

# NEWSLETTER

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## Government addresses housing affordability

On the 23rd March 2021 the Government announced that it would make a number of changes to the taxation of residential property to address housing affordability. Legislation has been enacted implementing some of the announced changes, whilst the balance are to be consulted upon before further legislation is drafted.



**Legislated changes** - The bright-line test taxes the sale of residential property if it is sold within a prescribed period of time, subject to specific exclusions such as for the family home and farmland. The new legislation prescribes that a residential property acquired on or after 27 March 2021 will be subject to a 10 year bright line test, i.e. if it is disposed within 10 years of acquisition (generally the date a binding sale and purchase agreement is entered into) any capital gain will be subject to income tax. For transactions part way through completion as at 27 March 2021, guidance has been released by Inland Revenue to assist in determining whether the new 10-year period applies or not.

The exclusion for the ‘main home’ has also been modified. Under the old rules the bright-line test applied on an all or nothing basis, i.e. if the property was ‘predominantly’ a main home it was not taxable on sale. This exclusion has been amended. For property acquired from 27 March 2021, if the main home is not used as the owner’s main home for more than 12 months at a time during the bright-line period, the profit on sale will be partly taxable based on the period it was not a main home. If the property was purchased before 27 March 2021 the main home exclusion continues to apply on an all or nothing basis.

**Changes to be implemented** - Although legislation has been passed increasing the bright-line period to 10 years, as outlined above, it has been proposed that the pre-existing period of five years will continue to apply to ‘new builds’. However, at this stage what comprises a

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new build has not been defined.

The Government also proposed to introduce new legislation to disallow interest deductions relating to income from residential investment properties. The Government referred to this as ‘closing a loophole’, even though being able to deduct expenditure incurred to derive taxable income is a fundamental and basic feature of New Zealand’s tax system.

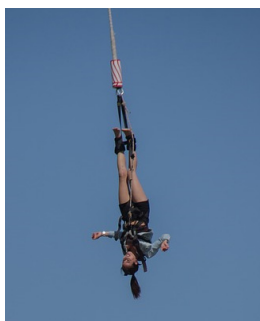
The Government intends to deny interest deductions for residential rental properties acquired on or after 27 March 2021. For properties acquired before 27 March 2021, the ability to claim interest will be progressively phased out over four income years starting from 1 October 2021 (i.e. by 25% each year until the 2025-26 income year). An exemption is to

be introduced for new builds. However, the definition of what comprises a new build has not yet been defined for this purpose either.

Over recent years a number of changes to the taxation of residential property have been made that did not appear to slow house price inflation, such as rental losses being ring fenced, depreciation deductions being denied, the bright line test being first introduced and then being extended to five years. But this is the first time a distinction is being created within the residential market itself by treating new builds differently. This could prove to fuel the price of new houses even more, particularly if the underlying issue of low supply has not been addressed.

## Employment recovery

Over a year on from NZ’s level four lockdown, businesses and communities alike have experienced their fair share of highs and lows. Many have had to rapidly adapt to the Covid-19 induced restrictions. For some, they have benefited from unpredictable productivity gains, meanwhile others have struggled to regain pre-pandemic momentum. Employment levels slumped to an eight year low in September 2020, with over 150,000 unemployed people. So nearly six months on, how does the job market stack up now?



Statistics released by Seek NZ reveal that March 2021 saw the highest number of jobs ever advertised on the site. Listings for jobs were up 11% on the prior month and up 55% on March 2020. Every region in NZ saw listings increase, with Bay of Plenty, Otago and the West Coast experiencing the largest growth (22%).

Perhaps in response to the expectation of a NZ / AU travel bubble, hospitality and tourism showed one of the most significant increases, with listings up 32% compared with February. Retail and consumer products followed closely behind with a 29% increase.

Trade Me Jobs paints a similar picture with over 70k jobs listed for the quarter ending 31 March 2021, representing a 22% increase in Q1 compared to prior year. The sectors with the largest year-on-year increase were automotive (50%), construction and

roading (43%), and manufacturing and operations (40%). Although prior year figures may show signs of the economic uncertainty first felt from Covid-19, the Q1 figures for 2021 still exceed those of Q1 of 2019 (up 15%) and Q4 of 2020 (29%).

Interestingly, despite the increase in job listings, Seek NZ data shows that applications per job are actually down.

