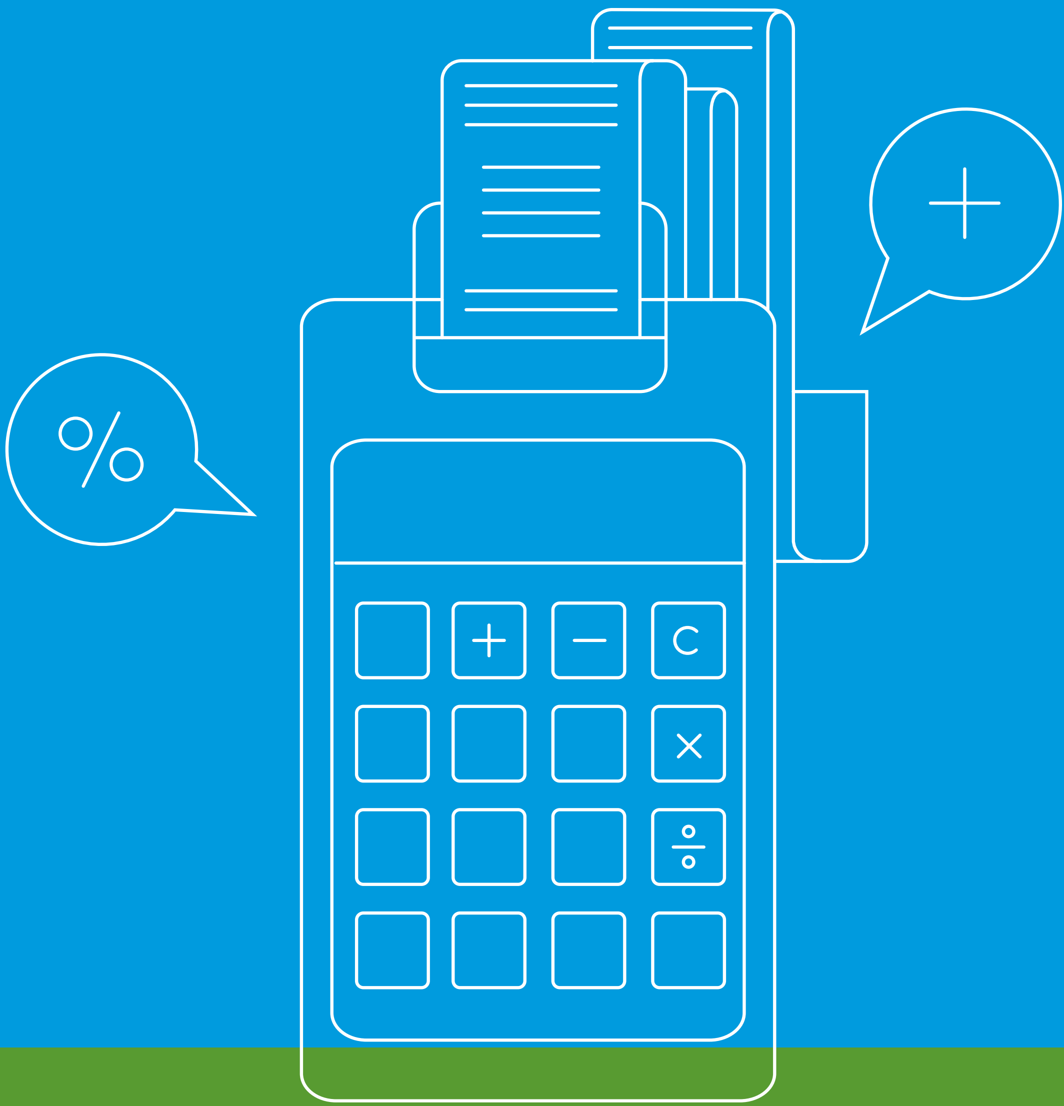


RSM

New Zealand

TAX UPDATE

December 2020

2020 is nearing an end and what a year it has been! As the international response to the Covid-19 outbreak continues we are working closely with clients both domestically and globally to prepare, respond, and share our experiences from a New Zealand perspective. Our commitment continues, but we are equally mindful that business "as usual as possible" must move forward. As we write this, New Zealand has less than 100 active cases however uncertainty surrounds us, and as your trusted advisors we are here to support you.

