

de Lacey & Associates Limited

CHARTERED ACCOUNTANTS

NEWSLETTER

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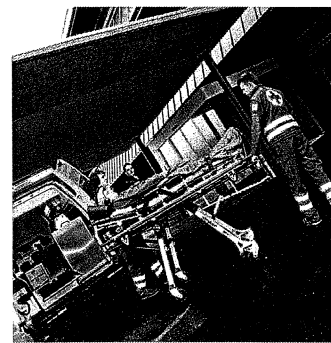
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Changes to donation tax credits

A tax credit is able to be claimed on donations made to organisations and charities that are registered on Inland Revenue's (IRD) list of Donee Organisations.



The amount of the credit is one third of the amount of the donation, and is limited to the amount of a person's taxable income. The claims process is straightforward; donation receipts can be uploaded to a person's online 'MyIR' account, and they are processed by IRD at the end of the tax year. However, as with many tax rules, there can be complexity.

The Income Tax Act 2007 requires a donation to be a "...gift of money of \$5 or more...", but there is little guidance on the meaning of the phrase. It is generally understood to require the gift to be of money and not goods or services. However, confusion arises because monetary gifts can take various forms. A dispute on the issue has been making its way through the Courts.

The taxpayers, Mrs Roberts and her late husband, created the Oasis Charitable Fund in 2007. Soon after its creation they lent the charity approximately \$1.7m. Between 2011 and 2015, they signed several deeds of gift progressively releasing the charity from the obligation to repay the loan. On each occasion they claimed donation tax credits for the debt forgiveness.

By forgiving a portion of the loan amount each year, the donation rebate claims were maximised because the annual amount was kept under the 'donor's' taxable income. Meanwhile, the charity

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was able to receive the benefit of the cash upfront.

The Commissioner disputed the donation rebate claims on the basis that debt forgiveness is not a 'gift of money', however both the High Court and Court of Appeal subsequently ruled in favour of Mrs Roberts. The Courts analysed historic legislation, as well as various dictionary definitions, and concluded that the words 'gift of money' mean more than just cash.

The decision was applauded by charities and philanthropists alike, as the flexibility of loan forgiveness encourages donations. However, this has been short-lived. On the same day as the Court of Appeal decision (17 December 2019), the Revenue Minister announced that the Court

decision was contrary to the policy intent. The Minister's statement made clear that donation tax credits should be limited to gifts of cash or cash equivalents only (i.e. bank transfers / credit cards) and should not be available for either debt forgiveness or other gifts in kind.

The Income Tax Act will be amended to reflect this intent. The change will be backdated to 1 April 2008, unless someone has already taken a tax position based on the old wording.

The charitable sector will need to wait and see whether this rule change will influence donors, and have an impact on the overall level of giving across New Zealand.

Global tax

A series of legislative changes have been implemented over the past few years as part of the Government's focus on ensuring multi-national corporations pay their fair share of tax.

International tax revenue represents approximately 10% of New Zealand's tax revenue each year. Not only does it need to be preserved, but given international tax practices exhibited by some multi-national companies, it should be expected to grow. However, the changes do not just affect the likes of Google and Apple, but also smaller businesses that undertake cross border transactions.

One area of Inland Revenue's (IRD) focus is the thin capitalisation ('thin cap') regime. Historically, if a NZ company had a loan from an overseas company in the same group, the NZ company could claim a full tax deduction for interest on the loan, providing the 'debt to assets' ratio (known as the thin cap ratio) was below 60%.

Although this test remains broadly the same, new legislation has changed the way the ratio is calculated, to reduce the asset value by liabilities that are not subject to interest. This is increasing the thin cap ratio.

Some businesses that have historically been below 60% are now above the threshold, and they are either restructuring their balance sheet to come back below 60% or accepting that their net interest deduction will be restricted.

