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# NEWSLETTER

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## INSIDE THIS EDITION





## Flooding events tax concessions

In response to the adverse weather events that hit in January and February this year, a number of tax concessions were released on 14 March 2023 in an attempt to provide some relief to those who were impacted.


The events have been collectively given the legislated name "North Island flooding events", which has been defined as including the following events, dates and Districts/Regions.

Cyclone Hale: 8/01/23 – 12/01/23, Coromandel, Gisborne, Northland, Wairarapa, Wairoa.

Heavy rainfall: 26/01/23 – 3/02/23, Auckland, Bay of Plenty, Northland, Waikato.

Cyclone Gabrielle: 12/02/23 – 16/02/23, Auckland, Bay of Plenty, Gisborne, Hawke's Bay, Northland, Tararua, Waikato.

Included in the March 2023 tax concessions are:

- Where employees are required to relocate to work on a project of limited duration relating to the rebuild or recovery of an area impacted by a North Island flooding event, an employer can provide the employee with tax-free accommodation or an accommodation allowance, for up to five years provided the employee starts the project within six months of the flooding event. Normally this tax-free accommodation period for out-of-town projects is three years.
- An exemption from PAYE and FBT for ex-gratia payments or benefits from an employer to an employee impacted by a North Island flooding event of up to $5,000, provided the payment or provision of the benefit is within eight weeks of the first date of the relevant event. Where the payment or benefit comprises accommodation, there is no $5,000 cap, however the eight-week time frame still applies.

Another response to the North Island flooding events was the extension of the temporary tax concessions relating to donated trading stock that were first introduced in response to Covid-19. They were due to expire on 31 March 2023, but will be extended to 31 March 2024.

For context, prior to March 2020, where a business disposed of its trading stock for less than market value, the business was treated as disposing of it for market value. As a result, a deemed taxable profit margin arose, creating a tax disincentive for businesses to donate their trading stock

As part of the COVID-19 related tax concessions, temporary amendments were made to this provision in March 2020 to allow businesses to make trading stock donations; for example, to hospitals or food banks, without incurring a tax liability on the donation.

There are two different treatments that apply:

1. Where donations of trading stock are made to a donee organisation (e.g. a registered charity) or a public authority, the deemed market value provision does not apply. As a result, in this scenario, a business would be allowed a deduction for the cost of the trading stock, with no deemed gross income arising.
2. Where donations of trading stock are made to non-associates that are neither a donee organisation or public authority, the business is treated as deriving an amount of income equal to the cost of the trading stock. As a result, in this scenario, the impact on the business' taxable income is nil.

The deemed market value provision was originally introduced in the 90s as a tax avoidance measure, to address situations where sole traders were using their trading stock for private purposes. However, the disincentive for businesses who are genuinely trying to help their community does raise the question of whether the provision was too harsh – an obvious and easy solution would be to make these temporary amendments permanent.

## Deductibility of holding costs for land

On 31 March 2023, Inland Revenue released a draft interpretation statement (PUB00417) addressing the deductibility of land holding costs - namely, interest, rates and insurance - and the relevance of whether the land is taxed on disposal. This had been an area of uncertainty since the introduction of the residential bright-line provisions in 2015, which can result in a disposal of land being taxable even if it was held on capital account or used privately.

Inland Revenue previously released a consultation document in October 2019, which considered three options in relation to a taxable disposal of land, where the land had been used wholly for private purposes (for example, a holiday home subject to the bright-line test):

1. Apportion the holding costs between the taxable gain and private use of the land.
2. Allow deductions for all holding costs, despite private use.
3. Deny deductions for all holding costs for periods of private use.

While Inland Revenue conceded that apportionment would provide the most accuracy, they concluded that due to complexity, the preferred option was to deny deductions for holding costs for periods of private use.