As part of our own expansion and growth we're excited to launch our inaugural Tax Update Newsletter. We had hoped to launch a quarterly edition earlier in the year but with the Covid-19 outbreak, our focus has been elsewhere.

We have signed you up for our newsletter in the hope that you will find great value in its content and that it will aid you in your own goals to grow and thrive. If you ever find that what we offer is not for you, simply click 'unsubscribe' at the bottom of any email.

Since the start of this year the Government has introduced a raft of tax rules in response to COVID-19. From March to June alone there have been 5 separate tax bills introduced and enacted. View our Covid resource site link for this information.

Also, earlier in June, the Government introduced the Taxation (Annual Rates for 2020-21, Feasibility Expenditure and Remedial Matters) Bill. The Bill contains changes to several areas of tax law discussed below. With confirmation of the new Government we expect the bill to be finalised shortly.

In our current edition of RSM Tax Update, we discuss some of the following key changes contained in the Bill:

- Tax deductions for feasibility expenditure on new investments;
- Habitual buying and selling of land;
- New purchase price allocation rules.

FEASIBILITY EXPENDITURE

In an effort to encourage businesses to invest in innovation and explore new assets, the Bill introduces new rules for the tax treatment of feasibility expenditure. The changes will also apply to certain "black hole expenditure". Black hole expenditure is a non-deductible/non-depreciable cost. The Bill considers expenditure incurred by a person in making progress towards completing, creating or acquiring property that is subsequently abandoned.

The new rules allow businesses to be able to claim a deduction for feasibility expenditure incurred in investigating a new asset, process or business model even if it is subsequently abandoned. It is proposed that the deduction will be spread over five years beginning with the income year in which the project is abandoned.

To simplify and reduce compliance costs, particularly for small and medium businesses, qualifying expenditure of less than $10,000 would be immediately deductible in the current income year – regardless of whether the project is abandoned or not.

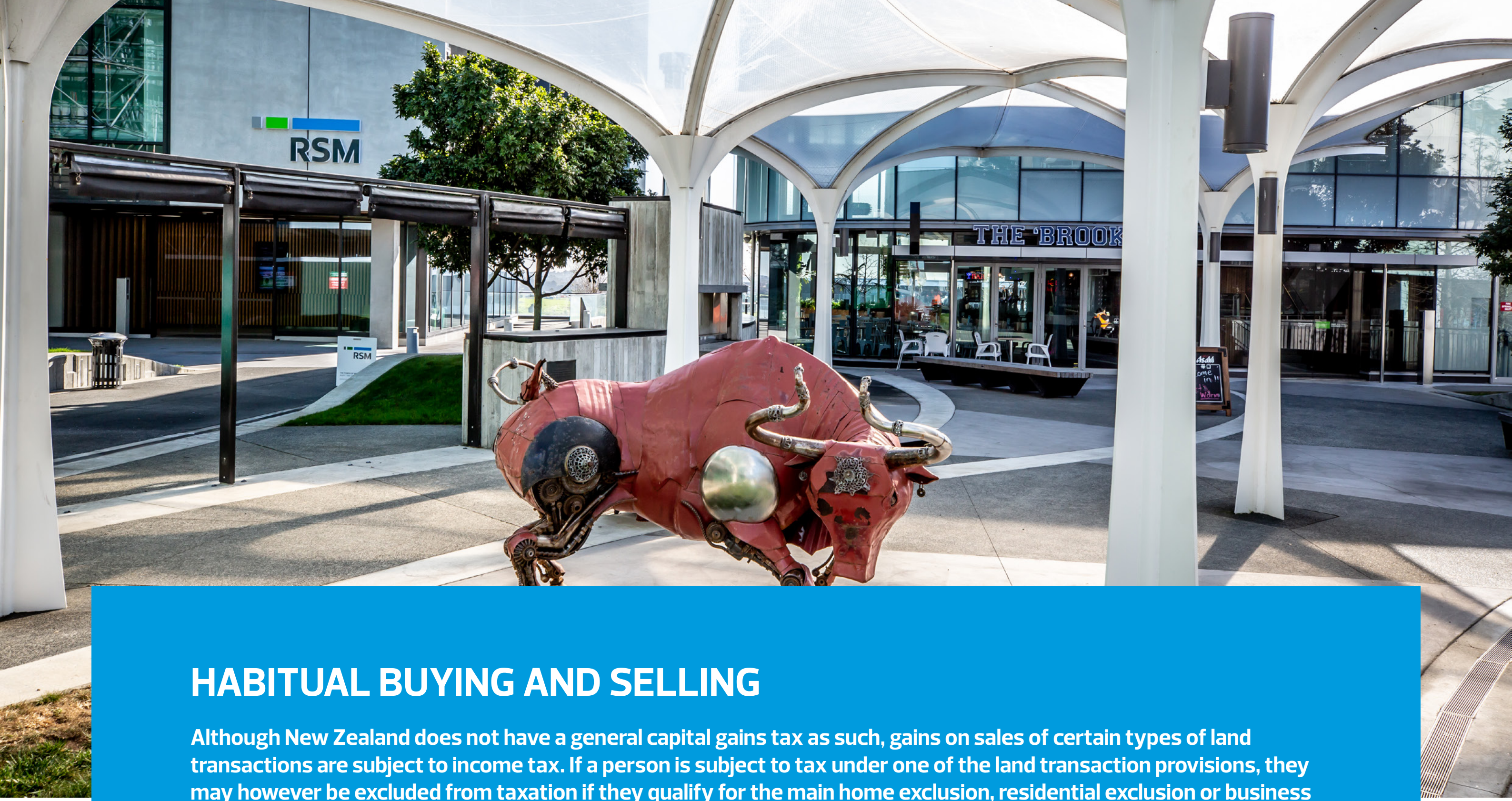
The expenditure would only be deductible if – had the project been successfully completed - the asset would be depreciable for tax purposes at more than 0% or a revenue account asset.