A related measure is a new set of rules known as 'Restricted Transfer Pricing' (RTP). The RTP rule focuses on NZ companies with loans from

overseas and seeks to ensure an appropriate rate of interest is charged. Previously a weak NZ balance sheet might have been used to justify a higher interest rate on an unsecured related party debt. However, the RTP rule requires the interest rate to be set with reference to the credit rating of the wider group's parent company, ignoring non-commercial terms. This is generally giving rise to reductions in interest rates, thereby reducing interest deductions in NZ.

Further rules target 'Hybrid Mismatch' arrangements. These arise where a legal arrangement has different tax outcomes in different countries. For example, convertible loan notes are commonly treated as 'loans' in NZ, such that a deduction is available in NZ for interest payments. However, they are treated as 'equity' (i.e. shares) overseas, such that interest received overseas is not taxed.

A tax deduction in one country with no corresponding taxable income in another clearly erodes the global tax base. IRD's new base erosion and profit shifting (BEPS) measures basically prohibit a NZ tax deduction if the amount received overseas is not subject to tax in that jurisdiction.

These rules are clearly complex and can be challenging for small and medium businesses to navigate. The IRD is attempting to ensure compliance with the new rules through the issue of a new BEPS disclosure form, which itself is complicated.

For affected entities, the new form applies for income years beginning on or after 1 July 2018.



Encompassing these rules within the annual tax compliance requirements not only emphasises the importance of assessing the impact of the

new BEPS measures, but also provides IRD with a platform to review and audit these disclosures.

Purchase price allocation

Buying or selling a business is a significant decision, and commonly involves vendor and purchaser negotiations on many aspects of the transaction.



The price is often one of the first points to be negotiated. Irrespective of whether the transaction is for shares in a company or its underlying assets, a single amount is typically agreed. However, where the transaction is for assets it is important to remember that the tax implications of selling the assets (e.g. trading stock, depreciable plant, equipment, goodwill and liabilities) needs to be determined and the amount derived is fundamental to this process.

For tax purposes, the price is allocated between the various assets on the balance sheet by a 'purchase price allocation' (PPA). For example, if depreciable assets are sold as part of a transaction and values have not been agreed on an asset by asset basis, the purchaser and vendor could determine different 'market values' resulting in inconsistent treatment.

This issue is exacerbated by the fact that vendors are motivated to allocate high values to non-taxable capital assets such as land or goodwill, whilst minimising the value attributable to assets such as trading stock, or plant and machinery, which reduces the vendor's tax bill on sale.

Conversely, purchasers can gain a tax advantage by allocating as much value as possible to revenue account assets and depreciable property, to provide larger future tax deductions.

Consequently, the Government is concerned that the tax base is eroded, if different pricing allocations are adopted by vendors and purchasers in a transaction.

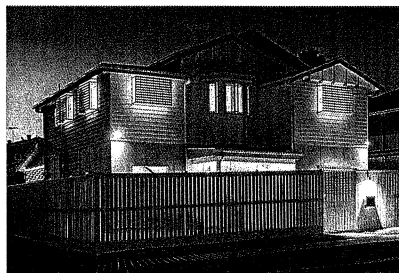
To address this, Inland Revenue (IRD) issued an official consultation paper in December 2019, with an aim to implement legislation in 2020, which seeks to ensure consistency in application of the PPA by both the vendor and purchaser.

In theory the IRD's proposal is simple. The vendor and purchaser must use the same PPA across the various assets included in the transaction, through mutual agreement. If they cannot agree, IRD proposes that the purchaser must use the vendor's allocation when filing their tax return. If the vendor does not prepare the allocation for any reason, then the purchaser can make it instead.

It is proposed that details of the PPA are provided to IRD within three months of the transaction. This additional disclosure is expected to encourage all parties to apply 'market value' fairly due to the risk of subsequent review by IRD.

GST on loan repayments

The recent High Court decision of *Burke v Commissioner of Inland Revenue* (2019) is a timely reminder that understanding the legal form of a transaction is important for applying the correct GST treatment.



Mr Burke was a GST registered, self-employed contractor, who renovated houses and buildings. In mid-2006, Mr Burke entered into a venture with Citywide Capital Limited (CCL). CCL gave Mr Burke a loan to fund the purchase and development of two properties.

