of income put forward by economists, Robert M. Haig and Henry C. Simons, is much more comprehensive. It includes as income the value of the goods and services a person consumes as well as any increase in the person's wealth. Under this comprehensive definition, the value a person derives from the use of an asset that person owns would be considered income also.

TOP proposes to align the concept of income for tax purposes to the comprehensive economic definition so that all forms of income are taxed. Such a change would shift the tax system's current focus on taxing labour income by ensuring a person's capital income is taxed adequately also.

One of TOP's main priorities is to tax people on the value of their homes as it sees this as a large gap in New Zealand's tax base. TOP provides the example that, where a person buys a house and rents it out, rent paid by the tenant is subject to tax. Whereas, in contrast, someone who buys a house and lives in it pays no tax. TOP argues that this difference in tax outcomes incentivises investment in owner-occupied housing at the expense of other more productive investments. In turn, TOP believes that this has contributed to current house prices, an over-reliance on overseas debt, and rising inequality. TOP's view is supported by the work of the Tax Working Group, which reported in 2010 that New Zealand had retained a tax bias in favour of investment in owner occupied and rental housing.

[1] See for instance, Dawson v Commissioner of Inland Revenue (1978) NZTC 61,252 (HC) and A Taxpayer v Commissioner of Inland Revenue (1997) 18 NZTC 13,350 (CA).

TOP's response

Owner-occupied housing

In the case of owner-occupied housing, TOP proposes to deem a minimum rate of income based on the person's net equity in their home (i.e. the house value minus money owing on the mortgage). This deemed income is to represent the benefit (imputed rent) that the person derives from living in the house. Presumably, this deemed income rate would be calculated by reference to market rents.

It is not clear at this stage whether TOP's proposal would extend to non-business assets held by individuals other than owner-occupied housing, rental properties, and land.

Business assets

TOP also proposes to impose a minimum tax on all productive business assets, deeming these assets to produce a minimum return equal to a risk-free rate of return (RFRR) on the assets' capital value (for example, the interest that would be paid if the capital was instead invested in government bonds).

TOP states that, where assets are producing less than this RFRR, these assets are either providing a disguised lifestyle benefit to the owner or the investment in those assets is economically irrational.

Revenue neutral

TOP has stated that any revenue raised under these taxes would be applied to reduce current personal income tax rates and, potentially, corporate tax rates. TOP acknowledges that how these tax cuts are distributed across income and corporate tax brackets would likely be the subject of political negotiation with any coalition partner. It suggests that these cuts should be allocated so that 80% of New Zealanders pay the same or less tax overall while the remaining 20% of New Zealanders would pay more.

Our comment

From a pure economic perspective, TOP's tax reform package may appear reasonable as it seeks to impose tax on a person's comprehensive income without any preference to any specific type of income. In particular, the Haig-Simons comprehensive income definition has been widely accepted as a sound starting point in formulating the base on which taxes are imposed. The advantage of imposing tax based on the Haig-Simons definition of income is that it reduces the distortionary impact of tax on investment decisions and incentivises the productive use of property assets. For example, land banking or leaving a house vacant and unused would become much more costly, thus encouraging the development of the land for productive use and increasing the supply of rental property. However, our key concern centres on the administration of such a regime and the issues that it could pose for taxpayers. We outline our concerns further below.

Imposing tax where no cash is received

Cash flow is a key issue that tax policy makers have struggled with when considering imposing tax on an unrealised or deemed basis. This is because the taxpayer does not receive any actual cash in relation to that deemed income. A worst case scenario arising from taxation on an unrealised basis would be where the taxpayer is forced to sell the asset to meet a tax liability.

While there are instances where tax is imposed on an unrealised or deemed basis in New Zealand (e.g. the financial arrangement rules and deemed rate of return method under the foreign investment fund rules), the application of those rules is generally limited. Given the potentially wide application of TOP's proposal, the implementation of such a regime would result in a significant change to the way a number of New Zealand taxpayers are taxed.

We note that TOP does propose some relief from this cash flow issue for people over 65 (who, as retirees, are more likely to be asset rich but have relatively low cash flows). Over 65s will be able to satisfy their tax liability in relation to their house by way of a mortgage to Inland Revenue. This mortgage (along with interest) would be repayable when the house is sold. However, this relief does not appear to extend to other persons who may also face cash flow issues (e.g. where an individual suffers a reduction in income following an accident).

Minimum tax on business assets

We question TOP's assumptions that assets producing less than a market return are necessarily either:

- disguising a private lifestyle benefit to the business owner; or
- an economically irrational investment.

We consider it may be overly simplistic to assume that taxpayers are engaging in some form of deceptive conduct if they own an asset that produces a less than market return. Further, the assumption arguably cuts across the general approach of New Zealand courts and Inland Revenue. That is, not to second guess the economics of taxpayers' business decisions.