The rules also introduce claw-back provisions for deductions claimed under the new rules should the project be reinstated and completed at a later date. This income arises in the income year in which the relevant project is completed. There is no limit to the time period over which these claw-back provisions can apply.
The new rules are proposed to apply to expenditure incurred in the 2020/2021 and later income years.

OUR VIEWPOINT

The 2016 decision by the Supreme Court in Trustpower Limited v Commissioner of Inland Revenue [2016] NZSC91, resulted in a U-turn on the tax treatment of feasibility type costs, leaving taxpayers uncertain. Inland Revenue updated its guidance following Trustpower and this limited the ability to deduct costs of such projects. Taxpayer expectations diminished: the result being an increased cost of capital projects (due to the "black hole" nature of the costs) and decreasing desire to invest. The proposed changes in the Bill are therefore a positive step.

We support the Government's view that tax should not be a barrier for businesses seeking to invest in new projects or assets, except when there is an explicit denial of deductions (for example, expenditure related to assets when the taxpayer is not expected to incur an economic loss, such as land and shares). However, we do have concerns on the claw-back provisions given the indefinite application timeframe. This open-ended timeframe creates wide reaching implications as records relating to expenditure claimed would have to be kept for more than 7 years (the current legislative requirement). It also creates an unfair advantage favouring Inland Revenue, who could bypass statute bar limitations to potentially review expenses claimed under these provisions.
We strongly advocate for a timeframe to be incorporated into legislation to provide certainty for taxpayers adopting these new rules.



HABITUAL BUYING AND SELLING

Although New Zealand does not have a general capital gains tax as such, gains on sales of certain types of land transactions are subject to income tax. If a person is subject to tax under one of the land transaction provisions, they may however be excluded from taxation if they qualify for the main home exclusion, residential exclusion or business premises exclusion.

These three exclusions will not apply if a person has a regular pattern of buying and selling land. The principle underlying these restrictions is that a regular pattern of buying and selling, or developing and selling family homes or business premises is indicative of a profit motive.

There are concerns that the current regular pattern restrictions as they currently stand allow taxpayers who habitually buy and sell land to structure around the rules as they currently apply quite narrowly to the activities of a single person. The current rules can be circumvented by using different people or entities to carry out separate transactions or by varying each transaction so that there is no pattern.

The proposed amendments expand the regular pattern restrictions to apply to regular patterns of buying and selling land by a "group of persons acting together".

Main Home and Residential Exclusions

For the main home and residential exclusions, a group of persons will be treated as undertaking buying and selling activities together when:

- **all the people occupy all of the properties together as their residence; and**
- **where a property is owned by a trustee or other entity, at least one of the people who occupy all the properties has significant involvement in, or control of, the trust or other entity.**

Scenario A:

Mr and Mrs A acquire a property in April 2020 in the name of Mr A and occupy the property as their residence. They sell the property in April 2023. They then acquire a new property to occupy in April 2023 under Mrs A. This property is sold in April 2026.