The loan agreement had a number of terms. Mr Burke was responsible for paying any suppliers

and sub-contractors directly. He was required to use CCL's accountant to process his GST returns, with any GST refunds to be collected by CCL as partial repayment of any outstanding loan.

Cashflow constraints meant Mr Burke was required to drawdown additional loan capital from CCL throughout the project, in order to pay suppliers. Under the loan arrangement, CCL paid suppliers directly, however the legal form of the arrangement between Mr Burke and CCL was an increase to the existing loan. At the time, CCL's accountant

submitted Mr Burke's GST returns claiming GST on the payments made to suppliers.

In August 2007, the first property sold, and Mr Burke made a loan repayment of approximately \$500,000 to CCL. During an IRD review commenced in 2015, the Commissioner discovered that GST had not been returned on the sale of the property in 2007, however it had been in a later GST return, filed on 11 March 2016. Furthermore, in the same GST return Mr Burke claimed GST on part of the repayment to CCL, equivalent to the additional amount he borrowed to cover supplier costs.

Mr Burke asserted that he was entitled to claim input GST on this amount, given it was in respect of payments to suppliers.

The Taxation Review Authority (TRA) concluded that input GST could not be claimed, as the repayment of these costs to CCL was simply a loan repayment, and not in exchange for a supply of any good or service as defined in the Goods and Services Tax Act 1985. Mr Burke appealed to the High Court, but unfortunately for him, the High Court agreed with the TRA.

This decision emphasises the importance of understanding the true legal nature of payments. GST is deducted on goods and services that are acquired for use in making taxable supplies.

The inability to connect the loan repayment to CCL, to the acquisition of goods and services used in the development should have led him to the conclusion that GST could not be claimed.

Snippets

Employee use of telecommunication tools and usage



Inland Revenue recently released Determination EE00 "Employee use of telecommunications tools and usage plans in their employment" to simplify

the PAYE / FBT rules for employee mobile phones.

The determination applies to three situations: Class A (principally business use of the phone), Class B (principally private use of the phone), and the De Minimis Class (a reimbursement payment of no more than \$5 per week, per employee).

Where there is principally business use of the phone, if the employer reimburses the employee 75% of their total phone bill, the whole reimbursement is exempt income. Alternatively, if they pay 100% of the bill, then 75% can be treated as exempt income of the employee.

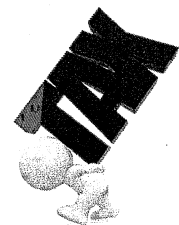
For principally private use, if the employer reimburses 25% of the total bill, then the whole amount reimbursed is exempt. Alternatively, if they pay 100% of the bill, then 25% can be treated as exempt income, with 75% taxable.

The De Minimis permits a payment of up to \$5 per week, amounting to no more than \$265 per year, per employee, to be treated as exempt income.

The devil is in the detail and there are a number of conditions that must be met before the above rules can be used, but it should provide employers with an easy rule of thumb to adopt.

Tax: a brief history

Tax is often quoted as being unfair. However, a review of taxes from historic periods can highlight how 'sensible' our current system is.



In ancient Egypt, the Pharaoh taxed citizens on many different goods, including cooking oil. Citizens were prohibited from reusing oil and buying oil from anyone other than the Pharaoh himself. Scribes would scour the city, searching homes and forcing households to buy new oil if they found they were non-compliant.

In 18th Century England, house builders were targeted in numerous initiatives, but quickly found cunning 'tax avoidance schemes'. They were firstly taxed on the number of bricks used in construction, so began to use bigger (and fewer) bricks to reduce their tax bill. They were subsequently taxed for the use of 'printed' wallpaper, so instead began to use plain wallpaper and painting patterns on the walls.

So, the next time you're looking at our tax rules thinking they're unfair, cast your mind back to some of these - it could be much worse!

If you have any questions about the newsletter items, please contact us, we are here to help.