Inland Revenue's view on this issue remains unchanged from the initial 2019 consultation document. The draft interpretation statement reaffirms that land held on capital account will not give rise to deductible holding costs, even if the disposal is taxable. It was emphasised that there must be a sufficient nexus between the expenditure and the derivation of income from the taxpayer's income-earning process, and that taxpayers must look at what the land was used for in the period that the expenditure is incurred. Consequently, holding costs will only be treated as deductible to the extent that there is income-earning use of the land. It is further noted that income-earning use can comprise holding the land for the purpose of resale or deriving rental income, but specifically excludes holding the land on capital account, even if it is taxable under the bright-line provisions.

The statement also clarifies that if there is both private use and income-earning use of the land, then holding costs will need to be apportioned. In the first instance, attention should be given to whether the mixed-use asset regime applies, in which case specific rules must be followed. Otherwise, general principles should apply, such as a time-based or space-based apportionment. To complicate things further, the interest limitation rules and the residential ring-fencing rules may also need to be considered.

Given the increasing scrutiny and tightening of legislation on residential property in recent years, Inland Revenue's stance is somewhat unsurprising. However, for those who feel strongly on this topic, consultations are open until 31 May 2023.

## Environmental correctness

The call for action regarding climate change and mitigating man's negative impact on the planet is not new. However, there has been a shift in the last few years. It has moved from being a focus of 'greenies' and the 'young' to being accepted by the mainstream population as something that can no longer be ignored. It has evolved into a broader attitude encompassing Environmental, Social and Governance (ESG) issues. With it has come an expectation and pressure from all stakeholders - customers/clients, shareholders and employees alike – for businesses to prove they are taking ESG seriously and what actions they are taking.

It's no secret that businesses have a large impact on the world's environmental state. Reports have found that 100 companies are responsible for 71% of the world's greenhouse gas emissions. To reduce this negative perception, global companies are betting big with sustainability investments. For example, international oil company BP have reformed their business by forming an 'integrated energy company' with a goal to reach net zero carbon emissions by 2050. They have created actional steps including developing offshore wind projects with capacity to power 5 million homes.

Realistic sustainable processes will vary depending on the nature and size of a business' operations. Focus could start on the four low-hanging fruit of a company's operation - energy, water, material, and waste. Implementing change to reduce these elements not only addresses ESG expectations but can lower operational costs, as well as yield potential increases in revenue. For example, remote working has grown in popularity since COVID-19, and it has become an employee's expectation that an employer will provide some form of flexible working. This offering is great for the environment, as fewer cars on the road equates to less carbon dioxide being emitted into the air. For paper items commonly used in the business place, look for materials made from post and pre consumer waste such as recycled products, which maintain a circular economy. There will be a portion of a business' carbon footprint that cannot be reduced through sustainable practices. For this portion, purchasing carbon offsets from carbon marketplaces can shift the needle to becoming carbon neutral.

Consumers are voting green with their wallets as they become educated about sustainability and ethical employment practices, causing buyers to reassess their purchasing habits. "Fast fashion" has become a well-known term – those who are lucky enough to afford it are doing their research about suppliers, to enable informed decisions when it comes to buying items such as clothes and shoes. People have become more willing to spend a bit extra for the peace of mind that they are not supporting unethical employment practices. In the same vein, existing and potential shareholders are increasingly scrutinizing a business' non-financial results when making investment decisions.

While sustainability initiatives may not always deliver immediate benefits to the bottom line, a business that promotes environmental practices on the forefront of its business model may attract or retain clients and customers; while also connecting with its employees who value environmental sustainability at a personal level.

## Trusts and distributions

Using a trust to manage and protect a family's business and personal assets is common practice in New Zealand. However, the tax rules applicable to trusts also differ to that applicable to individuals and companies. With the top personal tax rate increasing to 39% from 1 April 2021 while the trust tax rate has remained at 33%, the differential provides a benefit in retaining income in a Trust to be taxed at 33%.

However, the nature of the trust's activity, the assets held, the beneficiaries involved, and the costs incurred by the trust on behalf of its beneficiaries still need to be carefully managed. A common scenario is a trust being the sole shareholder of a company. A beneficiary of the Trust operates the company and pays themselves a salary. If the salary is intentionally set lower than market rates, with the remaining income of the company distributed to the trust in the form of a dividend, it could be deemed that a taxpayer has fixed the salary in an artificial manner to obtain a tax advantage and thereby is party to a tax avoidance arrangement.

