NEW ZEALAND
LAW SOCIETY

NZLS EST 1869

Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill

12/8/2020

Submission on the Taxation (Annual Rates for 2020-21, Feasibility Expenditure and Remedial Matters) Bill

1 Introduction

1.1 The New Zealand Law Society |Te Kāhui Ture o Aotearoa (Law Society) welcomes the opportunity to comment on the Taxation (Annual Rates for 2020-21, Feasibility Expenditure and Remedial Matters) Bill (the Bill). This submission provides feedback on the following parts of the Bill:

(a) Habitual buying and selling of land (clauses 5, 6 and 7)

(b) Feasibility expenditure (clauses 11 and 16)

(c) Purchase price allocation (clause 40)

Additionally, we have provided feedback on the amendments to the Unclaimed Money Act 1976 included in Supplementary Order Paper 510 to the Bill (SOP 510).

1.2 The Law Society does not seek to be heard but is happy to discuss this submission with the Finance and Expenditure Committee or officials if that would be of assistance.

2 Habitual buying and selling of land (clauses 5, 6 and 7)

2.1 Clauses 5, 6 and 7 extend the regular pattern restrictions in the main home exclusion (section CB16A), the residential exclusion (section CB 16) and the business premises exclusion (section CB 19), so that taxpayers cannot structure around the regular pattern restrictions by using different people or entities to carry out separate transactions, or by varying what is done to the land in each transaction so that there is no pattern.

2.2 The definition of "group of persons" is central to the proposed amendments to sections CB 16A, CB 16 and CB 19. Paragraph (b) of that definition for the purpose of sections CB 16A and CB 16 provides that a "group of persons" includes a trustee of a trust or another entity if a person referred to in paragraph (a) of the definition "has significant involvement in, or control of, the activities of the trustee or other entity". Paragraph (b) of that definition for the purpose of section CB 19 refers to a person, whether or not they occupy the business premises, who "has significant involvement in, or control of, the activities of all persons referred to in paragraph (a)" of the definition.

2.3 The Bill does not define the composite phrase "has significant involvement in, or control of". That phrase is not otherwise used for income tax purposes, although a similar phrase "has significant involvement in, <u>and</u> control of" is used in the definition of a "foreign exempt partnership" (but not separately defined) for the purpose of the qualifying foreign equity exemption in section CW 12.

2.4 The term "significant involvement in" is vague and open to interpretation. The word "significant" is imprecise and it is not clear what type of "involvement" is required. For example, it is not clear whether a shareholder would be treated as having "significant involvement" in a company and, if so, what level of shareholding would be treated as "significant".

2.5 The word "control" is also imprecise. For example, it is unclear whether this word includes de facto control or is limited to de jure control. By way of analogy, the interpretation of the phrase "control … by any other means" has created uncertainty in the context of the 'two companies' test of association in section YB 2(3), as evidenced by the conflicting dicta of Clifford J and Edwards J in *Concepts 124 Limited v C of IR* (2014) 26 NZTC 21-100 and *Staithes Drive Development Limited v C of IR* (2015) 27 NZTC 22-028, respectively.

2.6 Page 22 of the Commentary on the Bill states that, in the context of the proposed amendments to sections CB 16A, CB 16 and CB 19, these terms indicate that the relevant person is able to direct, alone or as part of a group, the relevant trust or entity's decision-making process.

2.7 Recommendation: The Bill should define the phrase "significant involvement in, or control of" in those terms, rather than leaving the phrase undefined.

3 Feasibility expenditure (clauses 11 and 16)

Extension of proposed section DB 66 to include costs in relation to abandonment

3.1 The Law Society welcomes the amendments in relation to the deductions for feasibility expenditure which will overcome the issues presented by the Supreme Court's decision in *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91.

3.2 The proposed section DB 66 (clause 16) allows deductions for expenditure incurred in "making progress towards completing, creating, or acquiring property" that would be depreciable property or revenue account property, on abandonment of further progress in relation to the relevant project.

3.3 In the income year in which the taxpayer abandons progress in relation to the relevant project there may well be costs incurred in relation to abandonment of the project which would not necessarily be treated as costs incurred in "completing, creating or acquiring" the relevant property which is subject to the particular project.

3.4 For example, reference is made to example 1 in the commentary to the Bill, which postulates a scenario where company A, an electricity generator, incurs expenditure over a 5-year period associated with measuring wind frequency at a potential site for a wind farm. The example records that the studies are inconclusive and the project is mothballed. In relation to that particular project, abandonment costs could include, for example, dismantling of the plant and equipment which has been set up on the relevant test sites, and possible remediation of the test sites which is required to be undertaken in the event of abandonment.