In April 2026 a new property is acquired under Trust A with Mr A and their solicitor as the trustees of this trust. Mr and Mrs A occupy the property following acquisition and sell this property in April 2029. They acquire a new property April 2029 under Trust B with Mrs A and an independent trustee as trustees of this trust. Mr and Mrs A reside at this property and sell this property 3 years later in April 2032.

Under the proposed rules, Mr A, Mrs A, Trust A and Trust B will be treated as a group of persons who undertake buying and selling activities together. As those buying and selling activities form a regular pattern with the properties bought and sold at regular intervals, all four persons will be subject to the regular pattern restriction. For the residential and main home exclusions the most important factor is that all the people in the group occupy all the properties.

Business Premises Exclusion

For the business premises exclusion, a group of persons will be treated as undertaking buying and selling activities together where:

- **all persons in the group occupy premises mainly to carry on a substantial business irrespective of the nature of any business carried on; and**
- **a person whether or not they also occupy land as a business premises has significant involvement in, or control of, the activities of all those in the group.**

Scenario B:
Company A owned by Mr and Mrs A acquire a business premises in April 2020, operate a business and sell in April 2022. Company B owned by Mr and Mrs A acquire a business premises in April 2022 and sell in April 2025. This occurs twice more whereby Company D and E are set up for the same purpose with buy/sell activity over similar periods of time (in relation to the business they operate from those premises).

Under the proposed law these companies will form a group of persons who are treated as undertaking buying and selling activities together. Because those buying and selling activities form a regular pattern and as the properties are sold at regular intervals, they will be subject to the regular pattern restriction.

It is acknowledged in the Bill commentary that expanding the regular pattern restrictions could be wide reaching and would potentially subject ordinary residential transactions that occur for genuine reasons, to tax. In addition small businesses that are upgrading premises as the business grows may fall foul of these proposals. A tax liability should not result merely because of a business' ongoing expansion. Without limitation to the expanded regular pattern restrictions, persons who are associated with another person in a business involving land (such as a dealer, developer or divider, or builder) will be at risk of additional tax liability. This is because they are, prima facie, subject to tax on all sales of land within ten years of acquisition whether or not the land is used in a business or other income-earning scheme. It would have rendered the exclusions available to such persons to ensure their genuine homes and business premises are not taxed on sale redundant.

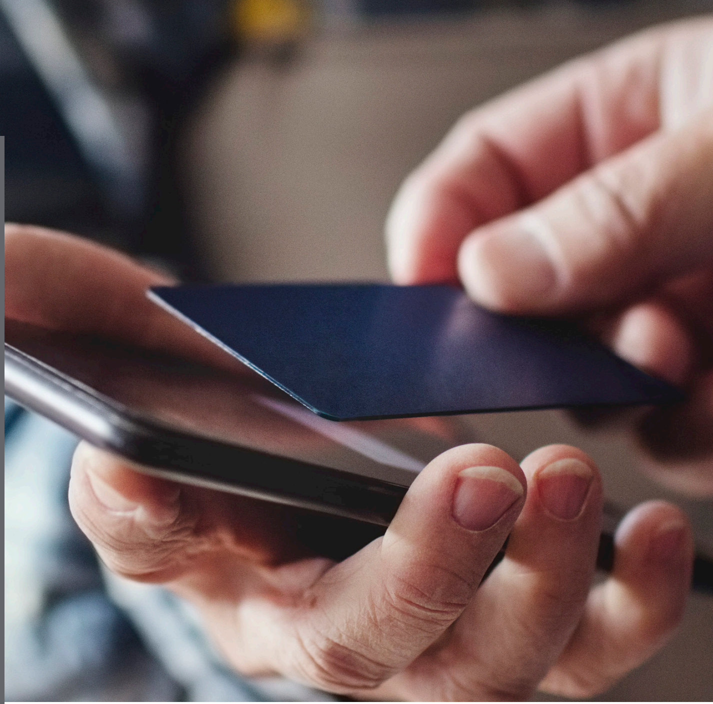
Thus to limit its application, the expanded regular pattern restrictions in the residential and business premises exclusions will only apply when the land was acquired with a purpose or intention of disposal. The rules are proposed to apply to land acquired after the date of enactment of the Bill. However, land acquired before the application date may be considered for the purposes of determining whether a group of persons have a regular pattern.