Where taxable income derived by a trust is subsequently used to fund the lifestyle of beneficiaries there is a risk that IRD could take the view that the funds paid to the beneficiaries should be treated as taxable beneficiary distributions. When

the top personal marginal tax rate and the trust rate was the same at 33%, there was no difference from a tax perspective and transactions were not subject to a high degree of review or scrutiny. Through this time, both trustees and their advisors may have taken a relaxed approach to how transactions were accounted for and documented. With income tax returns for the 31 March 2022 year now filed (by 31 March 2023), scrutiny by Inland Revenue is expected to increase, particularly if a beneficiary is subject to the top 39% tax rate.

If beneficiaries are reliant on dividend income that is derived by the trust, could Inland Revenue assert payment of the 'dividends' to the beneficiaries comprises taxable beneficiary income irrespective of the legal form of the payment. For example, if a trust owes a beneficiary $1m and a trust derives a dividend of $72,150 into its bank account and the same day that exact amount is paid to the lender – is it a loan repayment or the distribution of the dividend? If trustee resolutions reflect it is a loan repayment, will that suffice in the event of a review by Inland Revenue. What if there are no resolutions, what then? What if there is no loan to repay?

Issues like this have not been the subject of material scrutiny in recent years because the tax rates were aligned at 33%. But with the rates no longer aligned, care and due consideration must be applied to ensure tax outcomes are as expected and not open to challenge.

# Snippets

## Global tax rates

Inland Revenue made the headlines end of April 2023 with the release of its report on the amount of tax paid by our high-wealth individuals (HWIs). The findings were that HWIs' overall effective tax rate when taking into account all sources of income, including unrealised capital gains, is 8.9%. The Treasury simultaneously released a number of reports which investigated the progressivity of New Zealand's tax system. The Treasury found, using information from the Household Economic Survey, that an average middle-income New Zealander has an effective tax rate of more than double the HWI rate, at 20.2%.

When comparing these numbers at face value, it is no wonder the difference caused a reaction. However, without a comprehensive capital gains tax regime to tax the gains on sale of land and shares, the rate of 8.9% is not particularly surprising.

How do our tax rates compare to the rest of the world? Unfortunately, no other country has recently undertaken a similar exercise on the effective tax rate of HWIs, but it is possible to compare our other tax rates against the world's heavy hitters:

- Ivory Coast's highest personal income tax rate (i.e. tax on an individual's salary and wages) is an eye watering 60%. New Zealand's top personal marginal tax rate increased from 33% to 39% from 1 April 2021.
- The highest corporate tax rate goes to Puerto Rico, at 37.5% - higher than New Zealand's corporate tax rate of 28%.
- The highest sales tax is in Bhutan, at 50%. Our equivalent tax, GST, pales in comparison at 15%.
- Denmark has the highest capital gains tax at a rate of 42%. At this point in time, New Zealand does not have a broad-based capital gains tax.

## Proposed amendment to directors' duty

One of the fundamental director's duties within the NZ Companies Act 1993 ('the Act') is to act in good faith and in what the director believes to be the best interest of the company. This has traditionally been interpreted to mean decisions should be aimed at maximising shareholder returns. In September 2021, an amendment was proposed to make it clear that directors of companies can consider a wide variety of factors, such as:

- recognising the principles of the Treaty of Waitangi (Te Tiriti o Waitangi),
- reducing adverse environmental impacts,
- upholding high standards of ethical behaviour,
- following fair and equitable employment practices, and
- recognising the interests of the wider community.

On 8 May 2023 the Select Committee recommended that the list above is not enacted, but instead replaced with the following:

"To avoid doubt, in considering the best interest of a company or a holding company for the purpose of this section, a director may consider matters other than the maximisation of profit"

This addresses submitters' concerns that the original drafting of the bill may create inconsistencies within the Act, as well as confuse directors about their responsibilities. Further, some submitters felt that the law already allows a director to consider non-financial factors when deciding the best interest of a company.

We will wait to see what is ultimately enacted.

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