3.5 Such abandonment costs could not be considered to be costs incurred in "progressing" the "completion, creation or acquisition" of the relevant wind farm and would not be deductible under the proposed section DB 66. However, those abandonment costs should be treated as part and parcel of the proposals for deduction of feasibility expenditure as they are incurred in relation to the relevant project, abandonment of which currently results (without the proposed amendments) in black hole expenditure. That will continue to be the case if abandonment costs are not brought within the proposed deductibility regime, and such a result (i.e. non-deductibility) would not be consistent with the policy objectives of the amendments.

3.6 Recommendation: The proposed section DB 66 should be expressly extended to costs incurred in relation to abandonment of the feasibility project.

Proposed section CH 13 (clause 11) – clawback of feasibility expenditure previously deducted where property subsequently completed, created, acquired, or replaced

3.7 Proposed section CH 13 (clause 11) relates to the clawback of feasibility expenditure which has previously been deducted, where there is a subsequent completion or creation of the property or similar property which was the subject of the earlier feasibility project.

3.8 Subsection (2) of the proposed section CH 13 provides for clawback of deductions previously obtained "to the extent to which the deductions are directly for the property". The concept of deductions being "directly" for the property does not target the particular deductions which should be clawed back. The costs to be clawed back should be those which:

(a) in relation to depreciable property, form part of the cost of that property (which is subsequently created or acquired) and can then be subject to the depreciation regime; or

(b) in relation to revenue account property, can be properly treated as the cost of the revenue account property and which could be claimed as a deduction on the disposal of the relevant revenue account property in accordance with section DB 23.

3.9 There may be situations where the deductions previously claimed could be said to be incurred "directly" in relation to the subsequently completed or created property, but they are either not subject to the depreciation regime (because they cannot be regarded as the cost of that property) or not deductible as the cost of the completed, or created, revenue account property. If that is the case, those deductions should not be clawed back under section CH 13.

3.10 Recommendation: Subsection (2) of proposed section CH 13 should be more specific in targeting the deductions which are to be clawed back, namely those which on subsequent completion or creation of the property are deductible under the depreciation regime or deductible under section DB 23 (when the relevant subsequently completed or created property, being revenue account property, is disposed of by the relevant taxpayer).

4 Purchase price allocation (clause 40)

De minimis – proposed section GC 21(5)

4.1 There is a drafting flaw in proposed section GC 21(5). For example, there may be a situation where neither the seller nor the purchaser is required to make an allocation due to the transaction falling within the de minimis. However, due to section GC 21(7) applying when no allocation is made, this appears to mean that the operation of section GC 21(5) will likely always lead to subsection (7) applying.

4.2 Recommendation: In section GC 21(7), after "*In the absence of an allocated amount*", the following words should be inserted: "*and if subsection (5) does not apply*".

Interaction with other tax provisions referencing market value needs to be clarified

4.3 There are numerous situations in the Income Tax Act 2007 where assets are deemed to be disposed of at market value (for example, depreciable property, carbon units, revenue account property, trading stock). The new rules as introduced do not specifically provide that an agreed allocation applies for all purposes. Unless the interaction of these various regimes is clarified in the legislation, there is a technical risk that tax imposed by reference to a deemed market value transaction could require a different value to be used than the value that is allocated (which may not reflect a party's view of market value if they did not make the allocation, or if an allocation has been negotiated).

4.4 Recommendation: The legislation should address the interaction between the sections deeming certain property to be disposed of at market value and the new purchase price allocation rules.

The rules do not adequately cater for purchase price adjustments

4.5 More clarity is needed in relation to how the proposed rules are intended to apply when there is an element of uncertainty in relation to the final amount of consideration that will be paid at the time the sale completes. Such uncertainty may arise in a number of circumstances:

a. a purchase price adjustment mechanism driven off the value of the assets and liabilities or otherwise (e.g. a payment made by a party or under warranty and indemnity insurance due to a warranty breach or under an indemnity);

b. an earn-out provision;

c. an element of deferred consideration;

d. where funds are held in escrow for a period following completion of a transaction and are ultimately paid back to the purchaser rather than across to the seller.

4.6 Where these circumstances exist or later eventuate, consideration may not be finally determined until months or years after the transaction. This will in many cases be after the 2-month timeframe provided for a vendor to make an allocation.