OUR VIEWPOINT

We are pleased to see that the rules, as proposed in the current Bill limit the scope of application. The rules will only apply if the land was acquired with a purpose or intention of disposal.

When these changes were initially proposed in September 2019 in the consultation document "Habitual buying and selling of land", there was no limitation to the application of the regular pattern restrictions. This caused concerns that a business experiencing substantial growth and requiring them to move multiple times over a few years to more appropriate business premises, or a person, selling their home due to family reasons, would be inadvertently caught under the rules. This is not the intention and we welcome the revised rules which clarify this position.

We do note that the additional requirement to the restriction requiring the land to have been acquired with a purpose or intention of disposal is only applicable to the residential and business premises exclusions and does not cover the main home exemption which corresponds to the bright-line rules.



PURCHASE PRICE ALLOCATION

New rules will be enacted to govern how parties to a sale and purchase transaction allocate the total price between assets bought/sold for tax purposes. This will apply where two or more assets are acquired such as depreciable property and buildings which have differing tax treatments.

Under the current rules parties to a transaction are generally required to ascribe market values to the assets. The primary rule is that the allocation of value adheres to a market value principle but there is no requirement for the vendor and purchaser to use the same market value. There is also no requirement to ascribe a value to each asset acquired. This means that the vendor and purchaser can adopt different allocation values for different assets which best minimises their respective tax liabilities.

The new rules will remove this distortion and streamline the allocation of value. The key features of the new rules are:

- If both the vendor and purchaser have agreed to an allocation, both parties are bound by it for tax purposes and must adopt this position accordingly in their respective income tax returns.
- If the parties have not agreed to an allocation, the vendor gets first right to determine the allocation. The vendor must notify both the purchaser and Inland Revenue of their allocation within two months of ownership change of the assets. The vendor is required to determine the allocation based on market value however the allocation must not result in any additional tax loss on the sale of that property. Therefore the allocated price must be the lesser of the market value and the property's tax value (adjusted for a pro rata portion of the depreciation in the year of sale).
- If the vendor does not determine an allocation within the two month timeframe, the purchaser is entitled to determine the allocation and notify both the vendor and Inland Revenue of it.
- If neither party makes an allocation, the vendor is treated as disposing of the property for its relative market value, and the purchaser is treated as acquiring the property for nil consideration. The effect of this is that the purchaser is unable to claim depreciation or other deductions in relation to the property. This provides an incentive for the purchaser to determine allocation before filing their tax return.
- The rules are not required to be applied to a transaction if the total purchase price is less than $1 million, or the purchaser's total allocation to taxable property is less than $100,000 (de minimis threshold).

Inland Revenue can challenge the allocation if it considers that the allocation does not reflect market values. Inland Revenue however may not challenge the allocation if the low value depreciable property de minimis rule applies. This is where:

- the original cost of the property to the vendor is less than $100,000;
- the allocation to the property is no less than its adjusted tax value and no greater than its original cost; and
- where there are multiple identical assets each with an original cost of less than $100,000, the total amount allocated to those assets is less than $1 million.

Whilst not explicitly stated in the Bill, the accompanying Bill commentary has clarified that parties do not have to allocate a value to every individual item provided sufficient allocation is made at the asset category level, e.g. depreciable property, buildings, revenue account property, inventory, financial arrangements, land etc. Of course Inland Revenue will accept more detailed allocations. This is to help balance and eliminate most of the scope for tax manipulation without imposing unrealistic compliance costs.

The new rules apply to agreements for the disposal and acquisition of property entered into on or after 1 April 2021.

PURCHASE PRICE ALLOCATION

OUR VIEWPOINT

Although the proposed rules may have tax implications on the transaction, they will also have commercial implications on the parties. Whereas in the past vendors and purchasers were free to make allocations which best suited each of them, the price allocation will now be an item of negotiation. It is now best practice to include a purchase price allocation (or a mechanism for agreeing an allocation) in the sale and purchase agreement and we encourage both vendors and purchasers to consider this when negotiating sale and purchase agreements.

We anticipate that there will be further costs incurred as part of the due diligence process, as third-party consultation with experts/valuers will be necessary to ensure that value allocations across asset categories are agreed upon. This would add a layer of compliance to what is generally already a lengthy and complex process, particularly in a cross border transaction. In addition, any prospective purchaser needs to be involved in this from the outset to protect their own tax position.

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