With an abundance of listings, job hopefuls should feel optimistic that their career or job search is looking up. However, employers may be feeling the pressure to find the right fit. It is not uncommon for hiring managers to have post hire regrets when they find their new hire is not fit for the role, and this inevitably comes at a cost.

New Zealand employers have cited increased stress on colleagues, increased workload for existing team members and increased stress on managers as the three top consequences of a bad hire. However, the ripple effect doesn’t stop there with lost productivity, higher recruitment costs and low staff morale also arising as a result of recruiting the wrong person.

Despite the above, the current state of the job market shows positive signs for NZ’s ongoing recovery in response to Covid-19. A resurgence in listings for hospitality and tourism provides a spark of optimism for a sector which has been hit particularly hard.

## Penalising R&M

Classifying expenditure as either deductible repairs and maintenance (R&M) or non-deductible capital expenditure is not clear cut. It is a question of fact and no two situations are the same. But it is advantageous from a tax perspective to classify as much expenditure as possible as R&M, which gives rise to the risk of pushing ‘the line’ too far. There

isn’t a rigid test to be applied, but the courts have identified a two-stage approach for determining the nature of the expenditure and whether it comprises R&M:

1. Identify the relevant asset being repaired or worked on.

## 2. Consider the nature and extent of the work done to that asset.

Repair and maintenance of assets can be achieved in several ways. For example, the asset may simply be patched up or it could be restored to “as new” condition or substantial parts of the asset may be replaced. If the expenditure results in the reconstruction, replacement or renewal of the asset it is likely to be capital expenditure. Whereas, expenditure incurred to repair or maintain the asset to its original condition is generally deductible in the year it is incurred. If the expenditure creates a substantially new or improved asset, then it is likely to be capital.



A recent Taxation Review Authority case (TRA 015/19 [2020]) is one such example and serves to highlight the risk of getting it wrong.

The taxpayer in the TRA case incurred \$680k carrying out works at two adjacent properties. Of this, R&M deductions of over \$408k were claimed. The expenditure related to alterations to a building used as a bar and restaurant. Two building consent applications reflected the floor area of the relevant building would increase from 250m<sup>2</sup> to 592m<sup>2</sup> and described the work as the addition of a covered veranda and extra toilets. A fire consultant's report described the work as internal refurbishment and the creation of an external dining and recreation area that included the construction of trellis and

PVC roofing. The taxpayer tried to argue the work comprised two separate projects that could be apportioned between R&M versus capital expenditure.

The TRA disagreed with the taxpayer and took the view it was one capital project to extend and modernise the building and could not be apportioned. The TRA also considered the question of whether the taxpayer was liable for a shortfall penalty, which are charged based on the circumstances and the severity of the actions by the taxpayer. The TRA commented: “...the position taken by the disputant lacked any particular merit.”

Accordingly, a shortfall penalty for ‘unacceptable interpretation’ was imposed, subject to a 50% reduction for good behaviour.

There are five categories of penalty that can apply to a ‘tax shortfall’ on a graduated scale, specifically:

- 20% for not taking a reasonable tax position,
- 20% for taking an unacceptable tax position,
- 40% for gross carelessness,
- 100% for taking an abusive tax position, and
- 150% in the case of tax evasion or similar.

In practice, some discretion is exercised by Inland Revenue when deciding whether a shortfall penalty is charged and what type. However, in cases like this where a taxpayer is pushing the line too far, a penalty is more likely than not.

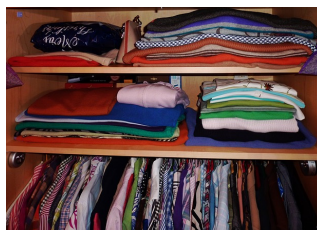
## Business interruption due to Covid-19

The onset of the Covid-19 pandemic had an immediate impact on businesses nationwide. Lockdowns and the border closure have caused massive disruption. For many this was temporary, for some, permanent.

Inland Revenue has released a draft Interpretation Statement “Income tax and GST – deductions for businesses disrupted by Covid-19 pandemic”. The statement sets out Inland Revenue’s ‘draft’ view on to what extent businesses can claim tax deductions for expenditure incurred whilst impacted by Covid-19. The deadline for comment is 28 May 2021.

Within the draft document Inland Revenue first covers the technical principles governing whether an expense is deductible or not and then covers a number of examples to demonstrate how the principles apply in practice. It appears Inland Revenue is taking a hard line.