4.7 Recommendation: The legislation could allow for the same hierarchy of rules to apply at the time any further consideration is paid.

The timing of deductions is not clear where an allocation has been made after the filing of a relevant tax return – proposed section GC 21(7)

4.8 Under proposed s GC 21(7), if neither the vendor nor purchaser makes an allocation, the vendor is treated as disposing of the property at its tax book value and the purchaser is treated as acquiring the property for nil consideration. We understand that the way the rules are intended to operate is that the purchaser will be able to ensure this situation does not eventuate by making an allocation (at any time). However, it is not clear under the proposals exactly how an allocation made late will work. In particular, the timing of any deductions needs to be further considered.

4.9 For example, if a purchaser acquires a financial arrangement or revenue account property in one accounting period, and no allocation was made until the next accounting period, do the relevant adjustments/deductions for each of the pieces of the property apply in the year of disposal or the year that the allocation is made? Under EW 31(2), base price adjustments should occur in the year of disposal. Similarly, sections EA 1 and EA 2 state that deductions for revenue account property and trading stock must be taken in the year of disposal. If a deduction does not arise until an allocation is made, this may be too late for the purchaser to actually claim the deduction. It also gives rise to potential manipulation by the purchaser to control the timing of deductions. This seems an undesirable outcome.

4.10 Recommendation: The legislation should be clarified to provide certainty on availability and timing of deductions where an allocation is made late.

5 SOP 510 – Unclaimed Money Act 1971 amendments

5.1 The amendments in SOP 510 are intended to modernise the Unclaimed Money Act 1971 (UMCA) and reduce compliance costs for holders and owners of "unclaimed money" and reduce administrative costs for Inland Revenue (IR).[1]

5.2 The Act has not been reviewed since its enactment in 1971 and the changes are welcomed. However, the $100 threshold in the 1971 Act applying to amounts that qualify as "unclaimed money" has been retained in the SOP.[2] The $100 threshold creates practical difficulties in relation to small balances held by lawyers in trust accounts under the Lawyers and Conveyancers Act 2001 (LCA). As noted in the Law Society's recent submission to IR about the proposed UMCA changes,

> One barrier to using the unclaimed money process which arises, is that dormant balances may well be for small amounts under the current $100 threshold. We are aware that Inland Revenue has noted in the past that it has received payments from lawyers below the threshold and this raises administrative efficiency issues for Inland Revenue.[3]

5.3 Lawyers can often be left with small balances held in a trust account, with no ability to locate a rightful payee. Although it is not mandatory under the LCA to pay funds to IR as unclaimed money, there is no other practical avenue for lawyers in cases where client authority is not held for payment to any other third party.[4]

5.4 The effect of the SOP is that amounts falling below $100 continue not to qualify as unclaimed money, unless the Commissioner exercises a discretion to accept the amount as unclaimed money. That is an unsatisfactory legislative limbo and runs counter to the objectives of introducing a modernised and better functioning regime both for holders of unclaimed money and for IR. There is no logical reason why the modernised regime should not deal with *all* unclaimed amounts, and the Law Society therefore <u>recommends</u> that the SOP be amended to provide a 'de minimis' threshold of 1c and above.

---

1 SOP 510 dated 26.6.2020, explanatory note: "Unclaimed money generally refers to money which has been abandoned by its owner. A common example is a bank deposit which has remained untouched in an account for a period of years. Under the Unclaimed Money Act 1971, an amount which is left for either 6 or 25 years (depending on the product category) will become "unclaimed money" (UCM) within the meaning of the Act."

2 Unclaimed Money Act 1971, s4(1)(e)(i). Under SOP 510, the meaning of "unclaimed money" includes proposed new s4(2)(e): that "the amount payable to an individual owner exceeds $100 or, if that amount is less than $100, the Commissioner agrees to accept the amount as unclaimed money".

3 Inland Revenue tax policy consultation 'Unclaimed money': NZLS submission 28.2.2020, available at https://www.lawsociety.org.nz/__data/assets/pdf_file/0008/143990/l-IR-Unclaimed-Money-Act-1971-28-2-20.pdf

4 NZLS submission 28.2.20 at pp2-3.

5.5. Alternatively, if the $100 threshold is to be retained, holders of unclaimed money would expect and welcome clear guidance from IR on how to deal with amounts below the $100 threshold, including the circumstances in which the Commissioner will exercise the discretion to accept lesser amounts.

Arti Chand
Vice President
12 August 2020