Examples where there is good reason for a capital investment to be making less than a RFRR includes where the investment is the commencement of a new business or where a business's return on investment is highly cyclical.

TOP does propose to allow businesses facing a temporary or cyclical downturn to defer their minimum tax for up to three years, with use of money interest (UOMI) being charged. However, it is unclear whether this three year period will apply to new businesses. Further, we question whether the time period of three years is a reliable basis for effectively distinguishing between rational and irrational investments.

Valuation issues

The imposition of a tax by reference to an asset's value can be extremely difficult to administer.

We recognise that the ability to obtain a market valuation or market rent for housing may be relatively straight forward as there is a ready market. However, this may not necessarily be the same for other assets. In particular, it may be difficult to obtain a valuation for an asset where there is no immediate market. Examples include things like goodwill or bespoke assets.

A tax based on the value of assets could therefore result in significant compliance costs, both in relation to obtaining valuations and also to subsequent disputes with Inland Revenue as to the correctness of any such valuation.

Māori land

Finally, a uniquely New Zealand issue to consider would be the impact of the proposed new tax on Māori land which may not be able to sold or easily developed due to its ownership structure and the long term retention of that land for cultural reasons.

The implementation of TOP's proposed regime would be a significant departure from New Zealand's current tax policy settings. As we draw closer to the election, we expect more public discussion on a range of issues including taxation. We hope this will generate some good and interesting public debate on New Zealand's current tax policy settings.

3

Inland Revenue finalises statement on feasibility expenditure

Last week, Inland Revenue finalised its interpretation statement, IS 17/01: Income tax - deductibility of feasibility expenditure. IS 17/01 sets out the general approach to the deductibility of feasibility expenditure, where such expenditure is not of a class that is deductible under a specific regime in the Income Tax Act 2007 (the Act).

Mark Chapple
Director

Harry Cundy
Manager

The finalised IS 17/01 follows on from a draft statement, PUB00278, that was released for consultation late last year, and updates Inland Revenue's earlier statement, IS 08/02, in the light of the Supreme Court's decision in *Trustpower Ltd v C of IR* [2016] NZSC 91.

In broad terms, the Supreme Court in Trustpower held that, where feasibility expenditure is incurred as an ordinary and recurring incident of a taxpayer's business, it will only be deductible where:

- 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 key difference between IS 17/01 and the earlier IS 08/02 was the removal of the "commitment test" where, at a high level, feasibility costs were considered by Inland Revenue to be deductible up until the point a capital project was committed to. The decision in *Trustpower* is reflected in the new IS 17/01, placing a significant restriction on the circumstances and the types of 'feasibility expenditure' that are deductible.

IS 17/01 is substantially similar to the draft PUB00278, with the addition of a small number of clarifying statements. The most relevant addition is Inland Revenue's emphasis that IS 17/01 applies only to feasibility expenditure that is incurred as ***an ordinary and recurring incident*** of a taxpayer's business.

Feasibility expenditure that is not of a recurring nature is stated to be outside the scope of IS 17/01 and ordinary deductibility principles are to be applied, including consideration of the application of the general permission and capital limitation. With this in mind, the expectation is that it may be more difficult for businesses to deduct one-off feasibility expenditure as such expenditure might more often be considered to be on capital account under ordinary principles. However, there may be instances where one-off expenditure will still be considered revenue in nature. In those circumstances, we expect the analysis in IS 17/01 to remain relevant i.e. the expenditure will be deductible to the extent that it was not directed towards a specific capital project or did not materially advance a specific project.

Finally, IS 17/01 also includes a flow-chart setting out the relevant questions to be considered when determining whether an item of feasibility of expenditure should be deductible.

4

Tax bills update

Bill	Introduced	Status	Key amendments
Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill	3 May 2016	Awaiting second reading	Closely-held companies especially look-through companies; non-resident withholding tax for related party and branch lending; related parties debt remission
Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill	8 August 2016	Enacted on 21 February 2017	Business taxation including new method for paying provisional tax; automatic exchange of information; disclosure requirements for foreign trusts.

Contributors

Geof Nightingale
Partner
T: +64 9 355 8853
E: geof.d.nightingale@nz.pwc.com

Sandy Lau
Director
T: +64 4 462 7523
E: sandy.m.lau@nz.pwc.com

Mark Chapple
Director
T: +64 4 462 7378
E: mark.chapple@nz.pwc.com

Emma Richards
Director
T: +64 4 462 7162
E: emma.h.richards@nz.pwc.com

Harry Cundy
Manager
T: +64 9 355 8623
E: harry.r.cundy@nz.pwc.com

Connect with us

Join our group on LinkedIn
Search for TaxNetWork under Group

Follow us on Twitter
@PwC_NZ

Visit us online at
pwc.co.nz

Email us
tax@nz.pwc.com

© 2017 PwC Legal. All rights reserved. PwC refers to the PwC Legal member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.