Broadly, an expense is deductible if it is incurred to derive assessable income or in the course of carrying on a business. The leading case on



whether a business exists was decided by the Court of Appeal in *Grieve v CIR* (1984). Inland Revenue revisits the principles of that case and outlines: whether a business exists or not is based on a two-fold assessment as to the nature of the activities carried on and the intention of the taxpayer in engaging in those activities. The end result being that if a business does not exist, then expenditure that is incurred post cessation is non-deductible.

Whether a business has ceased is determined by the facts in each scenario and the nature of activities that continue to be carried on. The example is provided of a small international tourism business that has had to stop making sales while the borders are closed. To minimise costs it holds \$100,000 of stock at its warehouse, which the owner visits weekly to maintain, he checks emails daily for new orders and continues to pay a security guard service to monitor and patrol the building. Inland Revenue take the view that “it is no longer possible to make a profit in the current climate” and that the pattern of activity, commitment of time and effort etc.

do not suggest an existence of a business. A different interpretation could suggest that a business continues to operate as resources, time, money and effort, remain committed with the view to profit in the future.

There appears to be a lack of acknowledgement by Inland Revenue that the current global situation created by Covid-19 is more likely to be temporary than permanent and therefore if a business has not literally closed its doors, the owners will be doing everything possible to reopen once life returns to normal. As stated in Grieve:

*The legislation sensibly allows for deductions and allowances to be claimed even where the overall result is a trading loss. It is not for the Courts or the*

*Commissioner to confine the recognition of businesses to those that are always profitable or to do so only so long as they operate at a profit.*

Inland Revenue also makes no allowance for whether the expense has been incurred to derive income in the future, nor how the need for the expense arose. For example, Australian case law supports the view that if the obligation to incur an expense arose as part of operating a business, it continues to be deductible after the business has ceased, e.g. interest on debt.

In the past Inland Revenue has cast doubt on whether the New Zealand courts would take a similar view. However, that uncertainty appears to have now been squashed.

## Snippets

### Fair market salary reminder



There is a general need for a business to pay associated employees a fair market salary for their personal service. Given the implementation of a 39% personal marginal income tax rate on income over \$180,000 from 1 April 2021, Inland Revenue's scrutiny of such salaries is expected to increase. This has been confirmed through Inland Revenue issuing two related documents in March 2021 in quick succession, namely:

- Interpretation Statement 21/02 – Income tax – Calculating income from personal services to be attributed to the working person (released 19 March 2021); and
- Revenue Alert 21/01 – Diverting personal services income by structuring revenue earning activities through a related entity such as a trading trust or a company: the circumstances when Inland Revenue will consider this arrangement is tax avoidance (released 29 March 2021).

Both of which are aimed at warning taxpayers against the use of associated entities or family members, to avoid the highest personal income tax rate on income from the supply of services that they personally perform. For example, surgeons or consultants operating through a company.

We have seen instances where the same flat salary amount is allocated annually to working shareholders for numerous years, without an annual review of that salary nor a comparison to market. Hence, it is a timely reminder to review salaries paid to associated employees, to ensure they reflect current market conditions.

As with any tax position, best practice would be to document the rationale for the allocated salary (e.g. market data or a file note), to evidence reasonable consideration and care has been taken.

### Supply shortages

COVID-19 has fundamentally disrupted global trade to the point there are a number of product shortages starting to play out, and in some cases of some surprising items:

- The shipping containers themselves: With only two makers of shipping containers globally and containers being trapped in the congestion at ports, there is now a shortage of containers, let alone the products that fill them.
- Toilet paper: At this stage, most people are aware of the high demand for toilet paper – with countless people stockpiling and panic-buying rolls to ensure that they don't run out during a lockdown. However, the risk now exists that manufacturers will run low on wood pulp due to the container shortage.
- Marmite: The popular but polarizing spread has also been in short-supply due to a lack of brewer's yeast amidst pub closures.
- Ketchup packets: The US is facing a shortage of ketchup packets because of the increased demand due to the change from dine-in to takeaway and delivery.
- Garden Gnomes: Left with few leisurely options available in lockdown, people have resorted to gardening as a source of entertainment. This boom in demand, coupled with a shortage of raw materials due to the Suez Canal incident, has seen the humble garden gnome become a hot commodity.



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